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Commissioner	:	Michael Peevey
Admin. Law Judge	:	Linda Rochester
DRA Witnesses	:	Robert Welchlin Chadwick Epps

Overland Consulting

Regulatory Audit of California American Water Company's General Office Expense

Base Period 2010, Test Year 2012, Escalation Year 2013

Application No. 10-07-007

Prepared for the

California Public Utilities Commission
Division Of Ratepayer Advocates

by

Overland Consulting
11551 Ash Street, Suite 215
Leawood, KS 66211
913-599-3323

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BEFORE THE PUBLIC UTILITIES COMMISSION
OF THE STATE OF CALIFORNIA

Application of California-American Water Company (U210W) for Authorization to Increase its Revenues for its General Office

QUALIFICATIONS OF ROBERT F. WELCHLIN

Q. Please state your name, your business address, and your position with Overland Consulting ("Overland").

A. My name is Robert F. Welchlin. My business address is 11551 Ash Street, Suite 215, Leawood, KS. I am a Senior Manager in Overland Consulting. A current resume is provided with this testimony as Attachment A.

Q. What was the scope of your review in these proceedings?

A. The scope of my responsibility included a regulatory audit of the service companies and allocations that contribute to CalAm's General Office revenue requirement, including the historical years 2009 and 2010, the budget year 2010 and the forecasted test year, 2012.

Q. What is the purpose of your testimony?

A. I am responsible for the analysis, recommendations and findings of Chapters 3 - 4 and 6 – 8. I am also responsible for the section in Chapter 5, Employee Compensation Benchmarking. Finally, I am responsible for Adjustments #8 - #16 in Chapter 2.

Q. Does this conclude your testimony?

A. Yes.

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

Application of California-American Water Company (U210W) for Authorization to Increase its Revenues for its General Office

QUALIFICATIONS OF CHADWICK B. EPPS

Q. Please state your name, your business address, and your position with Overland Consulting ("Overland").

A. My name is Chadwick B. Epps. My business address is 11551 Ash St., Suite 215, Leawood, Kansas. I am a Consultant in Overland Consulting. A current resume is provided with this testimony as Attachment A.

Q. What was the scope of your review in these proceedings?

A. The scope of my responsibility included a regulatory audit of the service company and allocations that contribute to CalAm's General Office revenue requirement, including the historical years 2009 and 2010, the budget year 2010, and the forecasted test year, 2012. ~~Please see the qualifications of Howard E. Lubow for a complete project scope description~~.

Q. What is the purpose of your testimony?

A. I am responsible for the calculations of Overland's recommendation for CalAm's revenue requirement and the CalAm's rate base. I am also responsible for Chapter 5, except for the section on Employee Compensation Benchmarking. Finally, I am responsible for Adjustments #1 - #7 in the Attachment 2-1.

Q. Does this conclude your testimony?

A. Yes.

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1. Executive Summary

This report contains the findings of a regulatory audit by Overland Consulting (Overland) of California American Water Company's (CalAm's) General Office revenue requirement for base year 2010 and forecasted years 2011-2013. CalAm is a subsidiary of American Water Works Company (AW). CalAm's General Office revenue requirement includes:

1. The California share of costs allocated by American Water Service Company (AWSC),
2. Expenses incurred by the California Corporate segment of CalAm,
3. Certain expenses traditionally attributed to CalAm's district operations (group insurance, pensions, other post-retirement benefits, other insurance and rate case expense), consolidated into the General Office category for this rate case.
4. A revenue requirement request for General Office rate base, which consists primarily of forecasted investment in software associated with a planned systems replacement (Business Transformation) project.

In addition to this Executive Summary, this report contains the following additional chapters:

2. Summary of Recommended Adjustments to CalAm's General Office O&M Expense and Rate Base - This chapter summarizes Overland's adjustments to ~~California American Water Company's (~~CalAm's~~)~~ General Office operating expenses and rate base.

3. Review of American Water Service Company - This chapter contains a functional (departmental) analysis of ~~American Water Service Company (~~AWSC~~)~~.

4. Business Transformation – This chapter covers our review of forecasted capital additions to CalAm's rate base and depreciation expense for AW's Business Transformation (major software systems replacement) project.

5. Salaries, Wages and Incentive Compensation - This chapter covers our review of General Office salary and wage (labor) expense and incentive compensation.

6. Pensions, Savings and Post-Retirement Welfare Benefits - This chapter covers our review of CalAm's directly incurred and allocated pension, post-retirement benefits other than pensions (PBOP) and employee savings plan expenses.

7. Group Insurance Expense - This chapter discusses group insurance expense, which includes employee medical, dental, vision, life and other employee-related insurance~~ expenses~~.

8. Regulatory (Rate Case) Expense - This chapter covers CalAm's requested rate case expense, which includes requests for rate case-related outside legal and

consulting~~ expenses~~, customer notice, filing print and mail and other costs CalAm attributes to its rate case.

Summary of Recommended Adjustments to CalAm's General Office Revenue Requirement

Following is a summary of our recommended adjustments to General Office expenses and rate base as requested by CalAm. Chapter 2 contains a more detailed discussion and quantification of these adjustments.

1. Adjust AWSC's Base Period Labor and Labor-Related Expenses to Reflect Actual Employees as of December 31, 2010 – Overland recommends limiting recovery of General Office labor and related expense to compensation for employees actually on service company payrolls as of December 31, 2010. This adjustment reduces CalAm-requested expense by $1,223,635 in base year 2010 and $1,300,929 in test year 2012 (Chapter 2, page 4).

2. Reduce Incentive Compensation to Amounts Aligned with Customer Benefits – Overland recommends adjusting incentive compensation consistent with DRA's recommendation that customer funding should be limited to the portion of the incentive plan payments that are aligned with operational objectives that provide customer benefits. Our adjustment reduces CalAm-requested expense by $753,984~~29,448~~ in base year 2010 and $801,205~~775,150~~ in test year 2012 (Chapter 2, page 6).

3. Remove Business Development Expense – Consistent with the Commission's decision in the prior rate case, Overland recommends removing expenses allocated from AWSC's Business Development function. This reduces CalAm-requested expense by $130,431 in base year 2010 and $138,670 in test year 2012~~-~~ (Chapter 2, page 8).

4. Remove AWSC Corporate Contributions Expense – Consistent with the Commission's decision in the prior rate case, Overland recommends removing charitable contribution and activities expense allocated to CalAm from AWSC. This reduces CalAm-requested expense by $59,246 in base year 2010 and $62,988 in test year 2012 (Chapter 2, page 8).

5. Remove Legislative and Political Influence Expense – Consistent with the Commission's decision in the prior rate case, we recommend removing expenses incurred by AWSC's Government Affairs function. This reduces CalAm-requested expense by $11,917 in base year 2010 and $12,670 in test year 2012 (Chapter 2, page 10).

6. Remove Unsupported 2009 "Admin" Expense added by CalAm to the 2010 Base Period Revenue Requirement – We recommend unsupported AWSC "Admin" expenses incurred 2009 be excluded from the revenue requirement funded by California customers. We recommended, and the Commission adopted, adjustments to remove similar "non-departmental" expenses in the prior rate case. This adjustment reduces CalAm-requested expense by $79,596 in base year 2010 and $84,624 in test year 2012 (Chapter 2, page 11).

7. Remove NSC Sales and Marketing Expenses – Consistent with the Commission's decision in the prior rate case, Overland recommends removing marketing and sales expense incurred by AWSC and allocated to CalAm. This reduces CalAm-requested expense by $76,405 in base year 2010 and $81,232 in test year 2012 (Chapter 2, page 13).

8. Reduce Requested Base Period Pension Expense to Actual 2010 GAAP Expense. Reduce Forecast Period Pension Expense to the Amounts Forecasted By AW's Actuary~~,~~ [redacted] [redacted] - We recommend base period pension expense equal to what was expensed~~incurred (recorded)~~ in 2010, and GAAP pension expense as forecasted by AW's [redacted] [redacted] for the years 2011-2013. This reduces CalAm-requested pension expense by $1,129,910 in base year 2010 and $3,063,295 in test year 2012 (Chapter 2, page 14).

9. Reduce Requested Base Period Post-Retirement Benefits Other Than Pensions (PBOPs) to Actual 2010 GAAP Expense. Reduce Forecast Period PBOP Expense to the Amounts Forecasted By AW's Actuary~~,~~ [redacted] [redacted] - We recommend base period PBOP expense equal to what was incurred (recorded) in 2010, and GAAP expense as forecasted by AW's [redacted] [redacted] for the years 2011-2013. This reduces CalAm-requested PBOP expense by $453,899~~458,192~~ in base year 2010 and $452,943~~615,985~~ in test year 2012 (Chapter 2, page 15).

10. Reduce Base Period Employee Savings Plan Expenses (401k and Defined Contribution Plan - DCP) to Amounts Actually Incurred in 2010. Reduce 2011-2013 Expense to the Base Period Amount Plus Labor Expense Escalation - We recommend base period 401k and DCP expense equal to the amount actually incurred by AWSC and CalCorp in 2010. For the forecast years 2011 through 2013 we recommend increasing base period amounts using appropriate labor expense escalation factors. This reduces CalAm-requested expense by $37,631 in base year 2010 and $43,489 in test year 2012 (Chapter 2, page 16).

11. Reduce Base Period Group Insurance Expense to Expense Actually Incurred in 2010. Reduce 2011-2013 Expense to Base Period Plus Labor Escalation – Overland recommends base period expense equal to what was incurred in 2010 and expense for forecast years 2011 through 2013 equal to the base period

escalated using the appropriate Commission-sanctioned escalation factors. This reduces CalAm-requested expense by $166,575 in base year 2010 and $1,317,388 in test year 2012 (Chapter 2, page 19).

12. Reduce Base Period Employee Expense for AWSC to the Amount Actually Incurred in 2010 - We recommend base period AWSC employee expenses funded by California customers be calculated using actual 2010 expense and escalated for the forecasted years 2011-2013 using the appropriate inflation factors. This adjustment reduces CalAm-requested expense by $100,450 in base year 2010 and $106,795 in test year 2012 (Chapter 2, page 20).

13. Reduce 2010 Liability, Property and Workers Comp. Insurance Expenses to Amounts Actually Incurred. Reduce 2011 Amounts to Five-Year Average of Years 2006-2010. Reduce Test Year 2012 and 2013 Amounts to 2011 Plus Escalation. - We recommend base period insurance expense equal to actual 2010 insurance expense. We recommend 2011 insurance expense based on the average of the years 2006-2010, adjusted for inflation. This reduces CalAm-requested insurance expense by $665,765 in base year 2010 and $754,933 in test year 2012 (Chapter 2, page 22).

14. Reduce Requested Regulatory (Rate Case) Expense - We recommend basing test period regulatory expense on currently authorized regulatory expense, reduced by an amount to recognize the savings in outside legal expenses attributable to the newly-hired legal staff. This reduces CalAm-requested rate case expense by $583,699 in base year 2010 and $1,950,205 in test year 2012 (Chapter 2, page 25).

15. Remove Business Transformation Depreciation Expense - Overland recommends removing BT depreciation expense from the revenue requirement, consistent with the recommended elimination of forecasted BT from CalAm's test year rate base. This reduces CalAm-requested rate base by $0 in base year 2010 and $513,988 in test year 2012 (Chapter 2, page 26).

16. Remove Depreciation for Software Written Off in 2010 and the Unexplained Portion of AWSC's 2010 ITS Depreciation Increase – Overland recommends an adjustment to ITS Depreciation to remove the depreciation from the Sharepoint system software written off in 2010 and $1.2 million in unexplained differences between the 2009 and 2010 ITS depreciation. This reduces CalAm-requested expense by $77,019 in base year 2010 and $81,884 in test year 2012 (Chapter 2, page 26).

Recommended Adjustments to CalAm's Requested Rate Base

1. Adjustment number 15 ~~also~~ reduces CalAm's requested General Office rate base investment (construction work in progress, plant, and depreciation reserve) to reflect the removal of BT investment. This reduces CalAm's rate base by $3,047,945 in base year 2010 and $10,041,246 in test year 2012 (Chapter 2, pages 25-26).

Summary of Other Recommendations

1. Overland recommends that the Commission consider that the ability to "bank" and later collect all incurred BT costs from customers through a balancing account is likely to create a disincentive for AW and CalAm to control the costs of implementing BT (Chapter 4, page 4).

2. Should the Commission approve CalAm's request to include pre-implementation BT expense in rate base, Overland recommends that the Commission consider imputing a 5 to 10 percent allocation of BT expenditures to the non-regulated business segment (Chapter 4, page 4).

3. Should the Commission approve rate recovery of forecasted BT expenditures (i.e. choose not to adopt DRA's recommendation), we recommend adjusting the CWIP, plant, reserve and depreciation expense amounts requested by CalAm to reflect the 10 month schedule delay that occurred in 2010 (Chapter 4, page 4).

4. Overland recommends that the Commission require AW to demonstrate the market competitiveness of its salary, total cash and total overall employee compensation prior to or in conjunction with the filing of its next California rate increase request (Chapter 5, page 5).

5. Overland recommends that the Commission consider whether customer funding of seven new positions for CalCorp is justified in light of the significant increase in CalCorp staffing that has already occurred (Chapter 5, page 6). We have not made an adjustment to remove the labor and related expenses associated with these positions.

6. Before granting a memorandum account associated with the cost of new health care legislation, Overland recommends that the Commission consider the following:

- A process by which a company is permitted to "bank" and recover costs from others (customers) in future periods diminishes the incentive the company might otherwise have to control and minimize such costs,

- Extracting the components of medical cost attributable to a new piece of legislation, as CalAm proposes to do, is likely to be difficult, if not patently subjective; and,

- As an alternative to requiring CalAm's customers to pay additional health care costs stored up in a memorandum account, the Commission could require that AW absorb the costs associated with the new health care legislation. AW could then choose to have shareholders, employees or both, absorb the costs.

Comparison of Authorized, Requested and Recommended General Office Amounts

Following is a comparison of authorized, requested and recommended General Office O&M expense for base period 2010.

Table 1-1

Application of California American Water (U210W) for Rate Increase
Summary of Commission-Authorized, CalAm Requested and Overland-Recommended General Office O&M Expense

	Commission Authorized (Per CalAm)			Base Period 2010, CalAm Requested		Base Period 2010, Overland Recommended	
		Inflated to 2010 at 3%					
Category	2009 Test Year	Total	Per Customer	Total	Per Customer	Total	Per Customer
Admin	-	-	-	79,596	0.46	410	0.00
Audit	88,024	90,665	0.53	92,540	0.54	59,128	0.34
Business Development	872	898	0.01	130,431	0.76	(17,124)	(0.10)
Bus. Transf. (Mgt Fee Only)	-	-	-	-	-	-	-
External Affairs/ Comm.	563,049	579,940	3.37	713,679	4.15	414,271	2.41
Finance	1,153,491	1,188,096	6.91	968,626	5.63	632,448	3.68
Human Resources	464,305	478,234	2.78	624,138	3.63	560,481	3.26
Investor Relations	32,235	33,202	0.19	33,466	0.19	24,070	0.14
Legal	754,493	777,128	4.52	660,876	3.84	246,814	1.44
Operation Services	679,719	700,111	4.07	577,470	3.36	409,552	2.38
Property	503,240	518,337	3.02	571,631	3.33	587,156	3.42
Regulated Operations	453,202	466,798	2.72	808,641	4.70	473,911	2.76
Regulatory Services	50,736	52,258	0.30	34,539	0.20	28,288	0.16
Laboratory	277,876	286,212	1.66	286,588	1.67	263,767	1.53
Benefit Svc Ctr	128,532	132,388	0.77	80,254	0.47	73,206	0.43
CSC	2,482,267	2,556,735	14.87	2,544,316	14.80	2,334,265	13.58
ITS	1,724,226	1,775,953	10.33	2,663,411	15.49	2,335,951	13.59
SSC	1,046,173	1,077,558	6.27	1,095,053	6.37	934,995	5.44
Procurement	150,947	155,475	0.90	153,872	0.90	156,126	0.91
Total AW Service Company	$10,553,387	$10,869,989	$63.23	$12,119,127	$70.50	$9,517,714	$55.36
CalCorp Traditionally District	8,727,200	8,989,016	52.29	10,127,571	58.91	7,422,125	43.17
CalCorp Traditionally CalCorp	3,418,100	3,520,643	20.48	9,265,991	53.90	8,727,241	50.77
Total General Office O&M	$22,698,687	$23,379,648	$136.00	$31,512,689	$183.31	$25,667,080	$149.30
Customers (Per CalAm)	171,602	171,913		171,913		171,913	

Sources: AWSC Authorized - CalAm Direct Testimony of Stephenson, Att. 10; AWSC Requested - CalAm Revenue Requirement Workbook. CalCorp (Authorized and Requested) - Exh.A CC Ch 2, Tbl 1and Exh.A CC Ch 3, Tbl 1
Commission-Authorized amounts for AWSC are before amounts transferred to CalCorp (to avoid double-counting).

Compared with amounts previously authorized for test year 2009, inflated to 2010, CalAm is requesting a per-customer increase in General Office O&M expense of 34 percent, from $136.00 to $183.31~~181.42~~. Overland's recommended O&M expense increase per-customer is 9.7 percent, to $149.30 per customer.

CalAm also requested a large increase in CalCorp's rate base to include forecasted contruction work in progress and plant associated with Business Transformation software. The impact of this adjustment on rate base is summarized below.

Table 1-2

Application of California American Water (U210W) for Rate Increase Summary of Commission-Authorized, CalAm Requested and Overland-Recommended General Office Rate Base								
	Commission Authorized (Per CalAm)		CalAm Requested			Overland Recommended		
Category	2009 Test Year	Inflated to 2010	2010	2012	2013	2010	2012	2013
Net Rate Base	$1,269,600	$1,307,688	$5,309,052	$11,860,706	$13,428,912	$2,261,108	$1,942,698	$1,766,710
Sources: Commission Authorized and CalAm Requested: CalAm Exh.A-CC, Ch.2 Table2								

Basis for CalAm's Requested General Office Revenue Requirement

In broad terms, the following changes explain much of the requested increase in General Office expenses:

- Increase In CalCorp Labor and Related Expense – CalAm's requested labor expense for CalCorp (after capital credits) increases 47 percent ~~from~~, from $3.06 million in 2009, to $4.51 million in the base period.[1] Most of the increase is explained by six employees transferred from CalCorp and seven new positions that CalAm has added or forecasts that it will add since the last rate case. Since the last rate case, AW transferred six employees from the service company to CalCorp. CalCorp also added four positions in 2009 and 2010, and has requested recovery of costs for an additional three positions in 2011 and 2012. None of the seven new positions are included in currently authorized CalCorp revenue requirements.

  Requested labor and labor-related expense for employees transferred from AWSC to CalCorp since the prior rate case is approximately $922,000 in base year 2010 and $1,019,000 in test year 2012, net of capital credits.[2] Of this, the

[1] CalAm CalCorp work paper 103-791 AG Labor

[2] 2010 labor and related expenses for five of six positions identified by CalAm witness Dana (CalAm Direct Testimony of Jeffery Dana, p.6) totals $794,000 for 2010. We were unable to identify the sixth position (ITS Client Relations) on CalAm's labor expense spreadsheet; however, assuming it is approximately $90,000 in 2010, total labor and related expenses for the six positions, net of capital credits, is $922,000 for 2010. ~~Chapter 5, Table 5-5 shows the calculation of these amounts~~.

amount that would have been allocated to other states if the employees had remained in AWSC is approximately $131,000 in~~for~~ 2012.[3]

Additional O&M labor and related expense, net of capital, for seven new (yet to be authorized) CalCorp positions added between 2009 and 2012 is $285,000 in base period 2010 and $585,000 in test year 2012.[4] There are also incremental office and employee training and travel expenses associated with these positions that we did not quantify. ~~Adding these expenses, it is reasonable to estimate the total operating expense impact of new CalCorp positions exceeds $1 million in test year 2012, before taking into account capital credits~~.

Overland's recommended CalCorp labor and related expenses is based on positions actually filled and on the payroll as of the end of 2010 plus the positions requested for 2011 and 2012. We did not develop adjustments to remove the expense associated with new positions (positions not previously authorized); however, we recommend the Commission consider whether customers should fund the expense associated with the new positions in light of the significant growth in CalCorp labor over the past few years.

- Increase in AWSC Management Fees – CalAm's requested AWSC management fee is $~~11.79~~12.12 million, an increase of ~~19.8~~ 23.2 percent over the previous service company authorization after removing the expenses of six employees transferred to CalCorp ($10.55 million - $0.71 million).[5] CalAm requested a 23~~20~~ percent increase despite the fact that AWSC's labor force~~staffing levels~~, the primary driver of its costs, has~~have~~ been decreasing for the past two years. CalAm's request includes a substantial amount of pro-forma labor and related expense associated with vacant positions. CalAm also requests a significant increase in the management fee for~~associated with~~ AWSC's Information Technology Services (ITS) function. Much of this relates to an increase in ITS depreciation expense for new telephone equipment, laptop computers and systems software, most of which is being depreciated over a five-year period. CalAm continues in this rate case to request customer funding for AWSC expenses that the Commission disallowed in the most recent prior rate case, including the labor and related expenses for vacant positions, unsupported "admin" expense, and~~ minor~~ amounts for previously disallowed legislative advocacy, business development, company charitable activities and corporate

[3] According to CalAm Direct Testimony of Dana, p.6, the amounts allocable to other states, prior to the transfers, include: 20 percent of a Finance Director, 20 percent of a Principal Analyst Rates and 30 percent of a Financial Analyst II~~-~~.

[4] Based on an analysis of CalCorp employees in CalAm workpaper "Corp Labor.xls." Chapter 5, Table 5-6 contains a breakout of the labor and related expense items requested by CalAm for these positions.

[5] CalAm Direct Testimony of David Stephenson, Attachment 10, shows authorized expenses before and after the removal amounts associated with the CalCorp transfers.

sales and marketing expenses. AWSC's labor expense is discussed in Chapters 3 and 5. ~~CalCorp labor expense is discussed in Chapter 5.~~

- Other Significant Expense Increase Requests – CalAm requests significant percentage increases in several General Office categories that include expenses not just for AWSC and CalCorp, but for CalAm's districts as well.[6] ~~cross the boundaries between AWSC management fees, CalCorp expenses and district expense.~~ These include:

1. Employee Group Insurance (Medical, Dental, Life and Related Insurance) Expense – As discussed in Chapter 7, CalAm's requested test year 2012 group insurance expense is 53 percent higher than expense actually incurred in 2010. Requested 2013 expense is 67 percent higher than 2010 expense. Much of the increase is forecasted for 2011. CalAm's requested 2011 group insurance expense is a 30 percent increase over its base period 2010 request, split approximately equally between requested medical cost inflation and an amount requested to replenish what CalAm describes as a deficiency in AW's medical trust account that developed over the past three years. Overland recommends base period 2010 group insurance based on insurance expense actually incurred in 2010. We recommend group insurance in the period 2011-2013 based on 2010 insurance expense escalated with appropriate Commission-approved inflation factors.

2. Pension and Post-Retirement Benefits Other Than Pensions (PBOP) Expense - Pension and PBOP expense is discussed in Chapter 6. AW's defined benefit pension and retiree welfare plans have been closed to new employees for several years.[7] CalAm's requested test year 2012 pension expense is 95 percent higher than actual amount expensed ~~incurred~~ in 2010. Requested PBOP expense is 55 percent higher than actual amount expensed ~~incurred~~ in 2010. AW's actuary, [redacted] forecasts that AW's pension and PBOP expenses (calculated based on GAAP) will decline between 2010 and 2013, the opposite of what CalAm is requesting. It is interesting to note that CalAm is requesting only ~~escalation~~inflation~~-based~~ increases in the pension expense included in AWSC management fees, far lower than the increases requested for CalCorp and the districts, even though all eligible~~participating~~ AW employees, whether in AWSC, CalCorp or the CalAm districts, are participants in the same pension and retire welfare plans.

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[6] CalAm refers to these expenses, to the extent incurred directly in California, as belonging to the category "CalCorp Traditionally District." They include group insurance, pensions, other post-retirement benefits, other types of insurance (liability, property and workers comp), postage costs and rate case (regulatory) expenses. Whether attributable to the districts or directly to CalCorp, these expenses are included in CalCorp General Office expense revenue requirement, whereas in past cases, the portions attributable to the districts were in the district revenue requirements. California-incurred expenses in these categories are summarized in CalAm rate filing Exh. A-CC, Ch. 3, Table 1.

[7] The pension plan was closed to all employees hired after 2005. The retiree welfare plan was closed to non-union employees hired after 2002 and union employees hired after 2005.

Overland recommends test year 2012 pension and PBOP expense based on 2012 forecasts by AW's actuary~~,~~ [redacted] [redacted]

3. Liability, Property and Workers Compensation Insurance – Base period non-labor expenses incurred in California should, in general, be based on a five-year average of actual expenses, adjusted for inflation to reflect constant base period dollars. CalAm's requested base period 2010 insurance expense is 44 percent higher than insurance expense incurred in 2010 and 31 percent higher than the inflation-adjusted average of expense for the prior five years. Requested test year 2012 insurance expense is 51 percent higher than the five-year expense average and 67 percent higher than 2010 actual expense. As discussed in Chapter 2, Adjustment 13, CalAm states that requested insurance expense is ~~are~~ based on what CalAm describes as insurance brokers' "best estimates" for the years 2010 through 2013, estimates that were apparently inaccurate by 44 percent in the year in which they were made. Overland recommends base period 2010 insurance expense based on actual 2010 insurance expense. For the years 2011-2013 we recommend insurance expense based on the five-year average expense incurred in the period 2006-2010, adjusted for inflation.

4. Regulatory (Rate Case) Expense – Rate ~~C~~case expense is intended to recover ~~include the~~ costs of conducting a rate case that are incremental to expenses incurred for in-house staff. According to Commission policy, such expenses are to be forecasted and amortized over the rate-effective period, which is~~has been~~ three years for CalAm. According to CalAm's calculations, currently authorized rate case expense (for the districts and CalCorp combined) is $1.24 million annually.[8] CalAm's requested test year rate case expense, at $2.79 million, is more than double the currently authorized level. Despite a regulatory staff of 11 employees, consisting of accountants, attorneys and other technical specialists, for which CalAm is separately requesting ~~more than~~ $1.89~~1.2~~ million annually in labor and related expenses, CalAm's requested rate case expense includes ~~more than~~ $8.4 million for outside attorneys, consultants, printing, customer notice and other expenses. CalAm's request covers its estimated expenses for two separate rate case periods; however, CalAm requests that the expenses be amortized over one three-year rate case cycle. We recommend ~~the Commission base~~ test year rate case expense based on currently authorized expense, adjusted to recognize the transfer of legal responsibilities from outside attorneys to in-house staff.

- Business Transformation - CalAm's proposed General Office revenue requirement includes a request to add a large projected expenditure for Business

[8] CalAm Rate Filing Ex. A-CC, Ch. 3, Table 1

Transformation (BT) software to rate base, and a request for associated depreciation expense. In light of CalAm's inability to demonstrate how customers will benefit from this additional cost, DRA recommended against including forecasted BT expenditures in the revenue requirement; therefore, we have calculated an adjustment to remove it. Overland estimates that the revenue requirement impact of CalAm's request is $343,000 in base period 2010, and $1.83 million in test period 2012, based on CalAm's requested BT investment, 10-year depreciation and pre-tax rate of return. The California revenue requirement impact of BT continues to grow until at least 2014, when it reaches approximately $2.6 million. Should the Commission grant CalAm's request for customer funding, the revenue requirement impact could ultimately be much higher if the project exceeds the currently budgeted amount upon which CalAm's request is based.

Discovery and Timeline Issues

Our recommendations reflect the information we were able to obtain from CalAm and the time available for analysis. We had difficulty obtaining certain key information from CalAm and the company declined to provide certain information. A considerable amount of time was engaged in negotiations and discussions with CalAm to justify the need for information and accounting data fundamental to the performance of the audit. Among the information that we did not obtain when requested, that had an impact on our ability to perform the audit, were CalCorp and AWSC operating results for the complete year 2010 and the 2011 CalCorp and AWSC budgets.

CalAm declined to provide information that showed actual expense for CalCorp and AWSC for the complete year 2010 until late in the project. This limited our ability to do discovery based on review of 2010 operating~~these~~ results. In addition, ~~A~~although many of CalAm's requested increases could have been tested by comparison with 2011 budget information that was approved and available last November~~year~~, CalAm declined to provide the 2011 budget. The budget, had it been provided, would have provided a baseline for assessing ~~testing the reasonableness of~~ CalAm's requests for large increases in certain costs in the 2011-2013 forecast period.

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2. SUMMARY OF RECOMMENDED ADJUSTMENTS TO CALAM'S GENERAL OFFICE O&M EXPENSE AND RATE BASE

This chapter summarizes Overland's adjustments to California American Water Company's (CalAm's) General Office operating expenses and rate base. Our recommended adjustments affect the following:

1. General Office O&M expense incurred by ~~American Water Service Company~~ ~~(~~AWSC~~)~~ and related allocations to CalAm,
2. California Corporation (CalCorp) General Office O&M expense traditionally classified as CalCorp expense,
3. California Corporation (CalCorp) General Office O&M expense traditionally classified as CalAm District expense (district group insurance, pension, post-retirement expenses other than pensions, district general insurance and district rate case expense), and,
4. CalCorp rate base and related depreciation expense

The following tables summarize our adjustments to O&M expense and rate base:

Table 2-1

Application of California American Water for Rate Increase (U210W)
Summary of Overland-Recommended Adjustments to CalAm-Requested General Office O&M Expense

General Office O&M Expense	2010	2011	2012	2013
As Requested By CalAm:				
AWSC Distributed to CalAm	$ 12,119,127	$ 12,717,929	$ 13,170,362	$ 13,631,789
CalCorp (Traditionally District)	10,127,571	11,942,241	14,282,672	13,456,589
CalCorp (Traditionally CalCorp)	9,265,991	9,757,999	10,395,425	10,766,280
Cal-Am Requested General Office O&M Exp.	$ 31,512,689	$ 34,418,169	$ 37,848,460	$ 37,854,658
Recommended Adjustments:				
Adj. #1: Labor and Labor-Related Expense	(1,223,635)	(1,261,568)	(1,300,929)	(1,340,477)
Adj. #2: Incentive Compensation (AIP)	(753,984)	(778,648)	(801,205)	(826,110)
Adj. #3: Business Development	(130,431)	(134,474)	(138,670)	(142,886)
Adj. #4: Contributions /Corp Social Resp.	(59,246)	(61,083)	(62,988)	(64,903)
Adj. #5: Legislative Influence Expense	(11,917)	(12,287)	(12,670)	(13,055)
Adj. #6: Non-Dept. (Admin) Expense	(79,596)	(82,063)	(84,624)	(87,196)
Adj. #7: Corp. Marketing & Sales Exp.	(76,405)	(78,774)	(81,232)	(83,701)
Adj. #8: Pension Expense	(1,129,910)	(2,433,220)	(3,063,295)	(2,326,785)
Adj. #9: PBOPs Expense	(453,899)	(453,115)	(452,943)	(423,281)
Adj. #10: Employee Savings Plan Exp.	(37,631)	(39,837)	(43,489)	(44,877)
Adj. #11: Group Insurance Expense	(166,575)	(1,042,557)	(1,317,388)	(1,638,243)
Adj. #12: Employee Expenses	(100,450)	(103,564)	(106,795)	(110,042)
Adj.#13: Liab., Prop., & Other Insurance	(665,765)	(651,693)	(754,933)	(775,723)
Adj.#14: Rate Case (Regulatory) Exp.	(583,699)	(566,857)	(1,950,205)	(1,926,625)
Adj.#15: Business Transformation	-	-	(513,988)	(513,988)
Adj.#16: ITS Software Write-off	(77,019)	(79,407)	(81,884)	(84,373)
DRA-Recommended General Office O&M Expense	$ 25,962,526	$ 26,639,022	$ 27,081,222	$ 27,452,391
Source: Attachment 2-1				

Table 2-2

Application of California American Water for Rate Increase (U210W) Summary of Overland-Recommended Adjustments to CalAm-Requested Rate Base				
Rate Base	2010	2011	2012	2013
Cal Am Rate Base	5,309,052	9,366,875	11,860,706	13,428,912
Adj.#15: Business Transformation	(3,047,945)	(7,424,177)	(10,041,246)	(11,662,203)
Rate Base	2,261,108	1,942,698	1,819,460	1,766,710
Sources: **CalAm Requested:** CalAm California Corporate Revenue Requirement Workpapers **Overland Recommended:** Attachment 2-1, Table 4-2				

Adjustments Discussion

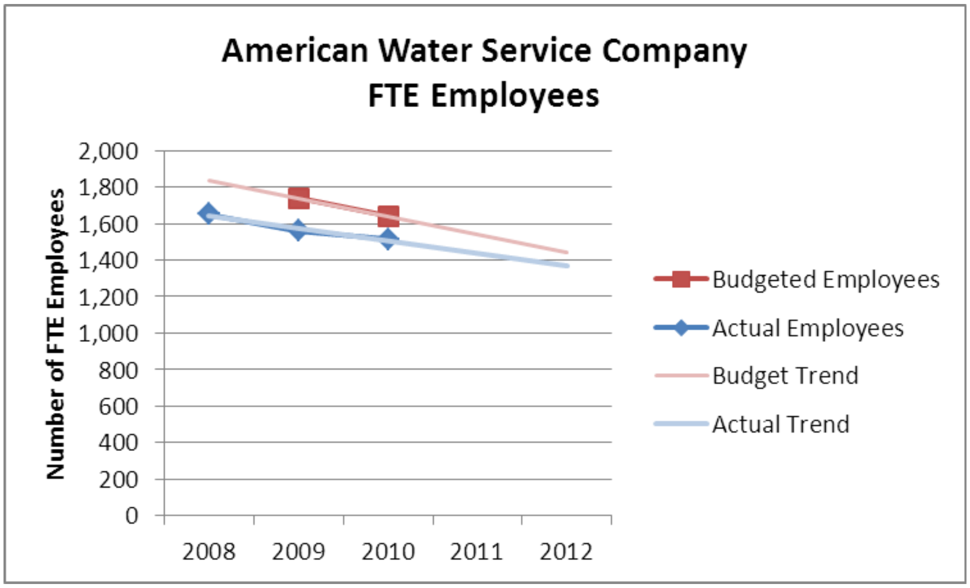
In total we recommend ~~15~~16 adjustments to the O&M, rate base investment and depreciation expense requested by CalAm. Each adjustment is discussed below.

Adjustment 1 - Adjust AWSC's Base Period Labor and Labor-Related Expenses to Reflect Actual Employees as of December 31, 2010

CalAm calculated requested General Office labor and labor-related expenses using budgeted (authorized) positions, rather than actual employees. For the following reasons, Overland recommends calculating AWSC's base period labor and related expenses using actual employees at year end 2010, rather than using 2010 budgeted positions, which include a significant complement of vacant positions.

- AWSC has an ongoing vacancy rate ranging from about 8 to 10 percent of total authorized positions. CalAm requests that customers be required to fund hypothetical labor expense for about one in 10 service company positions that are vacant at any given time. It is not reasonable to charge customers for labor and related expense that will not be incurred, for employees that are not on the payroll.

- As shown below, AWSC's labor force is declining, not increasing.



- There is no evidence of any customer growth in AW's regulated operations to justify higher AWSC force levels than it actually employed in the base period; in fact, AW has announced the sale of its Arizona and New Mexico operating companies, which will result in a reduction of about 4 percent of its regulated customer base. In our opinion it is unlikely that AWSC's staffing levels (apart from some additional hires for the Business Transformation project) will increase during the forecast period, and it is even more unlikely it will increase to the force level CalAm has requested. In fact, given the downward trend in AWSC's labor force, it is more likely that Overland's recommended staffing <u>overstates</u> the force level likely to be employed in AWSC in 2012 and 2013.

- We recommended the same type of adjustment in the last rate case, for similar reasons. In Decision 09-07-021, the Commission adopted our recommendation. Despite the Commission's prior decision, CalAm continues in this rate case to request that customers pay for labor and related expenses for service company employees that do not exist.

We have not recommended an adjustment to CalCorp's base period labor and related expenses because CalCorp's 2010 budgeted and end-of-year actual employees are in close alignment, and an adjustment would therefore be immaterial.

Our recommended adjustment to AWSC's labor and related expenses, summarized below, proportionally affects the following expense accounts:

Account 501200 – Labor
Account 501210 – Labor NS (Non-Scheduled) Overtime
Account 501211 – Labor Overtime
Account 501711 – Incentive Compensation

Account 501716 – Compensation Expense – Restricted Stock Options
Account 501718 – Compensation Expense – Restricted Stock Units

Table 2-3

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #1: Labor and Labor-Related Expense (O&M Exp.)				
	2010	2011	2012	2013
Service Company Total	$ (18,696,847)	$ (19,276,449)	$ (19,877,874)	$ (20,482,162)
CalAm Percentage	6.54%	6.54%	6.54%	6.54%
Service Company - CalAm	(1,223,635)	(1,261,568)	(1,300,929)	(1,340,477)
CalCorp Traditionally District	-	-	-	-
CalCorp Function	-	-	-	-
Total Recommended O&M Exp. Adj.	$ (1,223,635)	$ (1,261,568)	$ (1,300,929)	$ (1,340,477)
Escalation:				
Service Company	3.94%	3.10%	3.12%	3.04%
Sources: **Overland Recommended:** Attachment 2-1; Overland electronic workpapers **Service Company Escalation Factors:** Final SC WPs 102-105				

Adjustment 2 - Reduce Incentive Compensation to Amounts Aligned with Customer Benefits

AW provides incentive compensation through the following plans:

- <u>Annual Incentive Plan (AIP)</u> – The AIP consists of cash payments calculated as a percentage of base salary. Most management employees are eligible for this plan. Amounts paid are dependent on AW achieving its financial objectives. The distribution among employees depends on individual employee performance. Amounts requested in CalAm's revenue requirement are based on a budgeted accrual. Payments are made in March of the year following accrual, and may be different (most likely, lower) than the amount accrued.

- <u>Equity Awards</u> – Equity-based compensation is available only to higher-level executives (above middle management) through restricted stock and stock option plans. Awards are primarily dependent on AW achieving its financial objectives. Amounts requested by CalAm are based on an annual accrual. Stock awards are issued in installments of one-third of the total earned during a three-year period following the year earned.

CalAm's requested base period (2010) incentive compensation expense is 16.5 percent of salaries and wages for AWSC and 13.3 percent of salaries and wages for CalCorp.[9] AW stated that it does not maintain any data comparing its total cash compensation (salary plus incentive compensation) to market-comparable industry compensation, so

[9] Incentive compensation for CalAm's district-level employees is not part of General Office expense and was not within the scope of our review.

the comparability of AW's AIP incentive compensation to the market could not be evaluated.[10]

Regulatory Background - In the prior three rate cases, incentive compensation was reduced or removed from CalAm's revenue requirement. In Decision 03-02-030, the Commission denied CalAm's request to recover forecasted incentive compensation, noting that the requested amounts were "only estimates", and that CalAm had paid substantially less incentive pay than it had budgeted in two of three historical periods it cited.[11] In ~~the~~ General Office rate case Decision 06-11-050, CalAm agreed in settlement to remove incentive compensation from its rate request. In Decision 09-07-021, the Commission concluded that the incentive compensation in CalAm's rate request should be reduced from the estimated 100% incentive compensation payout in the test year 2009 to the actual payout rates from 2007. 2007 contained the most recent available data for actual payout rates.[12]

CalAm's Requested Incentive Compensation - CalAm states that its requested incentive compensation is based on the assumption that each employee will reach their target-level of performance and be paid 100 percent of their available amount for individual performance.[13] Because AW's financial results were on track to be above target in 2010, the company increased its accrual to 130 percent of the overall AW target. Below are the net amounts recorded in 2009 and 2010, and the amount CalAm has requested for the base period, including an allocation from AWSC and incentive compensation for CalCorp employees.[14]

AWSC Allocated + CalCorp Incentive Compensation	
2009 Actual Net Accrual	$ 543,176
2010 Actual Net Accrual	$1,690,152
2010 Base Period CalAm Request	$1,247,215

Overland's Recommended Adjustment to CalAm's Incentive Compensation Request - DRA recommends that funding of incentive compensation ~~program~~ should be aligned with the parties that receive the benefits from the goals or metrics achieved in the plan.[15] DRA and Overland reviewed the 2010 AIP Highlights Brochure and found that the determination of the amount funded for the AIP is based 70% on financial goals and 30% on non-financial goals. (See above for list of financial and non-financial goals.) The DRA explains in their report that the shareholders are the direct beneficiaries of American Water meeting their financial goals, while the ratepayers are the direct beneficiaries of American Water meeting their operational (non-financial) goals.

[10] Response to OC-169
[11] Decision 03-02-030, General Office – Salaries, p. 24
[12] Decision 09-07-021, Section 6.3.2.2, pp. 100-101
[13] Id.
[14] Amounts accrued for CalAm's district employees are not included in these amounts or in our adjustment because they are not part of the General Office revenue requirement.
[15] Division of Ratepayers Advocates testimony in A10-07-007.

Therefore, the DRA recommends that 30% of the AIP funding be recovered from ratepayers. Our recommended adjustment reflects DRA's recommended alignment of benefits, and is based on a 70 percent shareholder / 30 percent customer split of actual 2010 AIP expense for the base period. Our recommended AIP excludes 2010 expense accrued above the 100 percent-of-target level, as does CalAm's request.

Our recommended adjustment to equity-based incentive compensation is also consistent with DRA's recommendation that customer funding should be limited to the portion of incentive plan payments aligned with operational goals. As discussed in detail in Chapter 5, our analysis of equity awards showed that only 15 percent of the total award was linked with operational objectives directly benefiting customers. Thus, in accordance with DRA's recommendation that recovery of incentive compensation from customers should be tied to performance that produces customer benefits, our recommended adjustment:

- Reduces the AIP component of CalAm's request by 70 percent
- Reduces the equity award component of CalAm's request by 85 percent

The AW accounts affected and adjustment amounts are summarized below.

Account 501711 - Incentive Compensation (AIP)
Account 501716 - Compensation Expense – Restricted Stock Options
Account 501718 - Compensation Expense – Restricted Stock Units

Table 2-4

Application of California American Water for Rate Increase (U210W)
Summary of Overland's Recommended Adjustment to CalAm's Request
Adjustment #2: Incentive Compensation (AIP) (O&M Exp.)

	2010	2011	2012	2013
Service Company Total	$ (9,619,268)	$ (9,917,465)	$ (10,226,890)	$ (10,537,788)
CalAm Percentage	4.48%	4.48%	4.48%	4.48%
Service Company - CalAm	(431,243)	(444,612)	(458,483)	(472,421)
CalCorp Traditionally District	-	-	-	-
CalCorp Function	(322,741)	(334,037)	(342,722)	(353,689)
Total Recommended O&M Exp. Adj.	$ (753,984)	$ (778,648)	$ (801,205)	$ (826,110)
Escalation:				
Service Company	3.94%	3.10%	3.12%	3.04%
CalCorp		3.50%	2.60%	3.20%

Sources: **Overland Recommended:** Attachment 2-1; Overland workpapers **Service Company Escalation Factors:** Final SC WPs 102-105 Excel Workbook **CalCorp Escalation Factors:** CalCorp Corp Labor Excel file (100 day update)

Adjustment 3 - Remove Business Development Expense

CalAm's requested General Office expenses include business development expense. In Decision 09-07-021 the Commission concluded that CalAm had not met its evidentiary burden for including this expense in the California revenue requirement. The Commission found that CalAm's presentation failed to quantify or demonstrate specific benefits to customers for the amounts CalAm proposed to charge to its California customers.

The Western Region service company employees that made up the bulk of the requested business development expense in the last rate filing, and who were in the best position to increase the California customer base, are no longer with the company. The only requested expense that remains is an allocation of AWSC's national business development expense. CalAm's justification for continuing to request customer funding of this expense essentially boils down to an argument that since customers benefit from scale economies, and because expanding the customer base increases scale economies, customers should pay for business development.[16] CalAm's argument notwithstanding, the company is not forecasting any significant increase in its California customer base; in fact, AW's announced sale of its Arizona and New Mexico systems will <u>reduce</u> AW's customer base and <u>negatively</u> affect scale economies. The impact of the Arizona / New Mexico sale will almost certainly result in a CalAm request for still higher service company expense in the next rate case.

We requested CalAm describe AWSC's 2009 and 2010 business development efforts to increase the California customer base. CalAm identified three projects, none of which added to the customer base. We also requested a list showing California service territory expansions and customers added over the last five years.[17] CalAm identified two system additions which resulted in additional customers (Watertek, 823 customers, 2005; and Toro, 408 customers, 2007).[18] These additions are apparently the most recent CalAm has made and were also identified in the last rate case. In its data response, CalAm noted that in recognition of the fact that a significant portion of its business development activities is related to non-regulated business growth, AWSC's business development function charges the regulated segment for a "much lower proportion" of its expenses than other AWSC functions.[19] Based on our calculations, "a much lower [regulated] proportion" still results in a large majority – 71 percent – of business development costs being charged to regulated operations.[20]

We found no evidence that business development expense incurred at the national level provides any direct or indirect benefit to regulated California operations and we recommend the Commission make the same finding it made in CalAm's last rate case: remove business development expense from the regulated revenue requirement. Our adjustment to remove CalAm's allocation of AWSC business development expense affects multiple AWSC expense accounts. It is summarized below.

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[16] CalAm Direct Testimony of David Stephenson, pp. 92-93.
[17] OC-11-B
[18] OC-11-C
[19] OC-11-B
[20] This percentage is calculated from the "Final SC WPs 102-105". Overland took the percentage of regulated companies' management fee business development expense ($1,214,865) divided by the total management fee business development expense ($4,224,638) per the "Budget 2010" tab on which the SC rate case WPs are based.

Table 2-5

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #3: Business Development (O&M Exp.)				
	2010	2011	2012	2013
Service Company Total	$ (4,409,130)	$ (4,545,813)	$ (4,687,643)	$ (4,830,147)
CalAm Percentage	2.96%	2.96%	2.96%	2.96%
Service Company - CalAm	(130,431)	(134,474)	(138,670)	(142,886)
CalCorp Traditionally District	-	-	-	-
CalCorp Function	-	-	-	-
Total Recommended O&M Exp. Adj.	$ (130,431)	$ (134,474)	$ (138,670)	$ (142,886)
Escalation:				
Service Company	3.94%	3.10%	3.12%	3.04%
Sources: **Overland Recommended:** Attachment 2-1; Overland electronic workpapers **Service Company Escalation Factors:** Final SC WPs 102-105 Excel Workbook				

Adjustment 4 - Remove Corporate Contributions Expense

Utility regulators, including the California Public Utilities Commission, have traditionally prohibited utilities from charging ratepayers for expenses relating to charitable activities. In the previous rate case CalAm did not address the issue of removing charitable contributions from the revenue requirement. The Commission noted in its decision that it has a long-standing position on disallowing these contributions.[21] Despite the Commission's finding in the prior rate order, CalAm continues to request customer funding of AWSC's charitable contributions.

In accordance with Commission's long-standing policy, we recommend removing expenses associated with charitable contributions from CalAm's customer-funded revenue requirement. Our adjustment removes $152,437 in the base period from the budgeted expense in account 575140 – Charitable Contributions. The adjustment also reduces the remaining amount in AWSC business unit 032087 – Corporate Social Responsibility, by $594,422. In total, the adjustment reduces base period management fees charged to CalAm by $59,246. The adjustment is consistent with what we recommended and what we understand the Commission adopted in the prior rate case.

[21] Id

Table 2-6

Application of California American Water for Rate Increase (U210W)				
Summary of Overland's Recommended Adjustment to CalAm's Request				
Adjustment #4: Charitable Contributions & Corporate Social Responsibility (O&M Exp.)				
	2010	2011	2012	2013
Service Company Total	$ (746,859)	$ (770,012)	$ (794,036)	$ (818,175)
CalAm Percentage	7.93%	7.93%	7.93%	7.93%
Service Company - CalAm	(59,246)	(61,083)	(62,988)	(64,903)
CalCorp Traditionally District	-	-	-	-
CalCorp Function	-	-	-	-
Total Recommended O&M Exp. Adj.	$ (59,246)	$ (61,083)	$ (62,988)	$ (64,903)
Escalation:				
Service Company	3.94%	3.10%	3.12%	3.04%
Sources: **Overland Recommended:** Attachment 2-1; Overland electronic workpapers **Service Company Escalation Factors:** Final SC WPs 102-105 Excel Workbook				

Adjustment 5 - Remove Legislative and Political Influence Expense

The California PUC has traditionally prohibited California utilities from charging customers for expenses incurred to influence politicians or legislation. In the 2004 General Office rate case, the Commission disallowed expenses associated with a Government Affairs Director when it became clear that the position included legislative influence responsibilities.[22] In Decision 06-11-050, the Commission stated that its "policy is clear that political and lobbying activity should not be included in customer rates." In its 2009 decision concerning the most recent rate case the Commission determined that the Director of Government Affairs position, both at the NSC and at CalCorp, had responsibilities to influence legislation at the federal and state levels for American Water and/or California American Water and disallowed recovery of the expenses associated with those positions as well as the contract services expense for a firm that was used to communicate with federal agencies and provide access to members of Congress and their staff.[23]

Position descriptions for the Director of Governmental Affairs at both the Corporate and State level include legislative influence responsibilities. Excerpts from the State level Director of Governmental Affairs position description include the following:

- Establishes regular proactive communication outreach strategies and tactics in the state and local political arena to ensure state and local political relationships are solidified . . .
- Proactively meets with state and local government officials . . . to create strong relationships, mitigate emerging or potential problems and establish a level of trust between American Water, mayors and other appointed and elected officials.
- Is poised as the lead state lobbyist for the company charged with helping to change or support key legislation . . . that may have an adverse or positive effect on the company.

[22] Decision 03-02-030, General Office – Salaries pp. 21-22
[23] Decision 0907021 pp. 104-106.

- Manages local contract lobbyists . . . [and] holds regular meetings with the contract lobbyists to ensure . . . they are not just "bill trackers. . . "
- Establishes and maintains an effective bill tracking program and takes full advantage of opportunities for the company to be out front on industry-related issues.
- Builds effective alliances and coalitions to advance the company's position on key legislative initiatives.

These excerpts strongly suggest that the primary purpose of AW's Government Affairs function is to advance the company's legislative agenda. While this is consistent with AW's responsibility to advance its interests and those of its shareholders, it runs contrary to Commission policy for such activities to be funded by customers. As such, we recommend Government Affairs expense be removed from CalAm's customer-funded revenue requirement.

We determined that the state-level Director of Governmental Affairs did not allocate any costs to CalAm as it is a position in the central region. At the AWSC level we adjusted expense to remove the Government Affairs function from customer-funded expense.[24] Our adjustment affects multiple expense accounts and is summarized below

Table 2-7

Application of California American Water for Rate Increase (U210W)				
Summary of Overland's Recommended Adjustment to CalAm's Request				
Adjustment #5: Legislative Influence Expense (O&M Exp.)				
	2010	2011	2012	2013
Service Company Total	$ (410,883)	$ (423,621)	$ (436,838)	$ (450,117)
CalAm Percentage	2.90%	2.90%	2.90%	2.90%
Service Company - CalAm	(11,917)	(12,287)	(12,670)	(13,055)
CalCorp Traditionally District	-	-	-	-
CalCorp Function	-	-	-	-
Total Recommended O&M Exp. Adj.	$ (11,917)	$ (12,287)	$ (12,670)	$ (13,055)
Escalation:				
Service Company	3.94%	3.10%	3.12%	3.04%
Sources: **Overland Recommended:** Attachment 2-1; Overland's electronic workpapers **Service Company Escalation Factors:** Final SC WPs 102-105 Excel Workbook				

Adjustment 6 - Remove Unsupported 2009 "Admin" Expense added by CalAm to the 2010 Base Period Revenue Requirement

For purposes of calculating the service company revenue requirement attributable to California, CalAm reversed a net credit of $2,470,534 budgeted in AWSC business unit 32098 ("Non-Departmental") and replaced it with positive (debit) expense of $2,275,260, representing something CalAm calls "Admin" expense incurred in 2009. This adjustment

[24] It is important to understand that the national Government Affairs function represents only a small part of AWSC's External Affairs organization (one out of 31 positions at the end of 2010). However, it is also likely that additional External Affairs positions and expenses, which we have not identified for removal from customer-funded expense, probably support the Government Affairs function and its legislative influence responsibilities.

increased AWSC expense (before allocation) by $4,745,754 (from negative $2,470,534 to positive $2,275,260).

CalAm stated that most of the "Non-Departmental" amount consisted of a "corporate vacancy" adjustment budgeted to offset expense ~~budgeted~~ within individual AWSC business units for authorized, but unfilled positions.[25] We requested descriptions of the 2009 "Admin" amounts that CalAm substituted for the 2010 budgeted "Non-Departmental" net credit. Following are CalAm's descriptions for the top five 2009 "Admin" amounts (in terms of absolute value) that CalAm requests customers fund in the forecast period:[26]

Account 722306 – Gains Other Non-OR	$624,617
Account 501200 – Labor	$498,942
Account 534999 – General Overhead	$454,587
Account 504500 – Other Welfare Maint.	$266,088
Account 508200 – Empl. Stock Purch. Plan	$177,758

The $624,617 "Gain" is actually a loss incurred in 2009 for which CalAm provided no definition. CalAm did not explain what the loss was or why customers should pay, multiple times in future years, for a loss it incurred in 2009. The $498,942 in 2009 Admin "Labor" may include or consist entirely of the compensation of a "non-departmental" External Affairs employee, possibly a national-level lobbyist, whose duties we unsuccessfully attempted to get CalAm to describe in the prior rate case.[27] Among the other amounts included in "Admin" is $109,673 in incentive compensation, possibly for the same "non-departmental" employee.

The response CalAm provided does not explain the activities that underlie the 2009 expenses, how they benefit California customers, or why 2009 amounts were used instead of equivalent "Non-Departmental" amounts budgeted for 2010. As such, we recommend these expenses be excluded from 2010 base period and forecast period revenue requirement funded by customers. Our adjustment to remove 2009 "Admin" expense affects multiple expense accounts. It reduces base period AWSC expense, prior to allocation, by $2,275,260 and reduces AWSC allocated to the base period CalAm revenue requirement by $~~107,392~~79,596.

[25] OC-142-A

[26] OC-142-A

[27] If this employee's compensation is included in "Admin" labor expense, it is unclear why CalAm would adjust it into the revenue requirement, given the Commission's rejection of the expense in the prior rate case. It is also unclear why CalAm would attempt to recover a 2009 loss of $624,617 without explaining what it is or why California customers should pay for it.

Table 2-8

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #6: Non-Departmental (Admin) Expense (O&M Exp.)				
	2010	2011	2012	2013
Service Company Total	$ (2,275,260)	$ (2,345,793)	$ (2,418,982)	$ (2,492,519)
CalAm Percentage	3.50%	3.50%	3.50%	3.50%
Service Company - CalAm	(79,596)	(82,063)	(84,624)	(87,196)
CalCorp Traditionally District	-	-	-	-
CalCorp Function	-	-	-	-
Total Recommended O&M Exp. Adj.	$ (79,596)	$ (82,063)	$ (84,624)	$ (87,196)
Escalation:				
Service Company	3.94%	3.10%	3.12%	3.04%
Sources: **Overland Recommended:** Attachment 2-1; Overland's electronic workpapers **Service Company Escalation Factors:** Final SC WPs 102-105 Excel Workbook				

Adjustment 7 - Remove NSC Sales and Marketing Expenses

In Decision 09-07-021, the Commission stated that "sales and marketing expenses must be recorded below the line" and adopted our recommendation to remove $72,056 in expense allocated to CalAm.[28] Despite the Commission's finding in the prior case, CalAm continues in this rate case to request customer funding of the same expenses the Commission previously disallowed. CalAm asserts that brand recognition and promotion program expense it requests that California customers fund is "developed and executed to provide information and educational instruction to customers, so therefore the costs of these programs are appropriately paid for by ratepayers."[29] No descriptions of the programs were given as evidence that they educate the ratepayers on safety and/or usage related issues.

Position descriptions contain the following information about the sales and marketing activities CalAm requests from AWSC business unit 32068:[30]

- <u>Director Advertising & Marketing</u> – Responsible for leading and directing the overall strategic development and execution of the company's brand building strategy to ensure the effective evolution of the American Water brand.

- <u>Manager Advertising</u> – Assist with trade show and event planning efforts for corporate brand, subsidiaries, and functions.

- <u>Brand Manager</u> – Responsible for assisting in the development and rollout and governance of AW's new brand identity, policy & standards. Assist in brand implementation as it relates to all uses of American Water's corporate and state subsidiary logos. Works to align legal names with brand marks through filings

[28] Decision 09-07-021, pp.103-104
[29] OC-25-D
[30] OC-21

with each state government. Manage the brand agency relationship as it relates to development, implementation, and maintenance of all brand elements.

- Manager Customer Communication Resource – Ensures effectiveness of confidence report materials and alignment of those elements with an overall corporate brand focus, as well as with a regulated state process and cost-efficiency focus.

We recommend, in accordance with established Commission policy, as we did in the prior case, that corporate sales and marketing expenses be excluded from the customer-funded revenue requirement. Consistent with the Commission's disallowance in the prior case decision, we removed $1,587,509 from AWSC's sales and marketing expense. This adjustment reduces CalAm's O&M expense by $76,405, which is similar to the amount the Commission disallowed in the prior rate case.

Table 2-9

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #7: Marketing and Sales Expense (O&M Exp.)				
	2010	2011	2012	2013
Service Company Total	$ (1,587,509)	$ (1,636,721)	$ (1,687,787)	$ (1,739,096)
CalAm Percentage	4.81%	4.81%	4.81%	4.81%
Service Company - CalAm	(76,405)	(78,774)	(81,232)	(83,701)
CalCorp Traditionally District	-	-	-	-
CalCorp Function	-	-	-	-
Total Recommended O&M Exp. Adj.	$ (76,405)	$ (78,774)	$ (81,232)	$ (83,701)
Escalation:				
Service Company	3.94%	3.10%	3.12%	3.04%
Sources: **Overland Recommended:** Attachment 2-1; Overland's electronic workpapers **Service Company Escalation Factors:** Final SC WPs 102-105 Excel Workbook				

Adjustment 8 - Reduce Requested Base Period Pension Expense to Actual 2010 GAAP Expense. Reduce Forecast Period Pension Expense to the Amounts Forecasted ~~B~~by AW's Actuary~~,~~ [redacted] [redacted]

CalAm's General Office pension expense includes expense for AWSC, CalCorp and the districts. Pension expense for the districts was ~~formerly~~ included in CalAm's district-level revenue requirements in prior rate cases. CalAm records pension expense under Generally Accepted Accounting Principles (GAAP); specifically, Accounting Standards Codification (ASC) 715-30 (formerly FAS 87). ~~We understand that GAAP has been the basis for CalAm's recovery of pension expense from customers.~~ As discussed in detail in Chapter 6, CalAm has requested that customers fund far more for base period pension expense than it ~~actually~~ recorded to expense ~~incurred~~ in 2010, and far more in the years 2011-2013 than AW's actuary~~,~~ [redacted] [redacted] forecasts it will incur in those years.

AW records pension expense for a defined benefit pension plan that was closed to employees hired after 2005. AW's GAAP pension expense, which spiked significantly higher in 2009, began to decline the very next year, declining 17 percent during base period 2010.[31] In April, 2010, AW's actuary~~,~~ [redacted] [redacted] forecast~~s~~ed that pension expense will continue to decline each year from 2011 through 2015. By 2015, the expense for AW's closed plan is projected to be lower than the amounts incurred in the years prior to the 2009 spike.[32]

Against a backdrop of declining expense, CalAm requests customers fund 42 percent more in the 2010 base period than was actually expensed ~~incurred~~ in 2010, and 95 percent more in 2012 than was actually expensed ~~incurred~~ in 2010. In addition, CalAm's requested 2012 increases for CalCorp and the CalAm districts are six times greater, as a percentage of 2010 actual expense, than the increase requested for the service company, even though CalAm and service company pension expenses are the product of the very same pension plan.[33]

CalAm's requested pension expense increase is unsupported and should be rejected. In its place, we recommend base period expense equal to what was expensed~~incurred~~ ~~(recorded)~~ in 2010, and GAAP pension expense as forecasted by AW's [redacted] for the years 2011-2013. Our recommended adjustment is summarized below.

Table 2-10

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #8: Pension Expense (O&M Exp.)				
	2010	2011	2012	2013
As Recommended by Overland (1)	$ 2,673,174	$ 2,444,617	$ 2,158,418	$ 1,904,019
As Requested by CalAm (1)	3,803,084	4,877,837	5,221,714	4,230,804
Total Recommended O&M Exp. Adj.	$ (1,129,910)	$ (2,433,220)	$ (3,063,295)	$ (2,326,785)
Total AW Pension Expense (2)	$ 67,249,870	$ 61,500,000	$ 54,300,000	$ 47,900,000
Escalation:		-8.55%	-11.71%	-11.79%
Sources: **Overland Recommended:** Attachment 2-1, Table 6-1, Table 6-2; **CalAm Requested:** CalAm Workpapers (1) California allocated service co., CalCorp and CalAm districts combined; (2) 2010 is actual expense; 2011-2013 are as forecasted by AW's actuary				

[31] Response to OC-86, Attachment 1, AW Pension Plan Actuarial Valuation Report, p. MS-5
[32] Response to OC-173, Attachment, Exhibit 1
[33] 2012 requested expense for CalCorp and the CalAm districts ($4.4 million) is 2.2 times the amount actually incurred in 2010 ($2.0 million). 2012 requested expense allocated from AWSC ($835,000) is 21 percent higher than the amount actually incurred in 2010 ($690,000). The differences in approach for calculating California-incurred and service company-allocated pension increases appear to be the result of completely different analytical approaches, even though the source of the asserted increases is the same pension plan.

Adjustment 9 - Reduce Requested Base Period Post-Retirement Benefits Other Than Pensions (PBOPs) to Actual 2010 GAAP Expense. Reduce Forecast Period PBOP Expense to the Amounts Forecasted ~~B~~by AW's Actuary.~~,~~ [redacted]

~~Like pension expense,~~ CalAm's General Office PBOP expense includes expense for AWSC, CalCorp and the districts. PBOP expense for the districts expense was included in ~~CalAm's~~ district-level revenue requirements in prior rate cases. CalAm records PBOP expense under GAAP; specifically, ASC 715-60 (formerly FAS 106). ~~Overland's understanding is that GAAP has been the basis for CalAm's recovery of PBOP expense from customers.~~ As discussed in detail in Chapter 6, CalAm has requested that customers fund far more for base period PBOP~~pension~~ expense than it actually expensed~~incurred~~ in 2010, and far more in the years 2011-2013 than AW's actuary~~,~~ [redacted] forecasts it will incur (on a GAAP basis) in those years.

AW records PBOP expense for a retiree welfare plan that was closed to non-union employees hired after 2001, and closed to union employees hired after 2005. AW's GAAP PBOP expense declined from $41.6 million in 2009 to $~~48.7~~38.7 million in base period 2010.[34] In April, 2010, AW's actuary~~,~~ [redacted] forecasts~~s~~ed that PBOP expense will continue to decline each year from 2011 through 2015. By 2015, the expense for AW's closed plan is projected to be $32.4 million.[35]

Notwithstanding AW [redacted] forecast of declining expense, CalAm requests customer recovery of PBOP expense in an amount 59 percent higher for the base period and 55 percent higher for test year 2012 than the amount expensed ~~actually incurred~~ in 2010. For the portion of PBOP expense incurred directly on behalf of California employees (i.e., excluding expense allocations from AWSC), CalAm requests a 2010 base period amount 76 percent higher than the cost CalAm actually incurred in 2010. We did not find an explanation in the rate filing as to why CalAm's PBOP expense should increase when the company's actuary expects the expense to decline.

CalAm's requested PBOP expense increase is unsupported and should be rejected. In its place, we recommend base period expense equal to what was expensed~~incurred (recorded)~~ in 2010, and GAAP expense as forecasted by AW's [redacted] for the years 2011-2013. Our recommended adjustment is summarized below.

[34] Response to OC-86, Attachment 2, AW Retiree Welfare Plan Actuarial Valuation Report, p. MS-1
[35] Response to OC-173, Attachment, April 6, 2010 letter from AW's [redacted] Exhibit 3

Table 2-11

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #9: Postretirement Benefits Other than Pensions (O&M Exp)				
	2010	2011	2012	2013
As Recommended by Overland (1)	$ 769,478	$ 755,971	$ 742,045	$ 650,533
As Requested by CalAm (1)	1,223,377	1,209,086	1,194,988	1,073,814
Total Recommended O&M Exp. Adj.	$ (453,899)	$ (453,115)	$ (452,943)	$ (423,281)
Total AW Pension Expense (2)	$ 38,678,936	$ 38,000,000	$ 37,300,000	$ 32,700,000
Escalation:		-1.76%	-1.84%	-12.33%
Sources: **Overland Recommended:** Attachment 2-1, Table 6-3, Table 6-4; **CalAm Requested:** CalAm Workpapers (1) California allocated service co., CalCorp and CalAm districts combined; (2) 2010 is actual expense; 2011-2013 are as forecasted by AW's actuary				

Adjustment 10 - Reduce Base Period Employee Savings Plan Expenses (401k and Defined Contribution Plan) to Amounts Actually Incurred in 2010. Reduce 2011-2013 Expense to Base Period Amount Plus Labor Expense Escalation.

AW matches a portion of employee contributions under a tax-deferred 401k savings plan. For employees who participate in the defined benefit pension plan, AW contributes a maximum of 2.5 percent of salary. For employees hired after 2005 (who are not part of the pension plan), the maximum company contribution is 4 percent of salary.[36] In addition, as a replacement for the defined benefit plan for employees hired after 2005, AW has a Defined Contribution Plan (DCP) to which it contributes 5.25 percent of salary.[37]

Apart from expense requested for vacant positions (which we recommend for elimination as part of the labor expense adjustment), the 2010-2013 forecasted increase in allocated AWSC savings plan expenses reflects annual composite inflation of about 3.1 percent, proportional with escalation in labor expense, and appears reasonable. However, for CalCorp (and possibly for the CalAm districts[38]) CalAm has proposed a savings plan expense increase that is disproportionately higher than proposed increases in CalCorp labor expense. For the base period, requested CalCorp savings plan expense is nearly 28 percent higher than the amount actually incurred in 2010. For 2012, CalAm requests a 43 percent increase in CalCorp's savings plan expense, nearly four times greater than the requested increase in CalCorp labor expense. CalAm's requested increases are unsupported.

<u>Overland-Recommended CalCorp Employee Savings Plan Expense</u> - We recommend base period 401k and DCP expense equal to the amount actually incurred by AWSC and CalCorp. For the forecast years 2011 through 2013 we recommend increasing base period amounts using appropriate labor expense escalation factors. There is no

[36] CalAm Direct Testimony of Jeffrey Dana, p.21
[37] OC-110, Attachment 4
[38] Unlike pension and PBOP expenses, CalAm did not include district-level savings plan expenses in its General Office revenue requirement. As such, Overland did not review CalAm's requested district-level savings plan increase.

evidence that 401k or DCP expense should be inflated by 43 percent between the years 2010 to 2012.

Table 2-12

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #10: CalCorp Employee Savings Plan Expenses (O&M Exp.)								
	2010		2011		2012		2013	
As Recommended by Overland (1)	$	136,888	$	145,223	$	152,066	$	156,932
As Requested by CalAm (1)		174,519		185,060		195,555		201,809
Total Recommended O&M Exp. Adj.	$	(37,631)	$	(39,837)	$	(43,489)	$	(44,877)
CalCorp Labor Exp. (Salary and OT)	$	3,359,758	$	3,564,330	$	3,732,280	$	3,851,713
Escalation:				6.09%		4.71%		3.20%
Sources: **Overland Recommended:** Attachment 2-1, Table 5-3, Table 6-5, Table 6-6; **CalAm Requested:** CalCorp Corp Labor File (1) CalCorp and CalAm districts combined								

Adjustment 11 - Reduce Base Period Group Insurance Expense to Expense Actually Incurred in 2010. Reduce 2011-2013 Expense to Base Period Plus Labor Escalation

Group insurance expense includes AW's employee medical, prescription drug, dental, vision, life, AD&D and disability insurance programs AW's medical plan is administered by Horizon Blue Cross / Blue Shield and covers approximately 6,100 employees.[39] CalAm requests that customers pay 53 percent more for group insurance expense in test year 2012 than it actually incurred in 2010. CalAm requests that customers pay 67 percent more for group insurance in 2013 than it incurred in 2010.

Much of CalAm's requested increase can be traced to a requested 41.1~~40.3~~ percent increase in 2011 over expense actually incurred 2010. The 41.1~~40.3~~ percent difference between 2010 actual expense and 2011 forecasted expense breaks down as follows:

- 8.0~~7.2~~ percent is the difference between CalAm's base period 2010 expense request and expense actually incurred in 2010. Almost all of this difference is associated with vacant positions for which CalAm has requested base period funding (labor, payroll taxes, employee savings plan contributions, incentive compensation and group insurance). This component of the increase is removed in our recommended adjustment to labor and labor-related expense.

- 15.6 percent relates to medical cost increases AW attributes to a forecast provided by its benefits consultant. [redacted] ~~& Associates forecast.~~ [redacted] ~~f~~Forecast~~s~~ed ~~that AW's~~ 2011 medical cost inflation ~~will~~ includes:

    - 8.2 percent "industry trend" medical cost increase,
    - 2.1 percent inflation over and above the industry cost trend rate. ~~(~~Apart from inflation forecasted for new federally-mandate benefits, [redacted] it is

[39] OC-214-B, Attachment

forecast~~s~~ed that AW will be unable to hold its medical cost increase~~flation~~ to the industry trend~~)~~,
  - 5.3 percent inflation to implement new benefits, most of which are mandated by federal law (such as child dependent care to age 26), but none of which appear to be offset by benefit reductions elsewhere or paid for with increased employee contributions.

- 17.5 percent is attributable to what AW says is a funding deficit in its group insurance trust account. According to AW, the company did not charge its operating companies and business units enough in 2009 and 2010 to maintain the "required minimum balance" in its health care trust. We estimate the ~~company~~ total amount budgeted by AW in 2009, but not actually funded, was about $20 million.[40] We do not have a similar estimate for 2010.

Requested additional inflation in 2012 and 2013 is based on [redacted] the 8.2 percent industry trend rate, which CalAm apparently believes the company will be able to meet beginning in 2012. For the following reasons, CalAm's requested group insurance increases should be rejected:

- It does not appear that [redacted] 2011 cost inflation forecast of 15.6 percent incorporates the steps that AW took in 2011 to reduce group insurance expense (increasing employee contributions to insurance expense and eliminating "premium preferred" and "exclusive" provider plans).

- AW's under-funded ~~of~~ its insurance trust in 2009 and 2010, which allowed AW to record higher earnings in both years. Had AW funded what was required in 2009 and 2010 to keep pace with incurred costs, the amount~~s~~ CalAm says AW needs to rebuild its trust account balance would be lower, if it~~they~~ existed at all. Customers should not be required to reimburse AW's trust account in 2011 for amounts that AW should have funded itself to keep pace with actual costs incurred in 2009 and 2010.

- CalAm's group insurance inflation procedure, with its separate, much higher inflation rate, effectively raises composite inflation above the rates approved in DRA / Water Division escalation memos. For example, CalAm's separate medical inflation, which the company over-lays onto already-inflated service company expense, increases overall service company escalation by an additional 1.8 percent in 2011 (from 3.1 percent to 4.9 percent), by 0.6 percent in 2012 (from 3.0 percent to 3.6 percent) and by an additional 0.4 percent in 2013 (from 3.0 percent to 3.4 percent).

[40] As discussed in Chapter 7, we estimate CalAm's 2009 group insurance expense budget was about $20 million higher than the company chose to actually fund. The estimated $20 million difference between budgeted expense, ~~which~~ would likely have maintained the necessary balance in the trust account at least for 2009~~, and the amount actually funded, resulted in the same amount of additional pre-tax income~~.

- CalAm's separate, much higher group insurance inflation rate effectively double-counts the medical component of inflation already built into the Consumer Price Index – Urban Consumers (CPI-U) that Overland understands is the agreed-upon basis for escalating labor and labor related expenses. CPI-U already contains a component for medical inflation.

- Allowing AW to pass above-industry trend medical inflation to customers discourages AW from controlling its medical costs or even bringing them in line with the inflation trend experienced by the rest of the utility industry. In 2009, AW's medical insurance cost-per-employee, $10,246, was about 20 percent higher than that incurred by the average utility, $8,520, primarily because AW's employees contributed significantly less to their insurance costs (about 18 percent of gross cost in 2009) than employees in the average utility (about 32 percent of gross cost in 2009). Although AW increased its employee-contribution share to 23 percent in 2011, it is still well below the 2009 industry average. Given that the industry average employee contribution has probably increased since 2009, it is not clear CalAm has made any progress toward meeting it.

Group insurance issues are covered in additional detail in Chapter 7. Overland's recommended adjustment to group insurance expense:

- Calculates AWSC's base period expense based on the 2010 actual insurance funding rate multiplied by actual employees as of December 31, 2010. This component of the adjustment eliminates insurance expense associated with vacant positions and is included in adjustment #1 to labor and labor-related expense, discussed above.

- Maintains California's (CalCorp and CalAm) base period expense at the actual amount incurred in 2010.

- Escalates base period expense for 2011, 2012 and 2013 using DRA / Water Division escalation factors.

Our adjustment to CalAm-requested expense is summarized in the table below.

Table 2-13

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #11: Group Insurance (O&M Exp.)				
	2010	2011	2012	2013
Overland As Recommended	$ 12,745,971	$ 13,141,096	$ 13,551,098	$ 13,963,052
AWSC As Requested by CalAm	14,336,120	18,986,091	21,046,674	23,691,233
Difference	(1,590,149)	(5,844,995)	(7,495,576)	(9,728,181)
Less: Group Ins Adjusted in Adjustment #1	1,590,149	1,639,444	1,690,594	1,741,988
Difference Unrelated to Adjustment #1	-	(4,205,551)	(5,804,981)	(7,986,193)
CalAm Percentage	5.27%	5.27%	5.27%	5.27%
Recommended Adjustment - AWSC	$ -	$ (221,700)	$ (306,015)	$ (421,000)
Overland Total Recommended (1)	2,164,325	2,209,343	2,267,228	2,330,257
CalCorp Total Requested by CalAm (1)	2,330,900	3,030,200	3,278,600	3,547,500
Recommended Adjustment - CalCorp	(166,575)	(820,857)	(1,011,372)	(1,217,243)
Total Recommended O&M Exp. Adj.	$ (166,575)	$ (1,042,557)	$ (1,317,388)	$ (1,638,243)
Escalation:				
Service Company	3.94%	3.10%	3.12%	3.04%
CalCorp		2.08%	2.62%	2.78%
Sources: **Overland Recommended:** Attachment 2-1, Table 7-1 **CalAm Requested:** CalAm Workpapers (1) CalCorp and CalAm districts combined				

Adjustment 12 - Reduce Base Period Employee Expense for AWSC to the Amount Actually Incurred in 2010

Employee expense includes amounts in the following accounts:

Account 575340 – Empl. Exp. AG
Account 575342 – Empl. Exp. Conf./Registration AG
Account 575350 – Meals & Travel Deduct
Account 575351 – Meals & Travel Non-deductible
Account 550005 – Mileage Reimb- Personal Vehicle

Like labor expense, employee expense is an expense for which AWSC appears to build a permanent budgetary cushion. As shown in the table below, with the exception of Business Transformation in 2009 (for which it does not appear employee expense was anticipated), employee expense was significantly over-budgeted for nearly every department in 2009 and 2010. For the service company as a whole, budgeted employee expenses exceeded actual employee expenses by about 40 percent in both 2009 and 2010. Actual expenses of $4.2 million in 2009 and $4.5 million in 2010 are nowhere near the $7.6 million amount CalAm requests in its calculation of customer-funded AWSC expense.

Table 2-14

American Water Service Company Employee Expenses (including M&E) by Function - Total Spend (Capital + Mgt. Fees)				
Function (Rate Filing Category)	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Non-Departmental (Admin)	$ -	$ -	$ -	$ 8,715
Audit	238,680	39,217	167,976	29,227
Business Development	333,800	206,409	270,558	123,374
Business Transformation	-	264,976	977,050	343,621
External Affairs/Communication	487,245	354,976	574,056	369,295
Finance	809,179	382,135	817,866	398,763
Human Resources	552,046	406,871	634,868	402,030
Investor Relations	187,000	92,049	299,502	86,474
Legal	331,720	175,945	339,928	240,989
Operation Services	1,072,973	706,885	932,048	878,338
Property	2,200	4,315	2,240	4,619
Regulated Operations	1,027,760	630,942	914,734	404,398
Regulatory Services	42,056	47,446	60,700	40,604
Laboratory	39,287	16,107	30,000	17,676
Benefit Svc Ctr	23,000	3,492	16,830	3,375
CSC	191,405	117,350	283,175	182,782
ITS	998,238	636,353	916,632	773,289
SSC	218,175	95,891	213,912	154,363
Procurement	164,442	36,060	156,345	59,413
Total	$ 6,719,207	$ 4,217,418	$ 7,608,419	$ 4,521,345
Actual Pct. Of Budget		62.77%		59.43%
Sources: CalAm Revenue Req. Workbook, OC-72 and OC-135				

Overland-Recommended AWSC Employee Expense - We recommend base period expense funded by California customers be calculated using actual 2010 expense, rather than amounts that include a 40 percent budgetary cushion. Our recommended adjustment is shown below.

Table 2-15

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #12: Employee Related Expense (O&M Exp.)				
	2010	2011	2012	2013
Service Company Total	$ (2,226,572)	$ (2,295,596)	$ (2,367,219)	$ (2,439,182)
CalAm Percentage	4.51%	4.51%	4.51%	4.51%
Service Company - CalAm	(100,450)	(103,564)	(106,795)	(110,042)
CalCorp Traditionally District	-	-	-	-
CalCorp Function	-	-	-	-
Total Recommended O&M Exp. Adj.	$ (100,450)	$ (103,564)	$ (106,795)	$ (110,042)
Escalation:				
Service Company	3.94%	3.10%	3.12%	3.04%
Sources: **Overland Recommended:** Attachment 2-1, Table 2-14; **Service Company Escalation Factors:** Final SC WPs 102-105 Excel Workbook				

Adjustment 13 - Reduce 2010 Liability, Property and Workers Comp. Insurance Expenses to Amounts Actually Incurred. Reduce 2011 Amounts to Five-Year Average of Years 2006-2010. Reduce Test Year 2012 and 2013 Amounts to 2011 Plus Escalation.

CalAm's district-level general liability, automobile, workers compensation, and property insurance has ~~been~~ moved to the General Office expense category in this rate case. The table below summarizes 2009 and 2010 actual insurance expense and CalAm's requested expense for 2010 through 2013.

Table 2-16

California American Base Rate Filing 2010-2013 Actual and Requested Liability, Auto, Workers Comp & Property Insurance Expense							
Insurance Category: Amounts Net of Capital Credits	CalAm Accounts	2009 Actual	2010 Actual (As Recorded)	2010 Base Period Request	2011 - Requested	2012 - Requested	2013 - Requested
General Liability & Auto	557000 & 556000	1,028,276	696,982	1,398,718	1,530,032	1,624,786	1,669,955
Workers Comp.	558000	334,227	467,108	413,258	443,357	465,550	478,295
Property	559000	309,388	342,173	360,052	388,856	419,965	431,640
Total		1,671,891	1,506,263	2,172,028	2,362,245	2,510,301	2,579,891
Sources: Rate Filing Exh. A-CC Ch. 3 Table 1(100 day Update); Response to OC-148; Response to OC-73							

CalAm's requested base period (2010) insurance expense is <u>44 percent higher</u> than the amount actually incurred in 2010 and 31 percent higher than the five-year average of 2005-2009 expenses. CalAm's test year (2012) insurance expense request is <u>51 percent higher</u> than the five-year average of 2005-2009 expenses and 67 percent higher than 2010 actual expense. CalAm states that the Company's insurance brokers provided "best estimates" for 2010-2013 "in view of current insurance market conditions and influences.[41] Presumably, CalAm's base year insurance expense request, 44 percent higher than actually incurred, was based on the brokers' "best estimates." Based on the July 1, 2010 testimony date, it seems reasonable to assume the estimates would have been in 2010. Based on the apparent level of inaccuracy, we recommend the Commission put no stock in these estimates.

<u>Overland-Recommended Insurance Expense</u> – We recommend base period insurance expense equal to actual 2010 insurance expense. We recommend 2011 insurance expense based on the average of the years 2006-2010, adjusted for inflation. We recommend test year (2012) and 2013 expense based on recommended 2011 expense, adjusted for inflation. Our calculation of recommended 2010 and 2011 expense is shown below.

[41] CalAm Direct Testimony of Dennis Thorig, p.11

Table 2-17

California American Base Rate Filing 2010-2013 Calculation of Overland-Recommended Insurance Expense, 2010 and 2011								
Insurance Category: Amounts Net of Capital Credits	2006 Actual	2007 Actual	2008 Actual	2009 Actual	2010 Actual (Base Period Recommended)	Five Year Average	2011 Inflation Factor	2011 Recommended (W/ Inflation)
General liability & Auto	710,500	946,800	692,200	1,028,300	696,982	814,956		
Workers Comp.	652,900	687,700	389,600	334,200	467,108	506,302		
Property	315,600	305,300	256,800	309,400	342,173	305,855		
Total Before Inflation	1,679,000	1,939,800	1,338,600	1,671,900	1,506,263	1,627,113		
Inflation Restatement Factor	1.0832278	1.0472039	0.9954410	1.0106000	1.0000000			
Total Adjusted for Inflation	1,818,739	2,031,366	1,332,497	1,689,622	1,506,263	1,675,698	1.0208	1,710,552
Sources: Historical amounts (2006-2010) from Rate Filing Exh. CC EXP 105 - 106; Response to OC-148; Response to OC-73								

Our recommended adjustment to CalAm's requested insurance expense is as follows:

Table 2-18

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #13: General Liability Insurance (O&M Exp.)				
	2010	2011	2012	2013
Overland Total Recommended	1,506,263	1,710,552	1,755,368	1,804,168
CalCorp Total Requested by CalAm	2,172,028	2,362,245	2,510,301	2,579,891
Recommended Adjustment - CalCorp	$ (665,765)	$ (651,693)	$ (754,933)	$ (775,723)
Escalation:				
CalCorp		2.08%	2.62%	2.78%
Sources: **Overland Recommended:** Attachment 2-1 Table 2-16 **CalCorp as Requested and Escalation Factors:** CalCorp Workpapers				

Adjustment 14 - Reduce Requested Regulatory (Rate Case) Expense

Regulatory expense is supposed to cover the costs of preparing and administering rate cases that are incremental to the expenses incurred by in-house regulatory staff.

CalAm's Requested Rate Case Expense - CalAm has requested test year (2012) rate case expense of $2.8 million, based on a three-year amortization of $8.4 million in asserted expense.[42] CalAm's $8.4 million request includes the expense of two rate cases and two cost of capital cases The components of CalAm's request are summarized below.

[42] CalAm Direct Testimony of David Stephenson, p.6

Table 2-19

California American Water Company Estimate of Rate Case (Regulatory) Expense		
Expense	2010 Actual Amount	3 Year Amort.
Rate Consultant	$ 145,637	
EMA Consulting	115,597	
Legal Fees (Outside Counsel)	1,978,700	
SSC Labor	219,903	
SSC Expenses	66,011	
Travel Expenses Witness Training	90,707	
Witness Training	34,000	
Printing and Mailing	846,000	
Cost of Capital	683,622	
Total First Case	$ 4,180,177	$ 1,393,392
Inflation	246,631	
Total Second Case (Includes Inflation)	4,426,808	
In-house Attorney Savings	(211,800)	
Add First Case (Above)	4,180,177	
Total Both Cases, With Savings	$ 8,395,185	$ 2,798,395
Source: CalAm Workpaper CC Exp 115		

CalAm's expense excludes the salaries, benefits and other expenses of in-house staff employed to prepare and administer rate cases, and whose costs are included in labor and labor-related expenses that CalAm has requested for recovery elsewhere in the CalCorp revenue requirement. We determined that the additional salary and benefits O&M expense~~costs~~ for~~of~~ CalAm's professional regulatory staff, as requested for test year 2012, is ~~were about~~ $1.89 million~~887,000 annually in 2010~~, excluding ~~the costs of~~ office space, office overheads, employee expenses and administrative support staff. When CalAm's $2.8 million test year request is combined with the cost of professional employees Overland identified with the rate case process, CalAm's asserted test year cost of preparing and defending rate cases totals about $~~3.7~~4.69 million ($27.26~~21.46~~ per customer) annually, exluding office overheads for internal regulatory staff.

Legal Fees - A large portion of CalAm's asserted regulatory expense ($1.98 million total, $660,000 amortized) relates to external legal fees. During discussions with DRA, we learned that CalAm was encouraged to hire its own legal staff to help minimize external legal costs. As explained by CalAm:

> California American Water has opened an office in San Francisco near the Commission and plans to retain two full-time regulatory attorneys and a regulatory paralegal for that office. . . . California American Water opened the San Francisco office and added the internal legal positions in an effort to reduce outside legal expenses.[43]

[43] CalAm Direct Testimony of Stephenson, p.5

CalAm completed the process of hiring this staff during 2010, at an test year annual salary and labor-related expense~~s~~ cost of approximately $~~500~~665,000.~~ We conservatively estimate the cost of office space, overheads and employee expenses associated with the new legal staff is at least an additional $100,000, for a total cost of $600,000.~~ However, in the calculating its requested $2.8 million in annual regulatory expense, CalAm's credits these new positions with reducing the annual amortization of outside legal expenses by only $141,200 ($70,600 per case for two rate cases) ~~in annually~~ (for a "2nd in house regulatory attorney.")[44]

Currently Authorized Rate Case Expense - CalAm's current regulatory expense authorization is summarized below.

Table 2-20

California American Water 2009 Authorized Regulatory (Rate Case) Expense Per Company	
Jurisdiction	2009 Authorized
Coronado	$ 79,300
Village	79,400
Los Angeles	217,500
Monterey Water	350,000
Monterey Wastewater	28,700
Sacramento	467,200
Larkfield	20,100
Total Authorized Per CalAm	$ 1,242,200
Source: CalAm Rate Filing Exh. A-CC, Ch. 3, Table 1	

Overland's Recommended Rate Case Expense – We recommend rate case expense funded by customers be based on currently authorized regulatory expense, reduced by an amount to recognize the savings in outside legal expenses attributable to the newly-hired staff. Our calculation process is as follows:

1. We estimated the outside legal component of currently authorized regulatory expense by calculating the ratio of outside legal expenses to total regulatory expense in CalAm's request ($1,978,700 per case / $4,180,177 per case).
2. We reduced estimated outside legal services by 75 percent to recognize the replacement of outside services with the newly-hired internal legal staff.
3. We subtracted this amount from currently authorized regulatory expense to obtain recommended authorized expense, before inflation.
4. We escalated the resulting recommended authorized amount for the years 2010 through 2013.

[44] ($211,800 X 2 cases) / 3 years

Table 2-21

California American Water Overland Recommended Rate Case (Regulatory) Expense	
Regulatory Expense	2009 Amount
2009 Authorized Rate Case Expense	$ 1,242,200
2010 Legal Fees Ratio to Total Expenses	47.34%
Estimated Authorized Outside Legal Fees	$ 587,999
Recommended Reduction in Legal Fees - Pct	75.00%
Recommended Reduction in Legal Fees - Amt	$ 440,999
Outside Legal Fees Recommended for Authorization	147,000
Recommended Non-Legal Rate Case Expenses	654,201
Recommended Regulatory Expense, 2009 (Before Escalation)	$ 801,201
Recommended Regulatory Expense, 2010	$ 809,693
Recommended Regulatory Expense, 2011	$ 826,535
Recommended Regulatory Expense, 2012	$ 848,190
Recommended Regulatory Expense, 2013	$ 871,770
Source: CalAm Workpaper Exh. A-CC Ch 3 Table 1(100 day update)	

We believe our calculation of recommended expense is conservative in that it attributes <u>no savings</u> to efficiencies that should be realized from consolidating separate district-level and General Office cases into a single rate proceeding.

Our recommended adjustment to CalAm's requested regulatory expense is summarized below.

Table 2-22

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #14: Rate Case (Regulatory) Expense				
	2010	2011	2012	2013
Overland Total Recommended	809,693	826,535	848,190	871,770
CalCorp Total Requested by CalAm	1,393,392	1,393,392	2,798,395	2,798,395
Recommended Adjustment - CalCorp	$ (583,699)	$ (566,857)	$ (1,950,205)	$ (1,926,625)
Escalation:				
CalCorp		2.08%	2.62%	2.78%
Sources: **Overland Recommended:** Attachment 2-1, Table 8-1, Table 8-4 **CalCorp as Requested and Escalation Factors:** CalCorp Workpapers				

Adjustment 15 - Remove Business Transformation

AW is currently undergoing a Business Transformation (BT) project in which most of its major business software systems will be replaced. The most recent published budget for BT is approximately $280 million. CalAm's share of the amount currently budgeted is approximately $14 million. BT is scheduled to be deployed in stages in 2012 and 2013. CalAm has requested that customers fund a significant amount of investment and associated depreciation associated with BT in advance of implementation. CalAm is also asking for a balancing account to accumulate the actual costs of BT for later recovery. The approximate revenue requirement impact of including BT in revenue requirements, by year, is as follows:

2010 (Base Year)	$ 343,000
2011	$ 836,000
2012 (Test Year)	$1,645,000
2013	$1,827,152

In 2014, the year after BT is forecasted to be fully implemented, the California revenue requirement impact (which does not affect this GRC cycle) increases to $2.8 million.

Due to a lack of demonstrated customer benefits, the DRA has recommended customer not be required to fund investments in BT systems prior to their implementation. Chapter 4 includes a complete discussion of BT. Based on DRA's recommendation, Overland's recommended adjustment removes net BT rate base investment (construction work in progress, plant, and depreciation reserve) and BT depreciation expense from the revenue requirement. This adjustment is summarized below.

Table 2-23

Application of California American Water for Rate Increase (U210W)
Summary of Overland's Recommended Adjustment to CalAm's Request
Adjustment #15: Business Transformation (Rate Base and O&M Expense)

Rate Base	2010	2011	2012	2013
Overland Total Recommended Depreciation	-	-	-	-
CalCorp Total Requested by CalAm	3,047,945	7,424,177	10,041,246	11,662,203
Recommended Adjustment - CalCorp	$ (3,047,945)	$ (7,424,177)	$ (10,041,246)	$ (11,662,203)
O&M Expense				
Overland Total Recommended Depreciation	-	-	-	-
CalCorp Total Requested by CalAm	-	-	513,988	513,988
Recommended Adjustment - CalCorp	$ -	$ -	$ (513,988)	$ (513,988)

Sources: **Overland Recommended:** Attachment 2-1, Table 4-2 **CalCorp as Requested:** CalCorp Rate Base Workpapers

Adjustment 16 - Remove Depreciation for Software Written Off and the Unexplained Portion of AWSC's 2010 ITS Depreciation Increase

CalAm's requested management fee for AWSC's ITS function increased dramatically, from a request of $~~32.9~~ $1.68 million for the 2008 base period[45] in the prior rate case ($9.9~~6~~0 per customer), to ~~$51.7~~ $2.66 million ($15.~~54~~49 per customer) for the 2010 base period in this rate case. Much of the 56 percent increase can be traced to much higher ITS depreciation expense. AWSC's budgeted ITS depreciation expense increased by 87 percent, from $9.3 million in 2009, to $17.4 million in 2010. Requested base period depreciation was approximately double the amount requested in 2008.

[45] Adjusted to remove $102,135 transferred to CalCorp

A number of things appear to have caused the increase, but the predominant factor seems to be depreciation associated with "new assets," including "customized software" ($2.8 million additional depreciation), "off the shelf software" ($1.2 million depreciation) and "other equipment, hardware and software" ($1.6 million in additional depreciation). Among the systems added during 2009 and 2010, which contributed an additional $1.6 million in annual depreciation expense, were the web-based customer interface with the customer service system (allowing customers to see usage and pay bills online), and an upgrade to the interactive voice system (phone tree) that allows customers to get answers to service and billing questions without talking with a Call Center employee.[46] We believe ITS depreciation warrants additional scrutiny; however, time constraints required that we focus attention elsewhere.[47]

Among the items CalAm listed in a reconciliation of actual 2010 depreciation with 2009 is the write-off of $2.4 million in Sharepoint system software.[48] Through review of depreciation associated with ITS software and equipment additions in 2009 and 2010, we determined that the annual depreciation rate associated with the Sharepoint investment was about 25 percent.[49] Based on this, the annual depreciation that should be removed from for the software that was written off is approximately $600,000. We recommend removing from the revenue requirement CalAm's share of $600,000 in depreciation associated with this system, which was apparently written off.

A second item included in CalAm's explanation of the additional depreciation in 2010 is an adjustment to "the useful lives of Enterprise Software . . . from 3 years to 5 years resulting in a favorable one-time adjustment of $0.6 million." This "favorable" adjustment, which should decrease depreciation expense (the life was lengthened, according to CalAm), was, in fact shown in the reconciliation as having the opposite effect (explaining $0.6 million of additional expense in 2010).[50] Thus, approximately $1.2 million of the additional base period depreciation remains unexplained (when what should have been a $0.6 million reduction is included). As such, we recommend $1.2 million in unexplained differences between 2009 and 2010 ITS depreciation be removed from the 2012 test period revenue requirement.

Our total recommended AWSC's ITS depreciation adjustment, $1.8 million, results in recommended base period depreciation of $15.6 million. Our recommended ITS depreciation represents a 36 percent increase over the depreciation expense actually incurred in 2009. This adjustment, and its allocation to CalAm, is summarized below.

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[46] OC-230-A

[47] For example, it could be that the depreciation rates on the new assets are significantly higher than the rates on the assets they replaced.

[48] OC-230-A

[49] OC-230-B, Attachment

[50] OC-230-A

Table 2-24

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #16: ITS Software Write-off (O&M Exp.)				
	2010	2011	2012	2013
Service Company Total	$ (1,497,757)	$ (1,544,188)	$ (1,592,366)	$ (1,640,774)
CalAm Percentage	5.14%	5.14%	5.14%	5.14%
Service Company - CalAm	(77,019)	(79,407)	(81,884)	(84,373)
CalCorp Traditionally District	-	-	-	-
CalCorp Function	-	-	-	-
Total Recommended O&M Exp. Adj.	$ (77,019)	$ (79,407)	$ (81,884)	$ (84,373)
Escalation:				
Service Company	3.94%	3.10%	3.12%	3.04%
Sources: **Overland Recommended:** Attachment 2-1, Overland electronic workpapers **Service Company Escalation Factors:** Final SC WPs 102-105 Excel Workbook				

Attachment 2-1

General Office Operations and Maintenance Expenses
As Filed by CalAm, Summary of Overland-Recommended Adjustments, As Adjusted by Overland
2010 Per CalAm, Overland-Recommended Adjustments, and As Recommended by Overland

	Adjustment No.		1	2	3	4	5	6	7	8	9	10	11	12	13	14	16	
Line No.	Rate Filing Category	AWSC Expenses to be recovered	Adjust Labor and Labor-Related Expenses to December 31, 2010 Actual Headcount	Adjust Incentive Comp to DRA recommendation	Remove Business Development	Remove Charitable Contributions and CSR	Remove Legislative Influence Expense	Remove Unsupported "Non-Dept" (Admin) Expense	Remove Marketing & Sales Expense	Adjust Pension Expense to 2010 Actual	Adjust PBOP to 2010 Actual	Adjust DCP and 401k to 2010 Actual	Adjust Group Ins to 2010 Actual	Remove Employee Related Expenses	Adjust General Liability Insurance to 2010 Actual	Adjust Rate Case (Regulatory) Expense	Remove ITS Depr. Write-off and unexplained depreciation variance	NSC O&M Per Overland, 2010
1	**National (Before Allocation)**																	
2	Admin	$ 2,275,260	$ -	$ -	$ -	$ -	$ -	$ (2,275,260)	$ -	$ -				$ -			$ -	$ -
3	Audit	1,966,736	(306,917)	(137,471)	-	-	-	-	-	(3,358)				(136,952)			-	1,382,039
4	Business Development	4,224,638	184,493	(556,659)	(4,409,130)	-	-	-	-	(27,029)				(144,094)			-	(727,782)
5	Business Transformation	-	-	-	-	-	-	-	-	-				-			-	-
6	External Affairs/Communication	8,872,083	(298,996)	(794,568)	-	(742,594)	(410,883)	-	(1,587,509)	(58,006)				(199,580)			-	4,779,946
7	Finance	21,135,654	(3,939,781)	(1,496,106)	-	-	-	-	-	(173,428)				(402,608)			-	15,123,732
8	Human Resources	11,610,117	(1,247,847)	(893,930)	-	-	-	-	-	(79,800)				(226,827)			-	9,161,714
9	Investor Relations	1,244,595	(38,213)	(104,767)	-	-	-	-	-	(2,073)				(210,727)			-	888,816
10	Legal	8,890,808	(1,926,696)	(878,957)	-	-	-	-	-	(67,058)				(94,947)			-	5,923,150
11	Operation Services	8,204,279	(733,924)	(845,996)	-	-	-	-	-	(111,549)				(30,978)			-	6,481,832
12	Property	11,931,823	(49,545)	(8,267)	-	-	-	-	-	(9,361)				2,118			-	11,866,768
13	Regulated Operations	18,135,994	(2,030,747)	(1,544,192)	-	(4,265)	-	-	-	(174,497)				(405,826)			-	13,976,467
14	Regulatory Services	724,507	-	(86,650)	-	-	-	-	-	(6,849)				(19,780)			-	611,228
15	Laboratory	5,471,057	(276,468)	(102,236)	-	-	-	-	-	(39,323)				(12,292)			-	5,040,739
16	Benefit Svc Ctr	1,652,892	(89,433)	(52,849)	-	-	-	-	-	(24,404)				(13,311)			-	1,472,894
17	CSC	49,847,123	(2,502,750)	(367,275)	-	-	-	-	-	(555,823)				(100,274)			-	46,321,001
18	ITS	51,695,115	(3,159,094)	(919,628)	-	-	-	-	-	(246,256)				(119,536)			(1,497,757)	45,752,844
19	SSC	19,545,216	(2,125,592)	(706,093)	-	-	-	-	-	(201,338)				(57,434)			-	16,454,759
20	Procurement	2,478,616	(155,339)	(123,623)	-	-	-	-	-	(36,761)				(53,525)			-	2,109,369
21	**Total NSC**	$ 229,906,514	$ (18,696,847)	$ (9,619,268)	$ (4,409,130)	$ (746,859)	$ (410,883)	$ (2,275,260)	$ (1,587,509)	$ (1,816,913)				$ (2,226,572)			$ (1,497,757)	$ 186,619,515
22	**After Allocation to CalAm**																	
23	Admin	$ 79,596	$ -	$ -	$ -	$ -	$ -	$ (79,596)	$ -	$ -				$ -			$ -	$ -
24	Audit	92,540	(14,581)	(6,531)	-	-	-	-	-	(160)				(6,506)			-	58,231
25	Business Development	130,431	3,090	(13,649)	(130,431)	-	-	-	-	(522)				(2,952)			-	(14,034)
26	Business Transformation	-	-	-	-	-	-	-	-	-							-	-
27	External Affairs/Communication	713,679	(109,576)	(50,370)	-	(59,246)	(11,917)	-	(76,405)	(5,752)				(14,729)			-	385,684
28	Finance	968,626	(177,166)	(59,115)	-	-	-	-	-	(7,214)				(16,753)			-	708,379
29	Human Resources	624,138	(86,356)	(50,747)	-	-	-	-	-	(6,481)				(13,824)			-	466,729
30	Investor Relations	33,466	(1,035)	(2,837)	-	-	-	-	-	(56)				(5,707)			-	23,831
31	Legal	660,876	(239,623)	(21,096)	-	-	-	-	-	(83)				(3,704)			-	396,370
32	Operation Services	577,470	(56,983)	(41,935)	-	-	-	-	-	(7,525)				(1,911)			-	469,116
33	Property	571,631	417	(392)	-	-	-	-	-	(444)				105			-	571,316
34	Regulated Operations	808,641	(85,196)	(56,512)	-	-	-	-	-	(7,095)				(13,895)			-	645,943
35	Regulatory Services	34,539	-	(4,010)	-	-	-	-	-	(317)				(915)			-	29,296
36	Laboratory	286,588	(14,467)	(5,350)	-	-	-	-	-	(2,058)				(643)			-	264,071
37	Benefit Svc Ctr	80,254	(4,445)	(2,627)	-	-	-	-	-	(1,213)				(662)			-	71,308
38	CSC	2,544,316	(126,122)	(18,508)	-	-	-	-	-	(28,010)				(5,053)			-	2,366,623
39	ITS	2,663,411	(164,781)	(47,246)	-	-	-	-	-	(12,533)				(6,105)			(77,019)	2,355,728
40	SSC	1,095,053	(139,106)	(41,545)	-	-	-	-	-	(11,808)				(3,269)			-	899,324
41	Procurement	153,872	(7,705)	(8,773)	-	-	-	-	-	(1,575)				(3,926)			-	131,893
42	Total Cal-Am	12,119,127	(1,223,635)	(431,243)	(130,431)	(59,246)	(11,917)	(79,596)	(76,405)	(92,844)				(100,450)			(77,019)	9,836,340
43	Cal Corp Operating Expenses (Traditionally District)	10,127,571								(881,629)	(435,685)		(138,668)		(665,765)	(583,699)		7,422,125
44	**California AW GO Function (CalCorp)**	$ 9,265,991		$ (298,205)						$ (152,501)	$ (22,507)	$ (37,631)	$ (27,907)					$ 8,727,241

This document contains information that California American Water asserts is confidential.

3. Review of American Water Service Company

This chapter contains an ~~functional (departmental)~~ analysis of American Water Service Company (AWSC). As of December 31 2010, AWSC consisted of approximately 1,500 employees providing centralized corporate governance and management, customer and operating services to all AW subsidiaries. For ease of comparison, the functions (departments) discussed in this chapter are classified according to the "rate filing categories" CalAm used to classify expense for revenue requirement purposes.

Summary of Findings

1. AWSC Staffing and Organization - AWSC underwent organizational changes in 2008. This changed the components of the service company considered allocable to CalAm. The most significant change was a consolidation of certain regional operations at a divisional level. Our historical review of AWSC focused primarily on 2009 and 2010. Time did not permit a detailed analysis of the 2008 organization changes or their potential impact on CalAm.

2. AWSC Staffing Levels - Apart from an increase beginning in late 2010 to staff the Business Transformation function, AWSC's labor force has been declining and it appears likely to continue declining. Year-end 2009 staffing levels were lower than year-end 2008. Year-end 2010 staffing levels were lower than year-end 2009. Staffing in both years was significantly under authorized (budgeted) levels. Among the functions (rate filing categories, departments) with significant percentage reductions in labor force levels in 2009 and 2010 were Finance, Customer Service Call Centers, Regulated Operations and Operations Services.

3. Vacant AWSC Positions and CalAm-Requested Labor Expense - AWSC appears to have an on-going vacancy rate that averaged about 9 percent of authorized (budgeted) positions during the years 2009 and 2010. CalAm used authorized positions, rather than actual employees, as a basis for its AWSC revenue requirement request; thus, CalAm's calculations of AWSC labor and related expenses such as payroll taxes, incentive compensation and group insurance, which are budgeted based on headcount, reflect a request for customer funding for~~of~~ non-existent employees.

4. Admin (Non-Departmental) Costs – CalAm's requested revenue requirement for AWSC reflects the removal of a budgeted "non-departmental" net expense credit of approximately $2.5 million, and its replacement with 2009 "Admin" expenses of about $2.3 million. The non-departmental net credit that CalAm removed for ratemaking purposes includes an expense credit to offset some of the ongoing vacancies budgeted into AWSC costs at the department level. It may also include certain other costs. The "Admin" costs added in place of the non-

departmental net credit, and projected forwarded to 2011, 2012 and 2013, appear to include salary and incentive compensation for an External Affairs employee (and possible lobbyist) that the Commission disallowed in the prior rate case, and an undefined "other" loss attributable to 2009.

5. Increased Information Technology Services (ITS) Expense – CalAm's base period (2010) request for AWSC's ITS function is $2,663,411, or $15.49 per customer, a 55.6 percent increase over management fee CalAm requested in the last case. The increase occurred even though ITS staffing has decreased since 2008. Most of the increase in budgeted ITS expense is attributable to an increases in depreciation. Inquiry about the reasons for the increase in ITS depreciation expense, which doubled in 2010 from 2009, showed that over half the increase was due to depreciation on "new assets," including new software for income and property taxes, business planning, a web-based interface for customers (billing and account inquiry) and an improved interactive voice recognition (IVR, or phone tree) system for the customer service system.[51]

   We proposed an adjustment to ITS expense to remove forecast period depreciation associated with Sharepoint software that CalAm says was written off, and to eliminate the unexplained portion of the 2010 budgeted depreciation increase; however, most of the proposed depreciation expense increase is reflected in our recommended revenue requirement. However, we believe the Commission should take note of the fact that although CalAm has proposed that customers pay for increases for ITS systems that are beginning to create opportunities for lower staffing levels in customer service (and possibly other AWSC functions), CalAm has not recommended customers receive any of the savings expected from lower staffing levels; in fact, CalAm's requested AWSC revenue requirement does not even reflect the benefit of staffing decreases that have already occurred.

Summary of Recommendations

1. AWSC Labor and Labor-Related Expense – Overland recommends limiting service company labor and labor-related expenses funded by customers to actual salaries based on staffing as of year-end 2010. AWSC's staffing is declining, not increasing. We do not recommend rate recovery based on CalAm's budgeted staffing, which results in labor expense for~~based on~~ an employee force level higher than AWSC employed in either 2009 or 2010. Our adjustment to annualize base period labor expense based on year-end 2010 AWSC labor force levels is discussed in detail in Chapter 2. We proposed, and the Commission adopted, a similar adjustment in the prior rate case.

[51] OC-230-A & B, Attachment

2. Employee Travel and Related Expenses – An analysis of the expense accounts that contain employee travel and related expenses showed that for almost every AWSC function, budgeted expenses ~~significant~~ exceeded actual expenses incurred in both 2009 and 2010. We recommend base period 2010 employee expenses allocated to CalAm reflect actual, rather than budgeted, 2010 expenses. This recommendation is discussed in more detail in Chapter 2.

3. "Admin" (Non-Departmental) Costs – As discussed in detail in Chapter 2, undefined "Admin" expenses attributable to the year 2009 should be excluded from AWSC management fees charged to California customers.

4. Corporate Business Development Expense - Consistent with the prior rate order, and as discussed in Chapter 2, Overland recommends excluding AWSC Business Development expenses from CalAm's revenue requirement. We proposed, and the Commission adopted, a similar adjustment~~s~~ in the prior rate case.

5. External Affairs Legislative Influence, Sales and Marketing, and Charitable Contributions and Activities Expenses – As discussed in detail in Chapter 2, we recommend expenses incurred in AWSC's External Affairs function relating to legislative influence, corporate sales and marketing, and charitable activities be excluded from amounts funded by California customers. We proposed, and the Commission adopted, similar adjustments in the prior rate case.

6. ITS Depreciation – Budgeted ITS depreciation nearly doubled between 2009 and 2010, from $9.3 million to $17.4 million. As discussed in Chapter 2, we recommend removing from test year revenue requirements: 1) depreciation associated with Sharepoint software that was written off, and 2) the unexplained portion of an increase in 2010 depreciation.

Breakdown of AWSC's Total Spend Budget

The table below summarizes 2010 budgeted service company cost by major function (rate filing category or department). The management fee column contains the expense that forms the basis for CalAm's requested AWSC revenue requirement.

Table 3-1

American Water Service Company 2010 Budgeted Amounts			
Rate Filing Category	Management Fee	Capital Fee	Budgeted Total Spend
Non-Departmental	(2,470,534)	(9,666)	(2,480,199)
Audit	1,966,736	25,817	1,992,553
Business Development	4,224,638	90,607	4,315,244
Business Transformation	1,530,805	105,390,448	106,921,253
External Affairs/Communication	8,872,083	230,292	9,102,375
Finance	21,135,654	865,942	22,001,596
Human Resources	11,610,117	307,695	11,917,812
Investor Relations	1,244,595	13,592	1,258,187
Legal	8,890,808	373,819	9,264,627
Operation Services	8,204,279	6,020,124	14,224,403
Property	11,931,823	1,473,812	13,405,635
Regulated Operations	18,135,994	4,670,178	22,806,172
Regulatory Services	724,507	11,572	736,079
Belleville Laboratory	5,471,057	14,312	5,485,369
Benefit Svc Ctr	1,652,892	17,837	1,670,729
Call Center	49,847,123	59,324	49,906,447
ITS	51,695,115	10,295,849	61,990,964
Shared Services	19,545,216	719,488	20,264,704
Supply Chain	2,478,616	2,010,069	4,488,686
Total	226,691,526	132,581,112	359,272,637
Source: CalAm's AWSC revenue requirement w orkbook, "Budget 2010" sheet			

Service company costs are assigned to the regulated state operating companies as either a management fee or a capital fee. The overall budgeted capital fee is significantly higher in 2010 than it has been in prior years due to the Business Transformation project. The impact of Business Transformation on CalAm and its test period revenue requirement is discussed below.

CalAm's Requested AWSC Revenue Requirement

CalAm's service company revenue requirement consists of the following components:

- Distribution of projected AWSC management fees to CalAm, and

- Distribution of projected AWSC Business Transformation expenditures (classified by AWSC as capital fees) to CalAm's rate base.

Most of the discussion in this chapter concerns the management fee component of AWSC's costs charged to operating expense in CalAm's General Office revenue requirement. CalAm calculated its requested distribution of AWSC management fees to California as follows:[52]

[52] Information about CalAm's AWSC revenue requirement calculation was derived from CalAm's AWSC Revenue Requirement Workbook file (a MS Excel file containing numerous worksheets). Printed versions of certain worksheets from this workbook were filed as work papers in the rate case, but the workbook itself, which contains the formulas and other logic needed to understand the calculations, was not filed. We obtained a redacted, electronic version of the file from David Stephenson in December, 2010.

- CalAm began with a 2010 service company budget.

- CalAm made ratemaking adjustments to 2010 budgeted amounts prior to allocation or assignment to California. These adjustments consist of 1) removal of the management fee (expense) component of Business Transformation from allocable expense; 2) reversal of a "corporate vacancy adjustment" (an expense offset that offsets labor expense budgeted for positions that are vacant) and 3) addition of certain unspecified "Admin" expenses, based on amounts incurred in 2009.[53]

- CalAm allocated approximately 5.3 percent of the ratemaking-adjusted AWSC budgeted 2010 management fees to non-regulated activities.[54] The remaining ~~95~~94.7 percent is CalAm's calculation of AWSC management fees~~the amounts~~ attributable to the regulated state operating companies.

- CalAm's requested revenue requirement is based on a distribution of ~~distributed~~ 5.3 percent of total service company management fees (5.6 percent of regulated service company management fees) to California regulated operations.[55] The 2010 service company budget reflects a 5.1 percent allocation of total service company management fees (5.4 percent of regulated management fees) to California regulated operations.[56] CalAm's ~~relative~~ requested distribution to California is higher by about two-tenths of a percent because CalAm used 2009 management fee distributions, rather than those reflected in the 2010 budget. Excluding the Non-Departmental and Business Transformation categories (which are ratemaking adjusted), CalAm's use of 2009 instead of 2010 budgeted management fee distributions increases 2010 management fees charged to California by approximately $3~~53~~40,000.[57]

- CalAm applied inflation factors to 2010-requested management fees to calculate requested management fees for 2011, 2012 and 2013.

One of the important worksheets in this file (that was not, to our knowledge, filed as a work paper) is the 2010 AWSC budget, which contains the AWSC budget accounting detail and forms the basis of CalAm's base period (2010) AWSC revenue requirement.

[53] In addition, CalAm is "not requesting" recovery of $8,891 of $12,119,128 it calculates to be attributable to CalAm for 2010.

[54] CalAm's AWSC revenue requirement workbook shows $12.2 million (5.3 percent) out of $229.9 million in total base period (2010) AWSC management fee expense charged to the non-regulated category.

[55] CalAm AWSC revenue requirement workbook, provided to Overland by David Stephenson in December, 2010

[56] Regulated management fees are allocated to the state operating companies primarily using relative levels of customers. CalAm had 171,854 water and wastewater customers at the end of 2009, 5.1 percent of AW's 3,326,844 regulated customers (Response to OC-27) .

[57] CalAm allocation, 2010 budget, (without Business Transformation or "Non-Departmental"), $11.57 million / $225.2 million = 5.14 percent. CalAm allocation per CalAm's AWSC revenue requirement workbook (without Business Transformation or "Non-Departmental"): $12.04 million / $227.6 million = 5.29 percent. (5.29 percent – 5.14 percent) x $227.6 million = $0.34 million.

The following table summarizes the progression from AWSC's 2010 budget to CalAm's requested 2010 service company management fees.

Table 3-2

American Water Service Company Derivation of CalAm's Service Company Management Fee Request Based from 2010 Service Company Budgeted Amounts							
Rate Filing Category	1 2010 Budgeted Management Fees	2. Company Ratemaking Adjustments	3. Total 2010 Mgt. Fees - As Requested	4. Non-Regulated Management Fees	5. Total Regulated 2010 Mgt. Fees - As Requested	6. Mgt Fee Distributed to CalAm - As Requested (1)	7. Requested California Share of Total Mgt Fees
Non-Departmental	(2,470,534)	4,745,794	2,275,260	862,330	1,412,930	79,596	3.50%
Audit	1,966,736		1,966,736	167,441	1,799,295	92,540	4.71%
Business Development	4,224,638		4,224,638	1,234,997	2,989,640	130,431	3.09%
Business Transformation	1,530,805	(1,530,805)	-		-		
External Affairs/Comm.	8,872,083		8,872,083	572,997	8,299,086	713,679	8.04%
Finance	21,135,654		21,135,654	946,960	20,188,694	968,626	4.58%
Human Resources	11,610,117		11,610,117	858,304	10,751,814	624,138	5.38%
Investor Relations	1,244,595		1,244,595	592,501	652,095	33,466	2.69%
Legal	8,890,808		8,890,808	503,575	8,387,234	660,876	7.43%
Operation Services	8,204,279		8,204,279	509,698	7,694,581	577,470	7.04%
Property	11,931,823		11,931,823	1,434,392	10,497,431	571,631	4.79%
Regulated Operations	18,135,994		18,135,994	676,324	17,459,670	808,641	4.46%
Regulatory Services	724,507		724,507	52,106	672,401	34,539	4.77%
Belleville Laboratory	5,471,057		5,471,057	-	5,471,057	286,588	5.24%
Benefit Svc Ctr	1,652,892		1,652,892	195,114	1,457,778	80,254	4.86%
Call Center	49,847,123		49,847,123	783,393	49,063,730	2,544,316	5.10%
ITS	51,695,115		51,695,115	488,883	51,206,232	2,663,411	5.15%
Shared Services	19,545,216		19,545,216	2,319,453	17,225,763	1,095,053	5.60%
Supply Chain	2,478,616		2,478,616	37,260	2,441,356	153,872	6.21%
Total	226,691,526	3,214,989	229,906,514	12,235,728	217,670,787	12,119,128	5.27%
(1) Of the $12,119,128 total, CalAm indicates it is "not requesting" $8,891. Most of this is External Affairs expense.							
Source: CalAm AWSC revenue requirement workbook, based on 2010 AWSC budget. Col.1: "Budget 2010" sheet, Col.2: Calculated difference, Col1 - Col.3, Cols.3-6: "SC WP 102R" sheet, Col.7: Col.6 / Col.3.							

CalAm's Ratemaking Adjustments

The "Non-Departmental" ratemaking adjustment in the "Company Ratemaking Adjustments" column above includes two items: 1) removal of a $2,470,534 credit amount, the "majority" of which is related to corporate vacancies and 2) the addition of unbudgeted "Admin" expenses from 2009.[58] As shown in the table above, CalAm distributed $862,330 of the Non-Departmental / Admin expenses to non-regulated activities, leaving a regulated expense distribution of $1.412.930. CalAm does not describe these expenses, the activities that gave rise to them, why they are "non-departmental" or why they are not included in the 2010 budget, which is the basis for all other 2010 service company costs charged to California.

The other adjustment, removing Business Transformation expenses from the service company revenue requirement, is consistent with CalAm's request to capitalize BT costs and recover them through a projected test year rate base for California Corporation.

[58] OC-142 and OC-158

Assignments and Allocations to Non-Regulated Businesses and Activities

AWSC allocates certain expenses to non-regulated businesses and activities. CalAm's requested service company management fees are based on a non-regulated distribution of $12.2 million, about 5.3 percent of the ratemaking-adjusted 2010 AWSC budget. Like regulated allocations, this amount reflects 2009 actual assignments and allocations to non-regulated businesses, rather than 2010 budget relationships. ~~AWSC cost distributions to non-regulated businesses, as reflected in the 2010 budget, are summarized below.[59]~~

Overland did not conduct an audit of non-regulated activities or allocations.[60] In the prior rate case we found certain non-regulated activities had not been recognized or properly distributed to non-regulated cost objectives~~activities~~. Documentation shows that since the last rate case AW has conducted a review of its service company allocation process and developed a new set of non-regulated, or "Tier 1", allocation procedures.

In Decision 09-07-021 the Commission stated:

> CalAm bears the burden of convincingly demonstrating that it has allocated costs consistent with our principles. CalAm's presentation in this proceeding has not met that standard. We will rely on DRA's non-regulated allocation calculated from the SEC filing because that filing is the best evidence before us.[61]

As a result of this finding, the Commission reduced California's share of service company allocations by $716,334.

In Decision 10-06-003, responding to CalAm's Petition to modify the 2009 decision, the Commission redistributed the service company allocation it had previously distributed to non-regulated cost objectives~~activities~~ back to CalAm.

In reviewing the current service company revenue requirement, Overland did not make ratemaking adjustments to AWSC's "Tier 1" (non-regulated vs. regulated) allocations or direct charges because we did not audit them. The lack of ratemaking adjustments to AWSC's non-regulated cost distributions should not be mistaken for a conclusion that current allocation procedures result in a proper distribution of costs. To put this in perspective, it is useful to note that while non-regulated activities account for

~~[59] CalAm's 2010 Service Company Revenue Requirement Workbook, 'Budget 2010' Worksheet.~~

[60] We conducted a high-level analysis of the corporate organization and its regulated and non-regulated components. Based on this, and taking into account of the complexities of the non-regulated, or "Tier 1" allocation process, we determined that the potential impact on CalAm's revenue requirement of lower-than-required cost distributions to non-regulated activities was not significant enough to justify the several weeks of effort necessary to conduct a review of the process and nearly 50 different allocators.

[61] Decision 09-07-021, p.109

approximately 10 percent of AW's revenue, the distribution of AWSC's cost to non-regulated entities is only about 5 percent.

AWSC's Organization and Functions

AWSC provides corporate management and operating services for the state-based regulated water companies. Budgeted and actual year-end employees, by rate filing category (function), are summarized in the following table.[62]

Table 3-3

American Water Service Company Full-Time Equivalent Employees by Function (Rate Filing Category)					
Rate Filing Category	Budgeted Employees		Actual Employees		
	2009	2010	Dec-08	Dec-09	Dec-10
Non-Departmental	-	-	1	1	1
Audit	10	9	7	10	8
Business Development	62	14	16	12	16
Business Transformation	-	14	6	13	83
External Affairs /Comm.	39	35	31	32	31
Finance	150	109	131	138	93
Human Resources	70	50	43	49	44
Investor Relations	3	3	3	3	3
Legal	45	37	35	37	27
Operation Services	116	76	80	75	68
Property	12	11	11	11	10
Regulated Operations	103	121	131	119	112
Regulatory Services	2	2	2	2	2
Belleville Laboratory	36	34	36	35	32
Benefits Services Ctr	16	15	14	15	14
Cust. Svc - Call Centers	645	702	711	623	611
ITS	198	193	176	169	161
Shared Services Center	196	185	183	185	170
Supply Chain	37	33	36	33	30
Total	1,740	1,642	1,652	1,561	1,514
Source: Responses to OC-14, OC-18, OC-91 and OC-133					

To summarize the table:

- Actual employees at the end of years 2009 and 2010 averaged 91 percent of budgeted (authorized) positions for the year (89.~~6~~7 percent for 2009 and 92.2 percent for 2010), suggesting that, on average, about 9 percent of AWSC's budgeted positions do not represent actual employees. We found a similar relationship between AWSC's budgeted positions and actual employees in the

[62] The table excludes five AWSC employees dedicated to American Water Enterprises, an unregulated subsidiary.

prior rate case.

- Overall, service company employee counts are declining. Between year-end 2008 and year-end 2010, AWSC lost 138 FTEs, or 8.4 percent of its workforce.

- The only function that added significant employees was Business Transformation (BT), which added 77 FTEs in 2009 and 2010, most near the end of 2010. More than half (46) of the employees added by BT were transferred to BT from other service company departments. 21 of these were transferred from Information Technology Services (ITS). Another 15 transferred to AWSC and to BT from AW's state operating companies, and the rest were new hires. Most of the transfers and new hires occurred in the third and fourth quarters of 2010.

- The Finance function lost a significant number of employees in 2010, declining from 138 to 93 FTEs.

- The Customer Service Call Center lost 88 FTEs in 2009, and another 12 in 2010. Of the decline in 2010, five were transfers to Business Transformation.

AWSC Costs by Type of Cost

The table below summarizes AWSC's 2009 and 2010 budgeted and actual costs by type of cost.[63] It shows total spend, which includes costs billed as "management fees" (charged to CalAm operating expense), and costs billed as "capital fees" (charged to CalAm through rate base).

[63] Actual costs for 2010 are based on costs incurred through the third quarter, annualized. Costs for the year 2010 became available on or around January 10, 2011, by CalAm declined our request to provide them.

Table 3-4

American Water Service Company Service Company Total Spend				
Description	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Labor & Labor-Related				
Salaries and Wages	$ 109,605,610	$ 100,944,751	$ 104,191,671	$ 98,857,618
Incentive Comp	17,102,393	13,764,704	17,556,529	19,408,899
Payroll Taxes	9,219,688	8,107,930	8,735,280	8,378,710
Group Insurance	19,753,603	15,001,396	15,696,879	14,686,162
Pension & PBOP	24,268,107	22,969,978	20,617,357	18,275,321
DCP & 401K	4,714,848	3,876,320	4,349,781	4,168,184
Subtotal Labor & Labor-Related	184,664,249	164,665,079	171,147,497	163,774,894
Non-Labor				
Outside Services	15,474,644	18,533,451	51,781,430	24,904,526
Rents & Transportation	13,859,951	13,120,010	12,843,180	12,027,646
Other Insurance	3,536,564	2,888,049	3,109,810	2,417,401
Other Employee Benefits	3,332,000	3,845,547	1,382,180	3,442,417
Depreciation	19,395,626	21,704,680	27,617,285	30,626,126
General Office & Other	23,633,200	23,455,172	91,391,561	37,089,521
Subtotal Non-Labor	79,231,985	83,546,908	188,125,446	110,507,637
Total	$ 263,896,234	$ 248,211,987	$ 359,272,943	$ 274,282,531

Sources: CalAm Revenue Requirement Workbook, OC-72, and OC-135.

Labor and Labor-Related Costs

- <u>Salaries & Wages</u> include salaries and regular and overtime wages.

- <u>Incentive Compensation</u> includes the Annual Incentive Plan (AIP - variable pay for which most management employees are eligible), and equity-based incentive pay, including stock options and restricted stock units.

- <u>Payroll Taxes</u> includes Social Security (FICA), Medicare and federal and state unemployment (FUTA and SUTA) taxes.

- <u>Group Insurance</u> includes the costs of employee medical and life insurance plans.

- <u>Pensions & Other Post-Retirement Benefits</u> include the costs of the defined benefit pension plan, and the cost of post-retirement medical and life insurance.

Non-Labor Costs

- <u>Outside Services</u> include contracted services (audit, legal, information technology and consulting services) and temporary labor.

- <u>Other Insurance</u> includes property, workers compensation, general liability, directors and officers and other types of insurance (other than employee and retiree medical and life insurance).

- Rents include leases on buildings and equipment. We have also included interest expense in this category, as it consists primarily of the interest component of capital leases on buildings.

- Transportation includes leases on vehicles, and fuel, maintenance and other costs related to these vehicles.

- General Taxes include property taxes, other miscellaneous taxes, and federal and state income tax accruals. The income tax accruals are not included in the 2009 or 2010 budgeted amounts and they net nearly to zero in the actual data.

- General Office & Other includes everything else: employee expenses, utilities (telephone, cell phone, electricity), maintenance of computers and other equipment, software licenses, office supplies, postage, employee relocation, advertising, security and janitorial services, “community relations,” dues, association memberships and charitable contributions. The company removed small amounts of budgeted association memberships and contributions from its revenue requirement. This category also includes “gains and other non-operating revenues.” These are actually losses in 2010. However, they are not budgeted and therefore not included in the company’s requested revenue requirement.

Recommendations – Analysis by Type of Cost

Our analysis of AWSC’s costs by cost type showed labor and several related expenses tied to headcount, and employee travel expenses contained significant budget cushions (amounts that were budgeted, but not spent in 2009 or 2010). ~~Employee travel and transportation expenses are another category in which AWSC appears to build a cushion into departmental (business unit) budgets.~~ As discussed in Chapter 2, we recommend the following adjustments to ensure that California customers are not required to pay budgeted amounts that do not represent reasonable projections of actual incurred expense.

- Adjustment to annualize base period labor and labor related expenses based on actual employees at year-end 2010, rather than authorized employees. As discussed elsewhere, and as demonstrated by the force levels shown in table 3-3 above, AWSC had an on-going force level vacancy rate averaging about 9 percent during the years 2009 and 2010. Customers should not be required to pay CalAm for non-existent employees.

- Adjustment to base period employee expenses to reflect actual, rather than budgeted 2010 expenses. As shown in the following table, employee expenses are a second category of cost which shows an on-going, significant percentage difference between actual costs incurred and amounts budgeted.

Table 3-5

American Water Service Company Employee Expenses (including M&E) by Function - Total Spend (Capital + Mgt. Fees)				
Function (Rate Filing Category)	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Non-Departmental (Admin)	$ -	$ -	$ -	$ 8,715
Audit	238,680	39,217	167,976	29,227
Business Development	333,800	206,409	270,558	123,374
Business Transformation	-	264,976	977,050	343,621
External Affairs/Communication	487,245	354,976	574,056	369,295
Finance	809,179	382,135	817,866	398,763
Human Resources	552,046	406,871	634,868	402,030
Investor Relations	187,000	92,049	299,502	86,474
Legal	331,720	175,945	339,928	240,989
Operation Services	1,072,973	706,885	932,048	878,338
Property	2,200	4,315	2,240	4,619
Regulated Operations	1,027,760	630,942	914,734	404,398
Regulatory Services	42,056	47,446	60,700	40,604
Laboratory	39,287	16,107	30,000	17,676
Benefit Svc Ctr	23,000	3,492	16,830	3,375
CSC	191,405	117,350	283,175	182,782
ITS	998,238	636,353	916,632	773,289
SSC	218,175	95,891	213,912	154,363
Procurement	164,442	36,060	156,345	59,413
Total	$ 6,719,207	$ 4,217,418	$ 7,608,419	$ 4,521,345
Actual Pct. Of Budget		62.77%		59.43%
Sources: CalAm Revenue Req. Workbook, OC-72 and OC-135				

As the table demonstrates, AWSC incurred only about 60 percent of the employee expenses budgeted in 2009 and 2010. This pattern runs through nearly all functions.

Customers should not be required to pay for employee expenses more two-thirds higher than the amount~~s~~ incurred ($4.52 million actual X 1.68 = $7.61 million requested).

Analysis of AWSC Costs by Function (Rate Filing Category)

The following is a discussion of AWSC's 2009 and 2010 budgeted and actual staffing levels and expenses according to CalAm's "rate filing category" cost classification. Smaller, less significant categories that did not present audit or ratemaking issues are not separately discussed.

Non-Departmental ("Admin" Rate Filing Category)

The Non-Departmental function consists of Business Unit 32098. CalAm stated that the "majority of [the budgeted amount] represents a negative amount for [corporate staffing] vacancies."[64]

For purposes of calculating the revenue requirement attributable to California, CalAm reversed the $2,470,534 expense credit and replaced it with a positive expense of $2,275,260, representing "Admin" expense incurred in 2009. This adjustment increased expense by $4,745,754 (from negative $2,470,534 to positive $2,275,260).[65] The only thing we learned about the "Admin" amounts is that they consist of charges to a variety of accounts, the top five of which (in terms of absolute value), with the descriptions provided by CalAm, are summarized as follows[66]:

- Account 722306 – Gains Other Non-OR $624,617 [In this case, a debit (loss)]
- Account 501200 – Labor $498,942
- Account 534999 – General Overhead $454,587
- Account 504500 – Other Welfare Maint. $266,088
- Account 508200 – Empl. Stock Purch.~~-~~Plan $177,758

As noted above, these costs were incurred in 2009 and are apparently not part of the 2010 budget. The amount associated with labor may be associated with the "non-budgeted" External Affairs employee, who shows up in AWSC's staffing roster as a Director – External Affairs. In the prior case, a similar (probably the same) individual appeared in the "Non-Departmental" category. We recommended then, as we do now, that this individual not be funded in revenue requirements because the Company would not disclose his duties or how they related to the provision of reasonable and necessary regulated services. We believe the individual in business unit 32098 is likely the same individual. CalAm has not provided information as to the nature of the amount in "Gains – Other Non-OR." Since it is a debit amount, it is a loss, rather than a gain.

[64] OC-142-A
[65] OC-187 and OC-142-A
[66] OC-142-A

Table 3-6

AWSC "Non-Departmental" Staffing (FTEs)						
Business Unit		Actual				Budget
No.	Description	Dec '07	Dec '08	Dec '09	Dec '10	2010
32098	CORP-Non-Departmental	1	1	1	1	0
Total - Non-Departmental		1	1	1	1	0
Sources: OC-14, OC-18, OC-91 and OC-133, Prior Overland Report & Workpapers, Sept. 11, 2008.						

Budgeted and actual Non-Departmental amounts for 2009 and 2010 are summarized below. Note that these are not the same as the "Admin" amounts CalAm has requested in this case.~~ 2010 actual amounts are projected based on data for the first three quarters (as CalAm declined to provide data for the 12 months ending December 31, 2010).~~

Table 3-7

American Water Service Company Non-Departmental Total Spend				
Description	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Labor & Labor-Related				
Salaries and Wages	$ (1,853,346)	$ -	$ (1,588,609)	$ 651,337
Incentive Comp	(282,583)	30,533	(273,268)	282,403
Payroll Taxes	708,698	(19,323)	(124,765)	49,175
Group Insurance	(263,497)	(47,786)	(193,359)	58,841
Pension & PBOP	-	-	-	229,000
DCP & 401K	(85,145)	4	(68,925)	14,372
Subtotal Labor & Labor-Related	(1,775,873)	(36,572)	(2,248,926)	1,285,128
Non-Labor				
Outside Services	-	(6,444)	-	49,348
Rents & Transportation	-	-	-	(1,639)
Other Insurance	-	203,826	86,880	(103,393)
Other Employee Benefits	-	232,930	-	202,582
Depreciation	548,134	214,913	188,215	(13)
General Office & Other	(1,843,823)	746,532	(506,369)	504,644
Subtotal Non-Labor	(1,295,689)	1,391,757	(231,273)	651,529
Total	$ (3,071,562)	$ 1,355,186	$ (2,480,199)	$ 1,936,657
Sources: CalAm Revenue Requirement Workbook, OC-72, and OC-135.				

Allocations of Non-Departmental / Admin to Regulated Expense and to CalAm

Budgeted Non-Departmental costs are summarized below.

Table 3-8

2010 Budgeted Cost Distributions to CalAm Non-Departmental	
Item	Amount
Total Spend	(2,480,199)
Subtract: Capital Fees	(9,665)
Management Fees	(2,470,534)
Subtract: Allocation to Non-Reg	(205,301)
Regulated Management Fees	(2,265,232)
Management Fee Distribution to CalAm	(116,609)
CalAm Composite Pct. of Total Mgt. Fee	4.72%
CalAm Composite Pct. of Reg. Mgt. Fee	5.15%
Source: CalAm's AWSC revenue req. workbook, "Budget 2010" sheet	

CalAm removed the net-negative expense in the Non-Departmental category from the revenue requirement and replaced it with 2009 “Admin” costs. These costs, as requested by CalAm, are summarized in the following table.

Table 3-9

Revenue Requirement Cost Distributions to CalAm "Admin"	
Item	Amount
Total Spend	Unknown
Subtract: Capital Fees	Unknown
Management Fees	2,275,260
Subtract: Allocation to Non-Reg	862,330
Regulated Management Fees	1,412,929
Management Fee Distribution to CalAm	79,596
CalAm Composite Pct. of Total Mgt. Fee	3.50%
CalAm Composite Pct. of Reg. Mgt. Fee	5.63%
Source: CalAm's AWSC revenue req. workbook, "Budget 2010" sheet	

Recommendations - Non-Departmental / Admin

CalAm’s testimony does not discuss or justify the inclusion of Admin costs in the revenue requirement. Response to data request OC-142 does not describe the nature of these costs or why they should be recovered from CalAm’s customers. As discussed above, we believe $624,000 in “other” losses may not be recoverable from CalAm customers and they relate to an historical period, rather than the projected test period. It also appears that Admin labor expense may include the cost of the ~~consists of the~~ same ~~“~~“non-departmental” External Affairs Director that CalAm declined to explain in the last rate case. As CalAm has not explained what Admin costs are or why they are reasonable and necessary for the provision of regulated water service, we recommend no recovery of the expenses in this category from California customers.

Business Development

The Business Development function is responsible for developing new business opportunities. The position description for Director - Business Development states that "[t]his includes contacting municipal and privately owned water and wastewater operations to discuss acquisition, potential operations and management contracts, negotiate sales for resale contracts and develop other related business."[67] 2009 and 2010 Business Development budgeted and actual costs are summarized below.

Table 3-10

American Water Service Company Business Development Total Spend				
Description	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Labor & Labor-Related				
Salaries and Wages	$ 3,496,575	$ 1,656,522	$ 1,975,832	$ 1,849,289
Incentive Comp	1,007,807	358,196	704,537	649,080
Payroll Taxes	224,051	124,229	143,338	141,440
Group Insurance	309,052	156,280	154,451	149,613
Pension & PBOP	778,921	394,492	273,349	231,499
DCP & 401K	168,697	89,960	99,100	99,782
Subtotal Labor & Labor-Related	5,985,103	2,779,678	3,350,607	3,120,703
Non-Labor				
Outside Services	339,504	374,316	340,067	53,183
Rents & Transportation	31,800	55,231	40,663	31,306
Other Insurance	112,161	71,774	56,584	47,183
Other Employee Benefits	46,875	97,852	-	381,098
Depreciation	-	-	-	-
General Office & Other	513,593	400,379	527,324	353,318
Subtotal Non-Labor	1,043,933	999,553	964,638	866,088
Total	$ 7,029,036	$ 3,779,231	$ 4,315,244	$ 3,986,791
Sources: CalAm Revenue Requirement Workbook, OC-72, and OC-135.				

Labor and Labor Related Costs – In the last rate case Business Development staffing assigned to California originated mainly from a group of Western Regional employees. That group no longer works for the AWSC. The primary source of cost in the 2010 budget is a group of corporate employees. As shown below, total staffing at year end 2010 exceeded 2010 budgeted staffing by two FTEs.

Table 3-11

AWSC Business Development Staffing (FTEs)						
Business Unit		Actual				Budget
No.	Description	Dec '07	Dec '08	Dec '09	Dec '10	2010
032020	CORP-Corporate Bus Development	6	5	7	11	9
033020	WE-Business Development	5	4	0	0	0
033520	CE-Business Development	0	4	3	2	3
035020	SE-Business Development	0	3	2	3	2
Total Business Development		11	16	12	16	14
Sources: OC-14, OC-18, OC-91 and OC-133, Prior Overland Report & Workpapers, Sept. 11, 2008.						

Non-Labor Costs – In 2009 actual costs were close to budget. Actual costs were somewhat ~~costs are estimated to be significantly~~ below budget for 2010, primarily due to lower-than-budgeted outside services and general office expenses, offset by "other

[67] OC-22, p.205 of 1377

employee benefits" that were not budgeted.[68] ~~Outside services in 2010 are a small fraction of what was budgeted~~. ~~Employee training and employee travel expenses are significantly below budget for 2010~~.

Allocations of Business Development Costs to CalAm

The table below summarizes 2010 budgeted Business Development costs and their allocation to CalAm.

Table 3-12

2010 Budgeted Cost Distributions to CalAm Business Development	
Item	Amount
Total Spend	4,315,244
Subtract: Capital Fees	90,607
Management Fees	4,224,638
Subtract: Allocation to Non-Reg	1,214,865
Regulated Management Fees	3,009,772
Management Fee Distribution to CalAm	87,242
CalAm Composite Pct. of Total Mgt. Fee	2.07%
CalAm Composite Pct. of Reg. Mgt. Fee	2.90%
Source: CalAm's AWSC revenue req. workbook, "Budget 2010" sheet	

The Company's revenue requirement request is somewhat higher; specifically, it requests 2010 rate recovery of $130,431 (4.36% of a regulated management fee of $2,989,640 and 3.09% of the total management fee of $4,224,638). As noted, CalAm's requested allocations are not based on 2010 budget relationships.

Recommendations – Business Development

Consistent with the prior rate order, and as discussed in Chapter 2, Overland does not recommend the recovery of Business Development management fees from California customers. As with other AWSC functions, we calculated labor and labor-related expenses based on year-end 2010 staffing levels, but adjusted all pro-forma 2010 Business Development expense out of the service company management fee recommended for recovery from California customers.

Business Transformation

[68] $381,098 in unbudgeted other employee benefits appears to be severance pay, suggesting Business Development may have fewer employees in 2011 than it had in 2010.

The Business Transformation (BT) function is associated with a major systems retooling effort by AWSC that began ramping up at the end of 2010. The plan calls for replacing more than two dozen separate information system modules, including the general ledger and related systems (accounts payable, financial reporting, etc.), customer information, call handling, service billing, workforce management, asset management, and geographic information. Many of the existing system modules are being replaced with SAP-based systems. Accenture, an outside consultant, will be a major facilitator. 2009 and 2010 BT costs are summarized below.

Table 3-13

American Water Service Company Business Transformation Total Spend				
Description	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Labor & Labor-Related				
Salaries and Wages	$ -	$ 1,310,489	$ 1,597,431	$ 2,388,155
Incentive Comp	-	436,734	590,010	853,132
Payroll Taxes	-	85,385	119,139	147,696
Group Insurance	-	101,609	127,483	154,459
Pension & PBOP	-	165,198	300,625	254,600
DCP & 401K	-	74,785	69,952	151,127
Subtotal Labor & Labor-Related	-	2,174,201	2,804,641	3,949,169
Non-Labor				
Outside Services	-	2,914,423	39,403,562	9,467,162
Rents & Transportation	-	26,244	282,504	295,595
Other Insurance	-	34,271	41,597	34,684
Other Employee Benefits	-	128,306	-	19,662
Depreciation	-	8,489	138,000	149,631
General Office & Other	-	404,903	64,250,950	13,220,783
Subtotal Non-Labor	-	3,516,636	104,116,613	23,187,517
Total	$ -	$ 5,690,837	$ 106,921,253	$ 27,136,686
Sources: CalAm Revenue Requirement Workbook, OC-72, and OC-135.				

As shown in the table below, most of AWSC's BT costs are charged through capital fees. CalAm's request to recover BT is included in rate base. The small BT management fee, although charged only to CalAm and Illinois American water subsidiaries, is not included in CalAm's service company revenue requirement request.[69]

[69] OC-226 seeks information as to why there is a management fee (as opposed to a capital fee) for BT and why it is charged only to CalAm and Illinois American.

Table 3-14

2010 Budgeted Cost Distributions to CalAm Business Transformation	
Item	Amount
Total Spend	106,921,253
Subtract: Capital Fees	105,390,448
Management Fees	1,530,805
Subtract: Allocation to Non-Reg	-
Regulated Management Fees	1,530,805
Management Fee Distribution to CalAm	546,329
CalAm Composite Pct. of Total Mgt. Fee	35.69%
CalAm Composite Pct. of Reg. Mgt. Fee	35.69%
Source: CalAm's AWSC revenue req. workbook, "Budget 2010" sheet	

CalAm's BT rate base request flows through the CalCorp~~ifornia Corporation~~ portion of the General Office revenue requirement. The recovery of BT costs is discussed in more detail Chapter 4. During 2010, AWSC transferred a number of people from other service company functions into BT. This affected year end staffing in the service company and will affect the costs included in CalAm's rate base. The impact of these transfers on labor levels and on our recommended 2010 labor expense is discussed in Chapter 2.

Recommendations – Business Transformation

As discussed in a separate chapter, DRA recommends that Business Transformation be removed from CalAm's revenue requirement because CalAm has not demonstrated how it will produce benefits for customers that exceed the costs CalAm requests for customer funding. Overland has calculated an adjustment to remove forecasted BT construction work in progress and plant from forecast period rate base and to remove associated depreciation expense.

External Affairs / Communications

This function manages government relationships, corporate marketing, external and internal communications and corporate social responsibility.

Table 3-15

American Water Service Company External Affairs / Communications Total Spend				
Description	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Labor & Labor-Related				
Salaries and Wages	$ 3,639,331	$ 3,244,920	$ 3,483,291	$ 3,353,366
Incentive Comp	993,786	868,342	1,116,533	1,094,174
Payroll Taxes	256,482	243,484	274,487	278,756
Group Insurance	422,371	312,862	333,418	307,420
Pension & PBOP	760,140	521,816	596,485	505,167
DCP & 401K	220,098	172,974	156,552	173,889
Subtotal Labor & Labor-Related	6,292,208	5,364,396	5,960,765	5,712,772
Non-Labor				
Outside Services	862,740	954,354	931,800	1,013,528
Rents & Transportation	55,200	76,251	64,894	46,614
Other Insurance	111,972	87,945	97,621	81,402
Other Employee Benefits	147,820	227,822	55,657	428,485
Depreciation	15,233	44,507	51,048	47,188
General Office & Other	1,981,519	1,479,611	1,940,590	1,496,980
Subtotal Non-Labor	3,174,484	2,870,490	3,141,610	3,114,197
Total	$ 9,466,692	$ 8,234,886	$ 9,102,375	$ 8,826,969
Sources: CalAm Revenue Requirement Workbook, OC-72, and OC-135.				

Labor & Labor-Related Costs - Actual labor and labor-related expense for the overall category was ~~87~~85 percent of budgeted expense in 2009 and ~~is estimated to be~~ 96 percent of budget for 2010. Overall staffing levels have been stable since 2008. We did not have sufficient data on the regional business units to compare overall staffing back to 2007. However, it does not appear that employees in the "CE", "SE" and "NE" regional External Affairs departments allocate or charge material amounts of cost to CalAm.

Table 3-16

AWSC External Affairs / Communications Staffing (FTEs)						
Business Unit		Actual				Budget
No.	Description	Dec '07	Dec '08	Dec '09	Dec '10	2010
032022	CORP-Government Affairs	1	1	1	1	1
032025	CORP-External Affairs	2	2	2	2	2
032068	CORP-Marketing	5	6	6	6	7
032085	CORP-External Communications	4	3	3	3	3
032086	CORP-Internal Communications	2	2	2	2	3
032087	CORP-Corp Social Resp	0	0	1	1	1
033025	WE-External Affairs	2	4	4	3	3
033525	CE-External Affairs	unknown	7	8	7	9
035025	SE-External Affairs	unknown	4	3	4	4
036525	NE-External Affairs	unknown	2	2	2	2
Total External Affairs / Communications		16	31	32	31	35
Sources: OC-14, OC-18, OC-91 and OC-133, Prior Overland Report & Workpapers, Sept. 11, 2008.						

Non-Labor Costs – Actual non-labor costs were ~~87~~90 percent of budget in 2009 and ~~are~~ 99 percent of budget in 2010. ~~In both years, the variance is explained by primarily~~ There was over-budgeting of 1) employee expenses, 2) dues, ~~and~~ community relations and other donations and marketing expenses such as advertising costs, brochures and trade show expenses in both years, offset by higher-than-budgeted "other employee benefits" in 2010. Employee expenses were over-budgeted in both 2009 and 2010 for many business units. -The other over-budgeted items are unique to External Affairs.

Allocations of External Affairs / Communications Costs to CalAm

The table below summarizes 2010 budgeted External Affairs functional costs and their allocation to CalAm.

Table 3-17

2010 Budgeted Cost Distributions to CalAm External Affairs/Communication	
Item	Amount
Total Spend	9,102,375
Subtract: Capital Fees	230,292
Management Fees	8,872,083
Subtract: Allocation to Non-Reg	506,179
Regulated Management Fees	8,365,904
Management Fee Distribution to CalAm	742,266
CalAm Composite Pct. of Total Mgt. Fee	8.37%
CalAm Composite Pct. of Reg. Mgt. Fee	8.87%
Source: CalAm's AWSC revenue req. workbook, "Budget 2010" sheet	

Because the allocation relationships are different than the 2010 budget, CalAm's revenue requirement calculation recommends a California distribution of $713,679 (8.5 percent of the regulated management fee). One of the reasons that CalAm's composite distribution of regulated External Affairs expense is significantly higher than its 5.1 percent share of regulated customers is a large direct charge. This can be seen in CalAm's workpaper SC WP 102R as a direct assignment of $118,766 to California. The amounts in this workpaper are based on actual amounts directly charged in the same business units in 2009.

We asked CalAm for a full description of the External Affairs costs directly charged to California in 2009 (which became the basis for the amounts in CalAm's revenue requirement and in the 2010 budget).[70] Following is a complete copy of the detail provided in the response for this item. Note that it does not describe the nature of charges:

Function	Formula	Description	Direct Charge	Cell#
External Affairs/ Communication	100022	CO 05 (CA) DIR CHG EXP	105,802	R12

[70] OC-165-B

Even without the direct charge, CalAm's share of External Affairs expense charged to regulated operating companies is approximately 7.1 percent, which is still significantly higher than CalAm's 5.1 percent customer share.

Recommendations – External Affairs / Communications

As discussed in Chapter 2, Adjustment Summary, Overland recommends the removal of expenses associated with the Government Affairs component of the External Affairs rate filing category. Government Affairs' primary purpose~~s~~ is to track and influence legislation. Such expenses are normally funded by shareholders, not customers. A similar adjustment was made and adopted by the Commission in the prior rate case.

As discussed in Chapter 2, recovery of charitable contributions, corporate social responsibility and corporate marketing and advertising were also removed in the prior rate case and the adjustments were adopted by the Commission, as such expenses have not traditionally been recovered from customers in California. We recommend similar adjustments in this case.

Finance

AWSC's Finance category consists of the following functions:

- Corporate Finance secures debt and equity financing.

- Corporate Treasury is responsible for obtaining debt capital and compliance with debt covenants.

- Corporate Accounting and Income Tax are responsible for researching accounting and tax issues and monitoring compliance with GAAP and tax requirements. Corporate Accounting and Tax should not be confused with their transactionally-oriented counterpart~~s~~ expenses in the Shared Services Center.

- Planning, Reporting, Budgeting, Reporting and Compliance departments coordinate budgeting, financial forecasting and reports and explain internal operating results. They are also responsible for compliance with Sarbanes Oxley requirements.

- Regional (Western, Central, etc.) departments "interact with the state operating companies in the areas of Rates and Regulation, Planning, Budgeting and Forecasting, and Capital Compliance."[71]

[71] CalAm Testimony of Stephenson, p.68

Table 3-18

American Water Service Company Finance Total Spend				
Description	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Labor & Labor-Related				
Salaries and Wages	$ 14,295,416	$ 13,253,012	$ 11,840,986	$ 10,279,246
Incentive Comp	2,564,183	2,292,505	2,677,131	2,256,084
Payroll Taxes	1,026,630	1,013,406	937,611	866,543
Group Insurance	1,680,117	1,304,114	1,157,155	1,071,000
Pension & PBOP	2,998,549	2,256,349	1,809,025	1,532,841
DCP & 401K	770,718	758,009	589,032	639,155
Subtotal Labor & Labor-Related	23,335,613	20,877,395	19,010,940	16,644,869
Non-Labor				
Outside Services	2,261,424	3,466,260	2,092,359	3,314,951
Rents & Transportation	72,816	92,930	37,898	54,969
Other Insurance	444,911	352,389	339,591	283,265
Other Employee Benefits	288,418	531,705	78,123	474,616
Depreciation	-	-	-	-
General Office & Other	149,046	993,429	442,686	944,744
Subtotal Non-Labor	3,216,615	5,436,712	2,990,657	5,072,545
Total	$ 26,552,227	$ 26,314,107	$ 22,001,596	$ 21,717,414
Sources: CalAm Revenue Requirement Workbook, OC-72, and OC-135.				

Labor and Labor-Related ~~Finance~~ Costs – Actual labor and labor-related expense was ~~93~~89 percent of budget in 2009 and 88 percent of budget in 2010. As shown below, staffing declined significantly, from 138 FTEs at the end of 2009 to 92.5 FTEs at the end of 2010. Most of the decline (35.5 FTEs) can be attributed to the regional finance functions. Western Regional Finance, of which approximately 48 percent is allocated to California, decreased by five. At the corporate level, staffing declined by six FTEs in 2010. Corporate Planning and Reporting and Reporting and Compliance departments underwent reorganization. Corporate Tax and Treasury both lost employees. The Corporate Tax department was cut in half and the Director – Tax was replaced.

Table 3-19

AWSC Finance Staffing (FTEs)						
Business Unit		Actual				Budget
No.	Description	Dec '07	Dec '08	Dec '09	Dec '10	2010
032007	CORP-Finance	11	10	10	14	14
032017	CORP-Planning & Reporting	13	14	12	3	4
032027	CORP-Reporting & Compliance	5	6	8	15	18
032047	CORP-Income Tax	12	15	16	7	16
032057	CORP-Treasury	11	11	15	12	15
033007	WE-Finance	14	14	12	7	7
033507	CE-Finance	unknown	26	25.5	15.5	14.5
035007	SE-Finance	unknown	22	28	17	18
036507	NE-Finance	unknown	12.5	11.5	2	2
Total Finance		66	130.5	138	92.5	108.5
Sources: OC-14, OC-18, OC-91 and OC-133, Prior Overland Report & Workpapers, Sept. 11, 2008.						

Non-Labor ~~Finance~~ Costs – Non-labor costs were over budget by about $2.1 million for the Finance category as a whole. Outside services exceeded budget by about $1.3 million. Other Employee Benefits was over budget by approximately $400,000, due mainly to what appears to be the payment of unbudgeted severance to managers, primarily in the Income Tax and Treasury departments.[72] In the category General Office and Other, the Corporate Finance business unit had a large credit balance budgeted, which ~~had not been~~ was not incurred~~ as of the end of the third quarter~~.

Allocation of Finance Management Fees to California – The table below summarizes 2010 budgeted Finance costs and their allocation to CalAm.

Table 3-20

2010 Budgeted Cost Distributions to CalAm Finance	
Item	Amount
Total Spend	22,001,596
Subtract: Capital Fees	21,135,654
Management Fees	1,966,736
Subtract: Allocation to Non-Reg	970,625
Regulated Management Fees	996,112
Management Fee Distribution to CalAm	892,695
CalAm Composite Pct. of Total Mgt. Fee	45.39%
CalAm Composite Pct. of Reg. Mgt. Fee	89.62%
Source: CalAm's AWSC revenue req. workbook, "Budget 2010" sheet	

Customer Service Center

The Customer Service Center (CSC) consists of two call centers, one in Alton IL and one in Pensacola FL, which serve AW's customer base. The Alton center opened in 2003 and the Pensacola center opened in 2005. Prior to the opening of these centers, customer call center services were provided on a local and regional basis. The customer responsibilities of the CSC include:

- Call handling – taking inbound customer inquiry and order calls, processing customer requests and orders.
- Billing – calculating bills, processing adjustments and resolving billing issues.
- Collections – Outbound collection calling, processing notices, issuing shut-off orders, and resolving collection disputes.

Employee training, quality control and back-office functions (finance, work force management and general and administrative) support the customer activities. 2009 and 2010 budgeted and actual costs are shown below.

[72] 2010 actual costs are estimated based on annualizing data through September 30. It is likely that Other Employee Benefits costs could be overstated to the extent severance payments made before the end of the third quarter are improperly annualized in our estimate.

Table 3-21

American Water Service Company Customer Service Call Centers Total Spend				
Description	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Labor & Labor-Related				
Salaries and Wages	$ 22,986,781	$ 22,752,516	$ 23,949,678	$ 21,622,870
Incentive Comp	560,075	182,063	582,862	1,047,366
Payroll Taxes	1,962,707	1,886,042	2,200,298	1,916,285
Group Insurance	7,846,086	6,190,396	6,423,506	5,800,519
Pension & PBOP	4,989,724	6,062,198	5,518,430	5,563,242
DCP & 401K	611,330	200,849	786,936	213,776
Subtotal Labor & Labor-Related	38,956,703	37,274,064	39,461,710	36,164,058
Non-Labor				
Outside Services	3,820,897	1,624,214	392,549	137,638
Rents & Transportation	2,947,280	2,796,015	2,676,648	2,552,417
Other Insurance	735,156	586,836	690,148	575,493
Other Employee Benefits	419,297	233,542	156,695	246,634
Depreciation	2,579,949	2,913,657	3,185,814	3,782,071
General Office & Other	3,751,268	3,266,778	3,342,883	2,769,149
Subtotal Non-Labor	14,253,847	11,421,042	10,444,737	10,063,402
Total	$ 53,210,550	$ 48,695,106	$ 49,906,447	$ 46,227,460
Sources: CalAm Revenue Requirement Workbook, OC-72, and OC-135.				

Labor and Labor Related Costs – At the end of 2005, combined staffing for Alton and Pensacola was 607 FTEs. Staffing grew until 2008, peaking at around 711 FTEs (excluding seasonal employees) in December, 2008. Since then, as shown below, it has declined to 611 FTEs, approximately where it was in 2005. We expect staffing to continue to decline, as recent productivity enhancements, discussed below, continue to be implemented.

The 2010 CSC workforce plan, upon which CalAm based its revenue requirement projections, is significantly higher than the actual level of employees. AWSC's average staffing budget for the CSC was 702 FTEs in 2010, nearly 15 percent above actual year-end staff levels, and nearly high as the peak level of employees.

Table 3-22

Customer Service Center (CSC) Staffing (FTEs)						
Business Unit		Actual				Budget
No.	Description	Dec '07	Dec '08	Dec '09	Dec '10	2010
034005	CCA-Administration	12	12	12	9	11
034070	CCA-Call Handling	199	205	170.5	156	191
034071	CCA-Billing	116	123	120	115	132
034072	CCA-Collections	39	38	36	32	40
034073	CCA-Operations & Performance	13	11	12	11	11
034074	CCA-Business Services	14	15	12	13	12
034075	CCA-Education & Development	16	17	10	10	10
	Alton Call Center Total	409	421	372.5	346	407
037005	CCP-Administration	3	2	1.5	2	2
037070	CCP-Call Handling	242	276	230	239	271
037073	CCP-Operations and Support	3	5	4	4	6
037075	CCP-Education & Development	7	7	15	20	16
	Pensacola Call Center Total	255	290	250.5	265	295
Total Customer Service Call Centers		664	711	623	611	702
Sources: OC-14, OC-18, OC-91 and OC-133, Prior Overland Report & Workpapers, Sept. 11, 2008.						

Employee force levels in the call handling function, which makes up the majority of CSC employees, shows a clear downward trend from a peak in 2008. This trend is coincident with productivity improvements, including the replacement of older IVR technology (in 2009) and the launching of internet-based customer inquiry and bill pay capabilities (in 2010), as described in the testimony of CalAm witness Cooper, and as discussed below. AW expects the on-line system to generate additional productivity improvements and reductions in customer call volumes going forward. Based on this set of facts, the downward trend in employees should be reflected in CalAm's revenue requirement for AWSC. However, time constraints prevented us from performing the analysis and making the calculations necessary for this adjustment.

CSC Productivity Improvements – AW recently implemented two significant improvements in productivity that contributed to the reduction in call volumes and a reduction in call handling labor force levels. As described in the testimony of CalAm witness Karen Cooper:

- "In September 2009, American Water added My H20 online, an online customer self-service tool, to the American Water website. The site . . . is designed to allow customers to take care of some of their most common needs online. Customers can check their account balance, pay their bill, manage their account and . . . schedule appointments to turn service on or off.

- American Water implemented an upgrade to the Integrated Voice Response (IVR) in January 2010. This improved tool gives customers options for self-service or defaulting to a customer service representative, depending on their needs."[73]

[73] Cooper testimony, pp.5-6

We estimated the impact of these changes on test year 2012 staffing levels. For example, although H20 Online has been active for a year, AW expects increased customer usage of this tool, which will lead to additional reductions in calls. The CSC uses a three year forecast period.

One of the most important statistics tracked and forecasted by the CSC is call volume. Tim Cook, Director of CSC Operations, is responsible for forecasting call volumes. He is also responsible for the workforce plan for the call handling function, which is driven by call volumes. During our visit to the Alton call center on November 29, 2010, we asked Mr. Cook how H20 Online would affect call volumes in future years as it is adopted by more customers. He estimated a 6 percent per year increase in total online volume, and a corresponding decrease in live call volume going forward. We also asked what percentage reduction in call volume was built into his three-year workforce planning model. He said he did not know.

We followed up with data requests, attempting to get a handle on how productivity improvements might affect CSC staffing and CalAm's allocated share of customer service expense in the 2012 test year. Following are these requests and CalAm's non-responsive answers.[74]

> **OC-99**
> **Customer Service**
> For 2011, 2012 and 2013, please provide, by business unit and job title, the number of full time equivalent employees shown in the current "budget" view of Tim Cook's workforce planning model for 1) the Alton and 2) Pensacola call handling functions.
>
> **COMPANY RESPONSE:**
> California American Water objects to this data request on the grounds that it is not relevant to the general rate case. For the purpose of the general rate case, California American Water developed the 2011, 2012 and 2013 employee budgets for the Alton and Pensacola call centers based on the 2010 budget. It would be inappropriate to change the methodology for a single aspect of the overall budget. This information can be found at Data Response OC-001-Q001.

[74] In its data responses, CalAm states: "For the purpose of the general rate case, California American Water developed the 2011, 2012 and 2013 employee budgets for the Alton and Pensacola call centers based on the 2010 budget. It would be inappropriate to change the methodology for a single aspect of the overall budget." In response, Overland would simply observe that the actual CSC force level at the end of 2010 was 611 FTEs, nearly 100 FTEs less than CalAm's "appropriate-for-ratemaking" 702 FTE employee budget for 2010. CalAm's overstated budgeted force level applies to 2010, 2011, 2012 and 2013. It not only fails to take account of the impact of additional productivity improvements likely to be achieved by the 2012 test year, it also fails to reflect the impact of productivity already achieved in the historical 2009-2010 timeframe.

OC-100

Customer Service

Based on the November 30 discussion with Tim Cook, which identified a three year workforce planning time horizon, A) please identify, in terms of what is currently expected for budgeting purposes, the percentage increase in total call volumes expected to be driven from live calling to the internet by H2O online for the year 2011 vs. 2010, for 2012 vs. 2011 and for 2013 vs. 2012. (Note: based on our discussion with Mr. Cook we understand the percentage for 2011 vs. 2010 is currently estimated to be 6 to 10 percent).

COMPANY RESPONSE:

Please see the response to OC-099-001.

OC-101

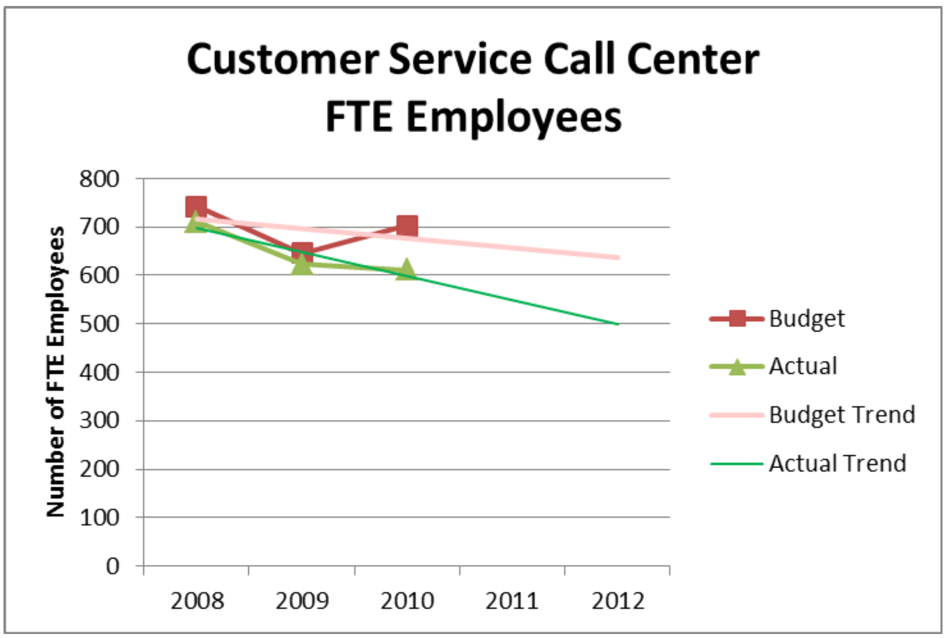
Customer Service

Based on the November 30 discussion with Tim Cook, which identified a three year workforce planning time horizon, please A) identify and describe the specific performance improvement assumptions that affect workforce levels that are built into the 2011 budget (compared with 2010), 2012 vs. 2011 and 2013 vs. 2012. and B) identify the overall impact these improvements, as forecasted in the workforce planning model, are budgeted to have on workforce levels in 2011 vs. 2010, 2012 vs. 2011 and 2013 vs. 2012 in the “most likely” or “currently budgeted” scenario or case.

COMPANY RESPONSE:

Please see the response to OC-099-001.

The impact of productivity improvements on the employee trend for the years 2011 through 2012 is shown below.



Non-Labor Costs – The CSC's significant non-labor costs include depreciation, outside services, rents and telephone expenses. Each of these is discussed separately.

- Depreciation – 2010 depreciation is $3.8 million, up from $2.9 million in 2009 and 19 percent higher than budgeted. The CSC function invested in a new Interactive Voice Unit and new software in 2009. It appears that 2010 is the first year to reflect the impact of these investments on annualized depreciation expense.

- Rents and Transportation – This consists primarily of rent on the Alton and Pensacola call center facilities and equipment and related interest expense on leasehold improvements. Overall, this cost category is approximately $124,000 under budget for 2010, due primarily to a favorable variance for rent on the Alton call center (as of the end of the third quarter, 2010).

- Outside Services – CSC incurred less than $150,000 in outside services in 2010, after incurring more than $1.6 million in 2009. A large portion of the amount budgeted for 2010 was associated with a planned evaluation of customer call quality, which the company chose not to do.[75]

- Telephone – Call center telephone expenses (excluding employee cell phones) were nearly $1.7 million in 2009. In 2010, they decreased to $1.28 million~~are down to around $1.25 million~~.[76] AW indicated that telephone expense is lower in 2010 because telephone maintenance costs have been moved from the CSC to ITS.[77]

- Insurance – CSC incurred about $577,000 for workers compensation, general liability and other non-health-related insurance in 2010. This is about $115,000 under the 2010 budget. In 2009, the CSC incurred slightly more, about $586,000, for the same insurance.

In both 2009 and 2010, outside services explain most of the net budget variance in the CSC's non-labor expenses. Removing outside services, actual non-labor expenses were 94.4 percent of budget in 2009, and we estimate they are 98.7 percent of budget in 2010.

Potential for Consolidation of CSC Operations into One Call Center – 2010 facilities expenses for the Pensacola and Alton call centers are approximately $5 million.[78] As discussed above, CSC employment is declining. During our visit to the Alton call center, we noted a sizeable percentage of the call center stations were empty during normal business hours (the morning of Tuesday, November 30, between 9 and 10 AM CST). In many cases, stations are reserved for individual employees, rather than being shared across shifts.[79] As shown in the table below, even with a lack of station sharing, across an entire 24 hour day, approximately 18 percent of the total call stations are not used. As of December 31, 2010, the CSC had 416 call handling employees (including part time and full time), spread out over a 24 hour day. As of November 30, as shown below, the CSC had more call handling stations than it had full and part time employees combined.

[75] Interview, Christina Russell – CSC Financial Analyst, November 30, 2010
[76] OC-~~72~~135 ~~(Amount is based on annualizing actual expenses through September 30.)~~
[77] Interview, Christina Russell – CSC Financial Analyst, November 30, 2010
[78] OC-72 (Includes rent, interest on capital leases, telephone, property taxes, janitorial, electricity, grounds-keeping and miscellaneous maintenance expenses. Amount is based on annualizing actual expenses through September 30.)
[79] Discussion with Karen Cooper, November 30, 2010

Table 3-23

American Water Customer Call Center Function Call Handling Stations Status (1) November 30, 2010			
Description	Occupied	Unoccupied	Total
Alton			
Call Handling CSR	113	45	158
Call Handling Supervisor	9	10	19
Total	122	55	177
~~Pensacola~~			
Call Handling CSR	214	24	238
Call Handling Supervisor	18	1	19
Total	232	25	257
Combined			
Call Handling CSR	327	69	396
Call Handling Supervisor	27	11	38
Total	354	80	434
(1) Total - Total stations. Occupied - Occupied at some point			

American Water Customer Call Center Function Call Handling Stations Status November 30, 2010			
Description	Occupied (1)	Unoccupied	Total
Alton			
Call Handling CSR	113	45	158
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Total	122	55	177
Pensacola			
Call Handling CSR	214	24	238
Call Handling Supervisor	18	1	19
Total	232	25	257
Combined			
Call Handling CSR	327	69	396
Call Handling Supervisor	27	11	38
Total	354	80	434
Source: OC-97	(1) Occupied at some point during the day.		

We also requested the number of stations occupied at the peak activity hour of the day. CalAm indicated the peak is reached during the 1PM hour. During this peak hour, the following occupancy occurred on two sampled dates: June 30 and November 30. 2010.[80]

June 30, 2010: 214 CSRs + 26 Supervisors (240 stations)
November 30, 2010: 255 CSRs + 29 Supervisors (284 of 434 stations occupied)

This translates to peak occupancy 55 percent of capacity on June 30 and 65 percent of capacity on November 30 (using 434 stations as an estimate of capacity). The peak hour occupancy for both centers on November 30 (the higher occupancy of the two dates sampled) was slightly more than the number of stations available at Pensacola alone. We do not know the capacity of the Pensacola call center for expansion of the

[80] OC-98

number of stations, but if it has additional space is available, it becomes even more likely that two physical call centers are not needed.

Overland questioned the soundness of the decision to open the Pensacola call center in our prior General Office expense report. Given current circumstances, and the trend toward lower force levels in the call handling function, we believe it remains reasonable to question whether AW needs two call centers and whether customers should be required to pay for under-utilized capacity.[81] A consolidation of operations into one physical center, by itself, could save approximately $2.5 million annually, based on the 2010 facilities costs as delineated above. We believe it very likely that the CSC would achieve additional labor and labor-related savings from the consolidation of management and supervisory positions into a single center.

Allocations of CSC Cost to CalAm

The table below summarizes the allocation of CSC management fees to CalAm as reflected in the 2010 budget. Overland recommends using the 2010 budget relationships, to the extent support, as the basis for allocation to California.

Table 3-24

2010 Budgeted Cost Distributions to CalAm CSC	
Item	Amount
Total Spend	49,906,447
Subtract: Capital Fees	59,324
Management Fees	49,847,123
Subtract: Allocation to Non-Reg	694,129
Regulated Management Fees	49,152,994
Management Fee Distribution to CalAm	2,511,958
CalAm Composite Pct. of Total Mgt. Fee	5.04%
CalAm Composite Pct. of Reg. Mgt. Fee	5.11%
Source: CalAm's AWSC revenue req. workbook, "Budget 2010" sheet	

CalAm's revenue requirement is based on a 5.18 percent overall distribution of regulated CSC expense to California (using 2009 factors instead the 2010 budget). CalAm's distribution includes an unsupported direct charge of $82,006 to California.[82] The

[81] In addition to the downward trend in force levels due to productivity improvements, on January 25, 2011, American Water announced the sale of its regulated Arizona and New Mexico properties to EPCOR USA. With this sale, AW will shed approximately 175,000 customers, about 5.2 percent of its customer base. While the overall effect of the sale is likely to put additional upward rate pressure on CalAm, the call handling function should experience a decrease in call volumes commensurate with the loss of customers, and a corresponding decrease in variable costs. The sale will create additional idle capacity in the call centers, and, absent the acquisition of systems to replace Arizona and New Mexico, should provide additional motivation for AW to close one of them.

[82] In request OC-165 we asked CalAm to describe specific costs that were directly charged and why they were directly charged instead of allocated. The response did not contain the requested explanations. In this case, the impact of the direct charge on the overall distribution to CalAm is minor enough that we do not believe it needs to be adjusted. We do not believe this explains the difference between CalAm's composite regulated expense distribution in the revenue requirement (5.18 percent, based

composite regulated management fee distribution reflected in the 2010 budget, 5.11 percent, is close to CalAm's share of AW's regulated customers, which was 5.17 percent as of year-end 2009.[83]

Operations Services and Regulated Operations

These rate filing categories include the business units from the service company's corporate and divisional operations departments; specifically:

- Corporate Operations
- Western and Eastern Division Operations

It is not entirely clear why CalAm chose to break the operations business units into two categories for revenue requirement presentation. The rate filing category "Operations Services" is composed only of business units from the Corporate Operations department, The "Regulated Operations" category is composed primarily of business units in the Western and Eastern Division Operations departments.

Based on the categorization of business units reflected in the 2010 budget data CalAm used to develop its revenue requirement, the Operations Services rate filing category includes the Chief Operating Officer, Operational Risk, Asset Management, Engineering, Maintenance and Technical Services. Regulated Operations (which should not be confused with Regulatory Services) includes the Environmental business unit ("Innovation and Environmental Stewardship").[84] For 2010, Regulated Operations also includes division-level Engineering, Network and Administration (executive) business units. Over half of the employees in this category work for Customer Relations business units. Customer Relations includes employees who coordinate customer premises activities and dispatch service work to field employees in the operating companies.

Operations Services Costs

2010 budgeted costs for both rate filing categories are shown below.

on 2009 allocations) and the distribution reflected in the 2010 budget (5.11 percent) – because both likely have similar amounts of directly charges.

[83] OC-27 Attachment 2

[84] Contrary to the Stephenson testimony, the primary environmental business unit is part of Regulated Operations, not Operations Services.

Table 3-25

American Water Service Company Operations Services Total Spend				
Description	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Labor & Labor-Related				
Salaries and Wages	$ 9,625,046	$ 7,140,046	$ 7,046,988	$ 6,868,279
Incentive Comp	2,225,641	1,730,595	1,806,834	2,261,914
Payroll Taxes	712,616	561,352	570,424	569,887
Group Insurance	1,253,064	765,658	751,007	794,651
Pension & PBOP	3,595,805	1,906,361	1,772,749	1,501,343
DCP & 401K	381,362	276,734	241,994	285,645
Subtotal Labor & Labor-Related	17,793,534	12,380,746	12,189,996	12,281,719
Non-Labor				
Outside Services	311,040	339,118	159,396	1,250,292
Rents & Transportation	189,515	160,097	140,537	118,460
Other Insurance	516,696	197,093	196,348	163,727
Other Employee Benefits	272,927	110,116	104,534	139,751
Depreciation	-	-	-	10,069
General Office & Other	1,790,499	1,240,955	1,433,592	1,111,931
Subtotal Non-Labor	3,080,677	2,047,378	2,034,407	2,794,230
Total	$ 20,874,211	$ 14,428,125	$ 14,224,403	$ 15,075,949
Sources: CalAm Revenue Requirement Workbook, OC-72, and OC-135.				

Labor & Labor-Related Operations Services Costs – Staffing declined from 80 FTEs at the end of 2008 to 68 at the end of 2010. CalAm's revenue requirement is based on 76 FTEs. ~~Actual costs for the year 2010 are 20.1 percent higher than 2009.~~ There appears to be a decreasing trend in full-time employees, as shown in the table below, and, with the exception of incentive compensation and group insurance, ~~the~~ corresponding actual labor and labor-related ~~charges appear to be~~ are decreasing as well. ~~2010 labor and labor-related costs are estimated to be 22.1 percent above the 2010 budget level requested by CalAm. In 2009, labor and labor-related costs were 30.8 percent below the budget~~.[85]

[85] It appears that the 2009 budget was based on a regional constitution of the organization of 107 FTEs that was never fully assembled. There were quite a few vacancies listed in the 2009 Operations Services Plan that were not filled at the end of the year. As shown above, staffing continued to decrease in 2010.

Table 3-26

Operations Services Staffing (FTEs)						
Business Unit		Actual				Budget
No.	Description	Dec '07	Dec '08	Dec '09	Dec '10	2010
032011	CORP-Chief Operating Officer	3	3	3	3	4
032016	CORP-Maintenance	0	0	0	0	1
032019	CORP-Operational Risk	10	9	8	9	9
032064	CORP-Operational Performance	4	5	4	0	0
032065	CORP-Asset Management	8	12	13	14	15
033016	WE-Maintenance	3	3	3	2	3
033019	WE-Operational Risk	3	1	1	1	1
033516	CE-Maintenance	unknown	11	8	8	10
033519	CE-Operational Risk	unknown	9	9	9	9
035016	SE-Maintenance	unknown	3	3	3	3
035019	SE-Operational Risk	unknown	1	0	1	1
036516	NE-Maintenance	unknown	1	1	0	1
036519	NE-Operational Risk	unknown	3	3	0	0
036550	CORP-COE-Engineering	8	9	9	8	9
036551	CORP-COE-Technical Services	8	10	10	10	10
Total Operations Services		47	80	75	68	76
Sources: OC-14, OC-18, OC-91 and OC-133, Prior Overland Report & Workpapers, Sept. 11, 2008.						

Non-Labor Operations Services Costs – In 2010, Operations Services incurred ~~nearly~~ $~~1.6~~ 1.25 million in outside services while only $159,000 was budgeted.[86] This variance was offset by a~~the approximately~~ $~~642,000~~321,000 favorable variance in General Office & Other costs. In 2009, non-labor costs were significantly under budget, specifically in the subcategories of Other Insurance and General Office & Other expenses. Overall, non-labor costs for 2010 were ~~are projected to be about 46~~37 percent above budget, primarily due to ~~the unbudgeted~~ outside services.

Allocations of Operations Services Costs to CalAm

The following table summarizes the 2010 budget progression from Operations Services total costs (shown above) to management fees assigned and allocated to CalAm. The 2010 budget composite distribution to CalAm is slightly higher than the amount or percentage reflected in CalAm's revenue requirement.[87]

[86] Outside services costs tend to be "lumpy" and can be difficult to budget. Once Business Transformation (a separate topic) is subtracted, 2010 actual outside services expenses across all AWSC functions is estimated to be $11.9 million, compared with $12.3 million budgeted.

[87] CalAm's revenue requirement contains a California distribution of $577,470; 7.5% of $7,694,581 regulated expense.

Table 3-27

2010 Budgeted Cost Distributions to CalAm Operation Services	
Item	Amount
Total Spend	14,224,403
Subtract: Capital Fees	6,020,124
Management Fees	8,204,279
Subtract: Allocation to Non-Reg	510,378
Regulated Management Fees	7,693,901
Management Fee Distribution to CalAm	517,907
CalAm Composite Pct. of Total Mgt. Fee	6.31%
CalAm Composite Pct. of Reg. Mgt. Fee	6.73%
Source: CalAm's AWSC revenue req. workbook, "Budget 2010" sheet	

Regulated Operations Costs

2010 budgeted costs for both rate filing categories are shown below.

Table 3-28

American Water Service Company Regulated Operations Total Spend				
Description	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Labor & Labor-Related				
Salaries and Wages	$ 10,735,700	$ 9,622,668	$ 9,842,906	$ 8,957,884
Incentive Comp	2,454,481	2,210,866	2,971,254	2,938,075
Payroll Taxes	749,398	784,725	755,180	703,584
Group Insurance	1,534,020	1,273,613	1,252,768	1,196,333
Pension & PBOP	1,739,864	3,090,510	2,281,235	1,931,979
DCP & 401K	411,194	290,351	367,187	345,449
Subtotal Labor & Labor-Related	17,624,658	17,272,734	17,470,528	16,073,304
Non-Labor				
Outside Services	421,609	359,376	422,164	502,234
Rents & Transportation	2,240,128	2,016,615	2,167,985	1,971,892
Other Insurance	245,472	260,095	277,845	231,686
Other Employee Benefits	114,804	555,253	55,568	137,957
Depreciation	1,465,387	1,932,705	1,833,611	1,154,803
General Office & Other	899,226	472,173	578,776	691,982
Subtotal Non-Labor	5,386,626	5,596,216	5,335,949	4,690,554
Total	$ 23,011,284	$ 22,868,950	$ 22,806,478	$ 20,763,858
Sources: CalAm Revenue Requirement Workbook, OC-72, and OC-135.				

Labor & Labor-Related Regulated Operations Costs – Staffing declined steadily from 131 FTEs at the end of 2008 to 112 at the end of 2010. CalAm's revenue requirement is based on 121 FTEs. ~~We estimate~~ 2010 actual costs were ~~to be 10~~7.5 percent lower than 2009, despite a ~~26~~33 percent increase in incentive pay. 2010 labor and labor-related costs were~~are estimated to be~~ 8~~.4~~ percent below the 2010 budget level requested by CalAm. ~~In 2009, labor and labor-related costs were estimated to be 0.7 percent above budget due to actual costs in the Pension & PBOP and Other Employee Benefits categories. 2009 actual Salaries and Wages, Incentive Comp and Payroll Taxes were under budget by 9.5 percent.~~

Table 3-29

AWSC Regulated Operations Staffing (FTEs)						
Business Unit		Actual				Budget
No.	Description	Dec '07	Dec '08	Dec '09	Dec '10	2010
032023	CORP-Eastern Division Ops	0	1	1	2	1
032024	Corp-Western Division Ops	0	0	0	2	1
032026	CORP-Regulated Ops	0	2	2	2	3
032066	CORP-Innov & Env Stewardship	14	15	17	17	19
033002	WE-Network	5	4	0	0	0
033004	WE-Tech Services	2	0	0	0	0
033005	WE-Administration	3	3	3	3	3
033006	WE-Service Delivery	1	1	0	0	0
033011	WE-Environmental Mgt	1	1	0	0	0
033014	WE-Engineering	0	0	2	3	3
033028	WE-Asset Planning	4	3	0	0	0
033502	CE-Network	unknown	3	4	2	3
033503	CE-Customer Relations	unknown	29	32	30	31
033505	CE-Administration	unknown	12	5	2	2
033511	CE-Environmental Mgmt	unknown	2	2	1	1
033514	CE-Engineering	unknown	13	9	11	12
035002	SE-Network	unknown	3	6	2	2
035003	SE-Customer Relations	unknown	35	0	0	0
035005	SE-Administration	unknown	2	2	4	4
035014	SE-Engineering	unknown	1	1	2	2
035503	ED-Customer Relations	unknown	0	32	29	34
036501	NE-Production	unknown	1	1	0	0
Total Regulated Operations		30	131	119	112	121
Sources: OC-14, OC-18, OC-91 and OC-133, Prior Overland Report & Workpapers, Sept. 11, 2008.						

Non-Labor Regulated Services Costs - Non-labor costs were under budget in both years. In 2010, actual expenses ~~are estimated to be~~were under-budget by ~~18.5~~12 percent, due primarily to lower depreciation expense. Adjusting for lower actual depreciation, remaining non-labor costs were close to budget.

Allocation of Regulated Operations Cost to CalAm

The table below summarizes the 2010 budget progression from total costs (shown above) to management fees assigned and allocated to CalAm. The 2010 budget composite distribution to CalAm is significantly lower than the amount in CalAm's revenue requirement.[88]

[88] CalAm's revenue requirement, based on 2009 allocation percentages, contains a California distribution of $808,671, 4.63 percent of $17,459,670 in regulated management fees.

Table 3-30

2010 Budgeted Cost Distributions to CalAm Regulated Operations	
Item	Amount
Total Spend	22,806,172
Subtract: Capital Fees	4,670,178
Management Fees	18,135,994
Subtract: Allocation to Non-Reg	465,050
Regulated Management Fees	17,670,944
Management Fee Distribution to CalAm	636,609
CalAm Composite Pct. of Total Mgt. Fee	3.51%
CalAm Composite Pct. of Reg. Mgt. Fee	3.60%
Source: CalAm's AWSC revenue req. workbook, "Budget 2010" sheet	

Information Technology Services

According to CalAm testimony, the ITS function consists of the following departments:[89]

- Enterprise Architecture – Responsible for long range planning.

- Client Services and Security – Implements systems to safeguard customer and financial information.

- Infrastructure and Operations – Responsible for operating and maintaining the data center, batch processing functions and the voice and data communications infrastructure.

- Business Applications Development – Designs and develops software applications necessary for operating company requirements.

- Client Services and Security – Provides end user desktop and help desk services, provisions user access, performs desktop and software patching, monitors cyber-security, manages system vulnerabilities and performs security testing.

[89] CalAm testimony of Stephenson pp. 78-79

Table 3-31

American Water Service Company Information Technology Services (ITS) Total Spend				
Description	2009 Budget	2009 Actual	2010 Budget	2010 Actual
Labor & Labor-Related				
Salaries and Wages	$ 16,087,766	$ 14,185,815	$ 16,751,514	$ 15,625,856
Incentive Comp	2,398,228	1,439,810	1,993,087	2,369,068
Payroll Taxes	1,262,968	1,186,040	1,427,320	1,380,436
Group Insurance	2,175,536	1,702,951	2,016,615	1,903,692
Pension & PBOP	3,657,021	3,137,302	2,876,966	2,083,681
DCP & 401K	745,496	690,053	819,109	836,308
Subtotal Labor & Labor-Related	26,327,014	22,341,971	25,884,611	24,199,041
Non-Labor				
Outside Services	4,598,788	5,026,067	4,333,216	5,776,520
Rents & Transportation	597,880	542,023	701,917	530,969
Other Insurance	516,768	381,053	498,050	415,301
Other Employee Benefits	549,965	734,428	261,819	667,157
Depreciation	9,306,341	11,474,457	17,422,035	20,524,214
General Office & Other	9,797,632	8,927,728	12,889,316	11,212,846
Subtotal Non-Labor	25,367,374	27,085,755	36,106,353	39,127,007
Total	$ 51,694,389	$ 49,427,726	$ 61,990,964	$ 63,326,048
Sources: CalAm Revenue Requirement Workbook, OC-72, and OC-135.				

The Scale of CalAm's Requested ITS Cost Increase - CalAm describes the centralized ITS operations as having a "per-customer" cost advantage over a stand-alone operation. Be that as it may, as shown in the following table, CalAm's base period (2010) ITS revenue requirement reflects a significant increase in ITS management fees charged to California compared to last rate case, both in total and on a per-customer basis.

Table 3-32

American Water Service Company ITS Total Spend Rate Request - Prior vs. Current Rate Request			
Description	Prior Rate Request: 2008 Budget (1)	Current Rate Request: 2010 Budget (2)	Percentage Increase
Labor & Labor-Related			
Salaries and Wages	$ 13,874,325	$ 16,751,514	20.7%
Incentive Comp	1,915,605	1,993,087	4.0%
Payroll Taxes	1,055,890	1,427,320	35.2%
Group Insurance	2,073,455	2,016,615	-2.7%
Pension & PBOP	1,672,650	2,876,966	72.0%
DCP & 401K	614,410	819,109	33.3%
Subtotal Labor & Labor-Related	21,206,336	25,884,611	22.1%
Non-Labor			
Outside Services	897,392	4,333,216	382.9%
Rents & Transportation	545,949	701,917	28.6%
Other Insurance	170,545	498,050	192.0%
General Taxes	325,775	261,819	-19.6%
Depreciation	8,695,910	17,422,035	100.3%
General Office & Other	8,107,955	12,889,316	59.0%
Subtotal Non-Labor	18,743,526	36,106,353	92.6%
Total Spend	39,949,862	61,990,964	55.2%
Subtract: Capital Fees	7,005,708	10,295,849	47.0%
Management Fees	$ 32,944,154	$ 51,695,115	56.9%
Per Customer	$ 9.96	$ 15.54	56.0%
(1) 2008 Budget (2) 2010 Budget			

In the last rate case, CalAm requested a California management fee of $1,786,495. Since the last case, CalAm indicates it has transferred $102,130 of California ITS expense to California Corporation.[90] As CalAm's equivalent ITS request in the last case was $1,684,365. Thus, the equivalent request for California ITS management fees in the last case was $9.90 per customer. Distributed to California, CalAm's base period (2010) ITS management fee in the current case is $2,663,411, or $15.49 per customer, a 55.6 percent increase over the request in the last case.

Among the more noteworthy increases since the last case:

- Depreciation Expense – CalAm and American Water have placed in service various new computer programs since the last rate case filing. These programs include Identity Access Management, Service First Upgrade, IVR Upgrade, Web Self Service and Web Hosting, Hyperion 9 and PowerTax.[91] The depreciation expense increase alone for these programs that is requested to be recovered from CalAm ratepayers is approximately $600,000, more than seven times the depreciation expense to be recovered from the previous rate case filing.[92]

[90] CalAm testimony of Stephenson, Attachment 10, Authorized Service Company Employee Costs Transferred to CalCorp, ITS
[91] David Stephenson's Direct Testimony p. 113.
[92] David Stephenson's Direct Testimony, Attachment 13.

- Maintenance Expense – This expense has increased as a result of adding new software applications and services. According to CalAm, the increase from the last rate case is approximately $5 million for the entire service company. See discussion for depreciation expense above to reference the addition of various programs and applications.[93]

- Miscellaneous Expense – These expenses relate to contract services that are being provided to train and support ITS employees on the Web Self Service application and also for a 3rd party network management service provider. In addition, annualized support for software licenses purchased mid-way through 2009 account for a significant increase in this subcategory. These miscellaneous expenses have increased approximately $1.5 million for the entire service company since the last rate case.[94]

Labor and Labor-Related ITS Costs - Staffing declined steadily from 176 FTEs at the end of 2008 to 160.5 FTEs at the end of 2010. CalAm's revenue requirement is based on 193 budgeted FTEs. Due to declining staffing, we estimate 2010 actual costs to be about 8 percent higher than 2009, despite a 65 percent increase in incentive compensation. Actual 2010 staffing is not close to the budget level of 193, and budgeted employees should not be used as a basis for establishing CalAm's test year revenue requirement.

Non-Labor ITS Costs – Non-labor costs are 44 percent higher than 2009, due primarily to a near doubling of ITS depreciation expense. CalAm provided the following explanation for the 2010 increase in ITS depreciation:[95]

Depreciation on ITS assets new in 2010	$5.6 million
Sharepoint software write-off	$2.4 million
IAM software – full year depreciation	$0.3 million
Depreciation life adjustment for certain enterprise software	$0.6 million
"Subledger reconciliation adjustment	$0.5 million
Total	$9.4 million

[93] David Stephenson's Direct Testimony p. 117.
[94] David Stephenson's Direct Testimony pp. 117-118.
[95] OC-230-A

Table 3-33

Information Technology Services (ITS) Staffing (FTEs)						
Business Unit		Actual				Budget
No.	Description	Dec '07	Dec '08	Dec '09	Dec '10	2010
032030	CORP-ITS Client Rel Admin	0	1	1	1	1
032031	CORP-Service Desk	8	7	11	8.5	9
032032	CORP-ITS-BAD-Core Shared	5	5	9	10	13
032033	Chg Ctrl & Desktop Automation	3	3	2	2	2
032034	CORP-ITS Appl Adm & Security	5	6	0	0	0
032035	CORP-ITS Sec Arch & Strategy	0	1	0	0	0
032071	CORP-ITS Admin	3	3	3	4	4
032072	CORP-ITS PMO	10	10	12	8	19
032073	CORP-ITS Infra/Oper Admin	2	2	3	2	3
032074	CORP-ITS Production	9	9	8	8	8
032075	CORP-Enterprise Server	14	17	19	19	20
032076	CORP-Communications	8	8	4	5	4
032077	CORP-ITS Security Operations	0	5	8	8	9
032078	CORP-ITS Adm Business Appl Dev	3	4	3	3	4
032079	CORP-ITS-BAD-Middle Office App	22	19	13	6	9
032080	CORP-Functional Applications	16	15	9	10	11
032081	CORP-ITS-BAD-Quality&Methodlgy	8	9	9	11	10
032082	CORP-ITS-BAD-Customer Facing	1	7	11	8	13
032083	CORP-ITS-BAD-Field Svc Apps	0	0	6	12	12
032093	CORP-ITS-Architecture	4	9	10	6	10
033531	CE-Western CS & S	17	16	28	29	32
036531	NE-Eastern CS & S	21	20	0	0	0
Total Information Technology Services		159	176	169	160.5	193
Sources: OC-14, OC-18, OC-91 and OC-133, Prior Overland Report & Workpapers, Sept. 11, 2008.						

Allocations of ITS Costs to CalAm

The following table summarizes the 2010 budget progression from the ITS function total costs (shown above) to management fees assigned and allocated to CalAm. CalAm's requested allocation to California using 2009 actual allocation relationships instead of those in the 2010 budget. The 2010 budget composite distribution to CalAm is not materially different than the amount or percentage reflected in CalAm's revenue requirement.[96]

[96] CalAm's revenue requirement contains a California distribution of $2,663,411; 5.2% of $51,206,232.

Table 3-34

2010 Budgeted Cost Distributions to CalAm ITS	
Item	Amount
Total Spend	61,990,964
Subtract: Capital Fees	10,295,849
Management Fees	51,695,115
Subtract: Allocation to Non-Reg	453,604
Regulated Management Fees	51,241,511
Management Fee Distribution to CalAm	2,643,634
CalAm Composite Pct. of Total Mgt. Fee	5.11%
CalAm Composite Pct. of Reg. Mgt. Fee	5.16%
Source: CalAm's AWSC revenue req. workbook, "Budget 2010" sheet	

Recommendation – ITS

As discussed in Chapter 2, Adjustments Summary, we recommend removing from test year revenue requirements 1) depreciation associated with Sharepoint software that was written off, and 2) the unexplained portion of an increase in 2010 depreciation.

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4. BUSINESS TRANSFORMATION

Business Transformation (BT) consists of a series of forecasted capital additions to AW's information systems. Specifically, as described in AW's Information Infrastructure Comprehensive Planning Study Report (CPSR):

> There are three recommended capital improvement projects to improve the performance of AW's data management capabilities, IT systems infrastructure, and customer service levels: Enterprise Resource Planning (ERP); Enterprise Asset Management (EAM); and the Customer Information System (CIS).[97]

Among the significant systems targeted for replacement in the BT process are the following[98]:

- General ledger / financial reporting and related systems, including human resources, procurement, accounts payable, timekeeping, job costing and service billing.

- Asset management and maintenance, field operations, service orders, job costing, workforce management and geographic information.

- CIS, web-based customer account management, account collection, call handling and scheduling and various other customer systems.

According to the CPSR, the estimated cost of BT projects, as of April, 2010, was $273 million: ERP - $94 million; EAM - $77 million and CIS - $102 million. The CPSR estimates ERP will be implemented and stabilized within 24 months of project commencement in September, 2010 (around September 2012). EAM and CIS are both forecasted to commence in September, 2011, and be installed and operational by December, 2014. Attachment 4-1 contains a list of specific systems to be replaced in the BT project, the vendors associated with the systems, and the targeted implementation dates.

Summary of Findings

1. BT Budget - AWSC's current budget for BT appears to be between $273 million and $280 million for the period 2009 through 2016.

[97] Information Infrastructure Comprehensive Planning Study Report, April 13, 2010, p.11
[98] ~~Response to~~ OC-171

2. Estimated CalAm BT Revenue Requirement - CalAm's has requested rate recovery of BT CWIP and plant for the test year. It is not clear that CalAm has disclosed the impact of requested BT on California customers. Assuming AW remains within its projected BT budget, we estimate the California revenue requirement impact for the period 2010-2014 to be as follows:

Table 4-1

Business Transformation Calculation of California Rev. Requirement As Requested by CalAm (1)			
	Amount		
Year	Total	Customers (2)	Cost per Customer
2010	$343,199	171,913	$2.00
2011	835,962	172,173	$4.86
2012	1,644,632	172,406	$9.54
2013	1,827,152	172,607	$10.59
2014	2,770,598	172,771	$16.04
Cumulative 2010-2014	$7,421,543		$43.01

Source: Calculation by Overland based on CalAm workpaper 'RB 100 thru 105 - 2010 Statewide GRC - CAW Corporate.xls'
(1) Based on CalAm's requested California pre-tax rate of return, rate base and depreciation expense. (2) 2010-2013 per CalAm, 2014 extrapolated by Overland.

3. Potential Depreciation Forecasting Error - Although the BT schedule indicates the first BT module (Enterprise Resources Planning) is not scheduled to "go live" until September, 2012, CalAm has included a full year's depreciation expense for what appears to be the ERP module in its test year (2012) revenue requirement.

4. Delays in Budgeted BT Spending - Of approximately $107 million in BT expenditures budgeted for 2010, AWSC spent only about $27 million. CalAm's BT Construction Work in Progress balance, forecasted in the rate case to be $5.8 million at the end of 2010, was in fact $1.7 million. AWSC appears to be 9 to 10 months behind in getting the BT project underway. Slippage in timelines can translate into higher-than-budgeted costs.

5. AW's Cost-Benefit Estimate for BT - A document provided with a May, 2010 presentation to the AW board of directors indicates that, for AW as a whole, BT costs will exceed benefits for the period 2009-2016. To the extent benefits are realized, the presentation document indicates they will take the form of lower labor costs from force reductions.

6. Potential for Budget Overrun and Related Customer Impact - CalAm has requested balancing account treatment for BT expenditures, which effectively means customers may eventually be required to pay for far more in BT investment than CalAm has estimated in this case. Accenture, AW's consultant, noted in one of its marketing brochures that "on average, IT projects come in at a success rate of only 29 percent: the average cost over-run is 56 percent and the

average schedule delay is 84 percent beyond plan."[99] As noted, BT is already about 10 months behind its original schedule. If revenue requirement treatment is granted, and if the cost overruns are more likely than not, balancing account treatment is effectively nothing more than a transfer of cost overrun risk from AW's shareholders to California customers.

7. CalAm's Inability to Quantify Customer Benefits from BT - CalAm states it cannot quantify what BT benefits, "if any," will be available to California ratepayers. CalAm expressed a belief that its requested balancing account would "mitigate these issues."[100] We see no mechanism by which issues concerning the transfer of un-quantifiable benefits to California ratepayers can be "mitigated" by balancing account treatment. In fact, as discussed above, balancing account treatment may increase the risk that customers will pay more for BT than CalAm has forecasted in this case.

8. AWSC Employees Transferred to the BT Project - The labor (salary, incentive pay) and labor-related (payroll taxes, benefits, pension) costs associated with 48 employees transferred from various AWSC functions to BT near the end of 2010, are included in both 1) CalAm's requested $14.1 million BT rate base expenditure, and 2) CalAm's requested service company management fees allocated to California. CalAm maintains this is proper because the employees transferred to the BT project from these functions will be replaced. As discussed elsewhere, ~~the~~ AWSC's labor force levels are declining, not increasing.

9. AWSC's Distribution of 2010 BT Charges - The 2010 budget shows BT capital and management fees associated with BT expenditures are charged only to AW's regulated companies.[101] There are no distributions to non-regulated cost objectives. CalAm's share of 2010 budgeted expenditures is $5.5 million, or 5.15 percent.[102]

Summary of Recommendations

1. Recommendation to Remove BT from CalAm's Revenue Requirement - Consistent with DRA's internal guidance~~recommendation~~ that the Commission not permit CalAm to include projected BT expenditures in revenue requirements in the absence of any quantification of customer benefits, Overland has removed BT expenditures from the our calculation of the California Corporation revenue requirement.

[99] Accenture.com, Industrialize Your Applications Delivery to Achieve High-Performance, p.2
[100] OC-194
[101] CalAm's 2010 budget shows that there 100 percent of budgeted BT costs are charged to the regulated water companies.
[102] CalAm AWSC Revenue Requirements Workpapers, AWSC, 'Budget 2010'

2. Adjust BT Rate Base and Depreciation to Reflect the 10 Month Schedule Delay If Pre-Implementation BT Costs Are Approved for Customer Recovery - Should the Commission approve rate recovery of forecasted BT expenditures (i.e. choose not to adopt DRA's recommendation), we recommend adjusting the CWIP, plant, reserve and depreciation expense amounts requested by CalAm to reflect the 10 month schedule delay. The most direct way to do this is to use the actual CWIP balance at the end of 2010, $1,678,857, instead of the requested forecast-based balance, $5,802,155. The difference between these two amounts, $4,123,298, should be used to adjust the CWIP and plant balances in subsequent years (2011-2013). For example, in 2011, 2012 and 2013, the requested combined CWIP and plant balance should be reduced by~~-~~ $4,123,298. The BT depreciation reserve and depreciation expense should be similarly adjusted for 2012 and 2013.

3. Balancing Account Treatment - As it considers whether to provide balancing account treatment, the Commission should consider that the ability to "bank" and later collect incurred BT costs from customers through a balancing account is likely to create a disincentive for AW and CalAm to control costs as it implements BT. The relatively small likelihood that costs will come in at or under budget effectively transfers ~~of~~ cost overrun risk from AW to California customers. From a customer point of view, these points argue against adopting balancing account treatment.

4. Impute an Allocation of BT Expenditures to the Non-Regulated Segment if Pre-Implementation Costs Are Approved for Customer Recovery - The 2010 budget, on which CalAm's requested BT revenue requirement is based, allocates BT costs only to regulated subsidiaries. Should the Commission approve rate recovery of forecasted BT expenditures, we recommend it consider imputing an allocation of BT expenditures to the non-regulated business segment. As a range for consideration, AWSC allocated approximately 5 percent of its overall expenses to the non-regulated segment and the non-regulated segment comprises approximately 10 percent of AW's corporate revenue. A non-regulated distribution within this range appears reasonable.

CalAm's Requested BT Revenue Requirement

CalAm had a $293,734 Construction Work in Progress (CWIP) balance associated with BT at the end of 2009. CalAm's rate base workpapers show California's forecasted share of BT expenditures over the period 2010 through 2013 is $13.9 million. The combined California expenditure of $14.1 million is 5.16 percent of AW's $273 million BT budget.[103] During the 2010-2013 period, CalAm is also forecasting the retirement of IT

[103] CalAm California Corporate revenue requirement workpapers, 'SCEP Summary'

software that appears to coincide with the implementation of the new BT software. This retirement removes $2.4 million in existing software from the books in 2012.

As shown below, we estimate the incremental test-year (2012) revenue requirement associated with BT is approximately $1.64 million. This is based on incremental BT rate base investment and BT depreciation. In 2013 the incremental revenue requirement grows to $1.83 million, as additional expenditures are incurred for the EAM and CIS modules. However, the full effect of CalAm's request doesn't occur until 2014, immediately after the forecasted implementation of the EAM and CIS modules. In 2014 the revenue requirement increases to $2.58 million.[104]

Table 4-2

Business Transformation Computer Software Expenditures CalAm-Requested California Revenue Requirement - BT Additions (1)					
	2010	2011	2012	2013	2014
<u>CWIP and Plant</u>					
BT CWIP BoY	293,734	5,802,155	9,046,199	6,410,397	8,176,204
BT CWIP Additions	5,508,421	3,244,044	2,504,082	1,765,807	864,917
Transfer to Plant	-	-	(5,139,884)	-	(9,041,121)
BT CWIP EoY	5,802,155	9,046,199	6,410,397	8,176,204	-
Plant BoY	-	-	-	5,139,884	5,139,884
BT Plant Additions	-	-	5,139,884	-	9,041,121
Retire Software Replaced by BT					
Plant EoY	-	-	5,139,884	5,139,884	14,181,005
Depr. Reserve BoY		-	-	(513,988)	(1,027,976)
BT Plant Additions			(513,988)	(513,988)	(1,418,101)
Other IT Additions			-	-	-
Retire Software Replaced by BT			-		
Depr. Reserve EoY	-	-	(513,988)	(1,027,976)	(2,446,077)
<u>Rate Base and Return</u>					
EoY Rate Base	5,802,155	9,046,199	11,036,293	12,288,112	11,734,929
Avg Year Rate Base	3,047,945	7,424,177	10,041,246	11,662,203	12,011,520
Times: Pre-Tax RoR	11.26%	11.26%	11.26%	11.26%	11.26%
Incremental BT Return	343,199	835,962	1,130,644	1,313,164	1,352,497
<u>Depreciation</u>					
BT Depreciation	-	-	513,988	513,988	1,418,101
Subtract: Depreciation - Software Replaced by BT	-	-		-	-
Incremental BT Depr.	-	-	513,988	513,988	1,418,101
Estimated BT Rev. Req. - CalAm Requested	343,199	835,962	1,644,632	1,827,152	2,770,598
(1) Based on Plant Additions and Depreciation Requested by CalAm 2010-2014. Source: CalAm California Corporation Revenue Requirement Workpapers					

[104] There are some potential offsets, associated with removing the depreciation on existing software, which may mitigate the revenue requirement impacts. If these potential mitigations are considered, the net revenue requirement impact is $1.49 million in 2012, $1.65 million in 2013 and $2.58 million in 2014.

CalAm's revenue requirement calculation classifies the BT request entirely as a capitalized (rate base) expenditure. However, the 2010 plant expenditures included in the California Corporate rate base request, $5,508,502, correspond almost exactly to the CalAm assignment of both BT management and BT capital fees in the 2010 budget, $5,506,461. Based on this, it appears that CalAm has, for revenue requirement purposes, capitalized BT management fees, even though service company management fees are normally expensed.[105]

Table 4-3

California Business Transformation Fees Budgeted for California (Company 5) for 2010	
Category	Amount
BT Management Fees	$ 546,329
BT Capital Fees	4,960,132
Total	$ 5,506,461
Source: CalAm AWSC Revenue Requirement workbook '2010 Budget'	

In addition, materials provided to the board of directors in May, 2010 show that a $280 million BT budget estimate breaks down between capital, expense and a regulatory asset, as follows:[106]

~~[begin confidential]~~

- Capital - $214 million
- Expense - $20 million
- Regulatory Asset - $46 million[107]

~~[end confidential]~~

It appears CalAm is requesting rate base treatment of its share of total BT costs, whether treated as capital, expense or a regulatory asset by AW for financial statement and billing purposes.

AWSC BT Expenditures and Allocations to California - The BT expenditures included in CalAm's revenue requirement request originate in the service company, where the BT project is being implemented. The 2010 budget on which CalAm's service company

[105] In OC-226 ~~W~~we asked CalAm why management fees budgeted for BT when it had stated in response to an earlier data request (OC-195) that "100% of Business Transformation costs are being treated as capital." CalAm responded that "costs associated with internal use software . . . are to be expensed or capitalized consistent with guidance provided by the AICPA's Statement of Position 98-1 . . ." However, it appears CalAm has taken the BT management fees, which it explains are expensed in accordance with AICPA SoP 98-1, and included them in the California Corporate rate base request; in effect capitalizing them.

[106] Response to OC-191, Revised, Confidential Attachment, p.18

[107] We did not perform discovery on the nature of or basis for the regulatory asset.

revenue requirement contains $106.9 million in planned BT expenditures. CalAm's share of 2010 budgeted expenditures is $5.5 million, or 5.15 percent.[108]

CalAm's rate filing and testimony do not explain how BT expenditures are allocated to California; however, CalAm's requested BT expenditure of $14.18 million is 5.19 percent of the $273 million budget expenditure described in the Information Infrastructure Comprehensive Planning Report. This percentage corresponds with CalAm's share of total regulated customers at the end of 2009. The 2010 Budget distribution of capital and management fees associated with BT expenditures shows that the costs are charged only to AW's regulated companies.[109] There are no distributions to non-regulated cost objectives.[110]

2010 Budgeted vs. Actual BT Expenditures

As discussed above, AWSC's 2010 budget contained $106.9 million in BT expenditures. Of this $105.4 was budgeted as capital fees, and $1.5 million was budgeted as management fees. Actual cost data for 2010 indicates $27.1 million in BT spending, putting the BT project behind by approximately 9 months, based on average 2010 budgeted spend of $8.9 million per month.[111][112] CalAm's year-end 2010 construction work in progress balance, which is forecasted in CalAm's rate filing to be $5,802,155 million, was in fact just $1,678,857.[113]

BT Costs vs. Benefits

In an effort to obtain some idea of how AW quantified the costs and benefits of BT, we requested the BT business case package provided to the board of directors prior to BT approval. Recognizing that this was an AW-wide project, our request was intended to obtain the business case reviewed and approved by the AW board. CalAm initially declined to provide any BT information provided to the board, responding with the statement "[t]he Board of Directors of California American Water has not authorized the business transformation project."[114] In a revised response, CalAm eventually provided a

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[108] CalAm AWSC Revenue Requirements Workpapers, AWSC, 'Budget 2010'

[109] CalAm's 2010 budget shows that there 100 percent of budgeted BT costs are charged to the regulated water companies.

[110] As discussed above, BT includes the implementation of most AW systems. Some, such as CIS, provide benefits primarily to regulated operations; while others, such as the general ledger and related financial systems provide benefits to both regulated and unregulated companies. Overland did not conduct an audit of regulated and non-regulated allocations in this proceeding. However, we do observe that some allocation of BT implementation costs to non-regulated cost objectives appears warranted.

[111] ~~Response to~~ OC-135

[112] This was confirmed by Michael Maloney, AWSC Budget Director. During our visit to AWSC in December, 2010, Mr. Maloney indicated BT was behind by approximately 10 months.

[113] ~~Response to~~ OC-168

[114] ~~Response to~~ OC-191 Note: We believe CalAm was well aware that we were referring the AW board, not the CalAm board, when asking about approval of BT.

board presentation, dated May, 2010, a date after BP had been approved and embedded in AW budgets.[115] We did not receive the requested business case materials which led to board approval of the project.

Within the information included in the May, 2010 board presentation package is the following:

- AW considered ~~[begin confidential]~~ [redacted] ~~[end confidential]~~ and SAP as the vendors to supply replacement software for BT. AW selected SAP. AW judged the total cost of ownership using SAP to be lower over the 2010-2024 evaluation period (p.9).

- During the seven-year period from 2009 through 2016, forecasted costs ~~[begin confidential]~~ [redacted] ~~[end confidential]~~ are projected to exceed benefits of ~~[begin confidential]~~ [redacted] ~~[end confidential]~~. (p12)

- Specifically, the presentation shows that AW expects the following annualized benefits, after ramp up, ~~[begin confidential]~~ (which appear to come primarily from FTE reductions) ~~[end confidential]~~ from the following projects : (p.12)

  - ERP - ~~[begin confidential]~~ [redacted] ~~[end confidential]~~ full ramp up projected for 2014.
  - EAM - ~~[begin confidential]~~ [redacted] ~~[end confidential]~~.
  - CIS - ~~[begin confidential]~~ [redacted]; ~~[end confidential]~~ full ramp up projected for 2016.

- The board materials show AW expects cost recovery (through incremental net income) to begin in 2012 (at $2 million), increase to $6 million in 2014, and level off at $12 million annually in 2016. However, this is predicated upon "achieving top-quartile performance relative to industry benchmarks." (p.14) [116]

We also asked CalAm whether it had documented and / or quantified the benefits, in terms of efficiencies and improved cost-effectiveness, that it expects to achieve to offset the $14 million cost it is requesting to be added to the California rate base. CalAm's response is as follows:~~[117]~~

> California American is participating on the team delivering the business transformation project. Because of the uncertainty in timing [the] project

[115] ~~Response to~~ OC-191, Revised

[116] Note: The increase to net income may be after some calculation of benefits flowing to ratepayers. However, net income can only increase to the extent benefits do not flow to ratepayers in the form of lower rates. To the extent benefits flow through lower rates, net income cannot be higher.

~~[117] Response to OC-194~~

> and magnitude and timing of any potential savings, ***if any***, California American appropriately requested a balancing account to mitigate these issues (emphasis added).[118]

CalAm has not quantified any BT benefits for California, only costs, and it hedges concerning the proposition that there will be any savings.

As discussed above, to the extent there are quantifiable benefits from cost efficiencies and process improvements, they will take the form of lower labor costs, achieved through FTE reductions (a classic substitution of capital for labor). We cannot see how force level reductions in the AW service company or elsewhere, achieved years down the road, will be quantified, recognized as BT savings or reduce BT costs recorded in a balancing account. In fact, based on what know about service company fees that CalAm requests as part of its AWSC revenue requirement (specifically, that they contain costs for budgeted employees that are not actually on the AWSC payroll), we can conclude with a relatively high degree of confidence that there is no reasonable mechanism by which savings from lower payroll costs, ***if*** they occur years into the future, could even be recognized as related to Business Transformation, let alone captured in a California balancing account and recorded as an offset to BT costs.

Internal Resources Committed to BT - During our visit to AW in December, 2010 we learned that AW would be transferring ~~approximately~~ "subject matter experts" to the BT project. In total, 63 AW employees were transferred to BT, most in the last quarter of 2010. 48 of these employees are from the service company. They are included in CalAm $14.1 million BT rate base request. The salaries associated with these employees are also included in the AWSC management fees CalAm is requesting for recovery from California ratepayers. To the extent they were not on the payroll in their "home" functions (indicated below) as of December 31, 2010, they have been excluded from Overland's recommended AWSC allocation to California in the base year and in the test year. We believe requesting them both as part of BT (in the $14.1 million rate base request), as well as part of the management fee in their home departments amounts to a request for double-recovery.

[118] OC-194

Table 4-4

Business Transformation Employees Transferred to BT AWSC Functional Sources	
AWSC Function	Transfers
CSC	5
Finance	3
HR	2
IT	23
Procurement	2
Operations Service	3
SSC	8
Reg Ops	2
Total	48
Source: OC-166	

CalAm, anticipating our thinking, provided the following additional information in response to OC-166:

> It is important to understand that the vacated positions due to Business Transformation will need to be filled and this process is underway and will be complete by the test year – 2012.

In response to the unsolicited portion of CalAm's data response, we observe the following:

- Service company force levels are declining, not increasing, and are likely to be lower, not higher, in 2012 than they are at the end of 2010.

- In many cases the employees transferred to BT are likely to represent AWSC's most valuable employees. As such, the transfers are likely to be temporary, rather than permanent, making replacements unlikely. Overland agrees that many of the positions vacated are likely to be re-filled, but in many cases they will be filled by the same employees who left the positions to work on BT.

- To the extent replacements are hired, they are likely to be offset by additional vacancies elsewhere, because service company force levels are declining, not increasing.

In light of CalAm's inability to quantify any customer benefits associated with BT, the recovery from California ratepayers of twice the amount labor cost associated with these 48 positions (first, as BT expenditures from the capitalized labor and labor-related costs of the transfers; and second, as labor and labor-related costs for the asserted replacements) should ~~be~~ meet a high test of reasonableness. We do not believe it is reasonable.

Attachment 4-1

American Water Applications Targeted for Replacement - Business Transformation Project					
Line No.	Current Application/Vendor	Module Name	Description (What does it do and why)	Replacement Vendor	Targeted Implementation
1	JD Edwards /Oracle	ERP	General Ledger/Financial Reporting, Human Resources, Procurement/Accounts Payable	SAP	2012
2	JD Edwards /Oracle	Time Keeping	Recording of worked time by employees	Kronos	2012
3	Vertex	Vertex	JD Edwards bolt on Application for Payroll taxes	SAP	2012
4	JD Edwards /Oracle	Job costing	JD Edwards module utilized to track and manage costs for projects and/or jobs	SAP	2014
5	JD Edwards /Oracle	Service Billing	Service Company Billing (SCB) is the accounting process that allocates service company costs to business.	SAP	2012
6	ECIS/Vertex	Customer Service	Customer Information System	SAP	2014
7	ECIS/Vertex	Service Orders	Core functionality in ECIS that allows authorized users to generate Scheduled and non Scheduled work assignments for the field. Turn on/off, Emergency, collections, etc.	SAP CRM/ERP/Clicksoft functionality	2014
8	EDIS	EDIS	Archived Old Customer information system prior to ECIS	SAP	2014
9	WebDash	WebDash	Call handling application that pops up a screen to the user of the customer's account of the person calling in.	SAP	2014
10	CODA	CODA	Collection Direct access is an AW custom application that allows outside first party collection agencies to access ECIS information in order to more effectively and efficiently collect on past due accounts and handle customer inquiries pertaining to collections.	SAP	2014
11	Ventyx	Advantex	Workforce management system - auto update workorders in the field. Dispatch of work orders, system administration, and workforce availability.	ClickSoft Workforce Management	2014
12	Ventyx	Advantex ServiceFirst Reporting	Reporting System with reports based on the Adventex data from the Adantex system, ad-hoc relational and cube-based reports use Microsoft Technologies	ClickSoft Workforce Management	2014
13	Infor (CMMS) - Externally Hosted	Data Stream	Enterprise Asset Management and maintenance system	SAP	2014
14	PeopleClick	PeopleClick	Position requisitioning, Recruitment, Applicant Tracking and On Boarding of employees	Success Factors	2012
15	Impact 360	Impact 360	Call Taker resource scheduling software at the call center	SAP	2014
16	Clarify	CLARIFY	Tracking of HR Benefits questions by employee's and alumni	SAP	2012
17	LGS	Letter Generation System	AW custom developed application to generate letters for customers, print letters and allow display of historical letters sent to a customer.	SAP	2014
18	OAM	OAM	Online Account Manager - Web based application that allows usage data customers to download their usage information as well as inquiry on a specific premise.	SAP	2014
19	OPD	Operations Parameter Database	Data warehouse for storing operational data for statistical reporting such as water sales and system delivery	SAP	2014
20	Org Unit Administration	Org Unit Administration	Administration application for Org Unit and Org Unit related files.	SAP	2012
21	Complaints Investigation (CID)	Complaints Investigation (CID)	Complaints handling application. Used to track and report customer complaints that require investigation.	SAP	2014
22	ProductCode	ProductCode	Listing and descriptions of Product Codes for Accounting strings	SAP	2012
23	ESS Training	ESS Training	Provides tracking for Training Course information, overview, registration, attendance and certification.	Success Factors	2012
24	Form 80 / AIP	Form 80 / AIP	Annual Incentive Plan (AIP) payout process	SAP	2012
25	GIS	GIS	GIS will be integrated with SAP to provide additional geospatial attributes to our physical assets	Enterprise GIS/SAP interface	2014
26	Source: Response to OC-171, Attachement				

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5. SALARIES, WAGES AND INCENTIVE COMPENSATION

This chapter covers our review of employee salaries and wages (labor), and incentive compensation. These expenses are recorded in the following object accounts.

- Account 501200 – Labor
- Account 501210 – Labor NS (Non-Scheduled) Overtime
- Account 501211 – Labor Overtime
- Account 501711 – Incentive Compensation
- Account 501716 – Compensation Expense – Restricted Stock Options
- Account 501718 – Compensation Expense – Restricted Stock Units

Payroll taxes (Social Security, Medicare, and federal and state unemployment taxes), group insurance, and employee savings plans are directly tied to labor and recommendations concerning these expenses directly follow labor expense recommendations.[119]

Pensions, postretirement benefits other than pension (PBOPs), group insurance, and company contributions to employee savings plans are covered in separate chapters. CalAm's rate-requested salaries, wages, and incentive compensation expense includes the following components:

- Service company expenses allocated to CalAm as management fees, and[120]
- California Corporation (CalCorp) expenses (Exh. CC Exp-200 pp. 49-69).

Summary of Findings

1. Cal-Am Requested Labor and Labor-Related Expenses - CalAm's requested General Office salaries, incentive compensation and labor-related expenses, including group insurance, payroll taxes and employee savings plan expenses are based on budgeted, rather than actual employee positions. Although the number of budgeted and actual positions in CalCorp were approximately the same at the end of base period 2010, this was not true for AWSC. The difference between AWSC's budgeted (authorized) positions and actual employees is significant and on-going. At the end of 2009, approximately 11 percent of AWSC's positions were vacant. At the end of 2010, AWSC's vacancy

[119] Table 5-2, below, shows CalAm's requested California labor expense revenue requirement (the first three accounts listed above). Table 5-4, below, summarizes CalAm's requested incentive compensation expense (the last three accounts listed above).

[120] Service company group insurance expense cannot be directly referenced in the rate filing, because the filing and related support presents AWSC costs on a functional, rather than account, basis. To the best of our knowledge, the only place CalAm's calculation of the California share of service company group insurance expense for the period 2010-2013 can be found is the table below in this report.

rate was approximately 8 percent.[121] AWSC's labor force levels, vacancies and requested labor expense are covered in Chapter 3. CalCorp labor expense is discussed below.

2. Growth in CalCorp Labor Expense – As summarized in the following table, CalCorp's labor force and its labor-related expenses have grown significantly since 2005, from a little more than $3 per customer to almost $30 per customer. Among the changes that occurred in the 2008-2010 period were the addition employees to fill four new positions (O&M expense impact of approximately $285,000 in 2010), and the transfer of six positions from AWSC, which increases CalAm's 2010 cost~~expense~~ by approximately $1~~18~~21,000, due to amounts shifted into California that had been allocated to other states. Assessing the reasonableness of past growth in CalCorp labor, in terms of benefits to California customers, over the entire historical period would require a detailed, retrospective analysis of changes in CalCorp's CalAm's and other components of AW's organization that was beyond the scope of our work in this rate filing. Therefore, to make a base period labor expense recommendation for CalCorp based on actual employees at the end of 2010 requires us to make an assumption, but not a conclusion, that CalCorp's labor force and actual labor expenses are reasonable.

Table 5-1

Growth in CalCorp Labor and Labor-Related Expense, Net of Capital Credits 2005-2010						
Item	2005	2006	2007	2008	2009	2010
Salaries and Wages	$146,070	$204,206	$1,182,775	$2,338,389	$2,926,616	$3,359,758
Incentive Compensation	369,150	(245,985)	306,829	278,648	(209,438)	805,881
Payroll Taxes	68,572	24,953	84,081	284,178	316,886	324,848
Group Insurance	7,867	43,456	122,857	297,134	381,355	382,309
Employee Savings Plans	-	(5,261)	37,770	96,888	123,255	136,888
Total Net Expense	$591,659	$21,369	$1,734,312	$3,295,237	$3,538,674	$5,009,684
Cumulative Percentage		-96%	193%	457%	498%	747%
Sources: CalAm CalCorp workpapers CC Exp 103 & CC Exp 107; OC-148						

3. Forecasted Growth in CalCorp Labor Expense 2010-2012 – CalCorp is requesting authorization for seven new positions (to be added between 2009 and 2012) which increase O&M expense by $283,000 in base period 2010 and by $585,000 in test year 2012. Five of these positions (with a total test year O&M expense impact of $427,000) have already been filled. In addition to new positions, six employees were transferred to CalCorp from AWSC since the last rate case authorization. These increase requested test year O&M expense for CalCorp by $927,000. However, because a large share of the expense was previously allocated to CalAm by the service company, the 2010 base year total

[121] Overland found similar service company vacancy rates in 2007 and 2008 when we conduct a review in the prior General Office GRC.

cost~~test year O&M~~ impact on CalAm (the amounts that would have been allocated elsewhere absent the transfers) is only about $~~108,000~~121,000.[122] Total requested CalCorp labor and labor-related expenses, compared with 2010 actual amounts, are summarized below.

Table 5-2

CalAm's Requested CalCorp Labor and Labor-Related O&M Expense, 2010-2013 Compared with Actual 2010 Amounts (All Amounts Net of Capital Credits)					
Item	2010 (Actual)	2010 (Requested)	2011 (Requested)	2012 (Requested)	2013 (Requested)
Salaries and Wages	$3,359,758	$3,419,523	$3,584,213	$3,753,072	$3,873,169
Incentive Compensation	805,881	843,494	880,091	910,988	939,853
Payroll Taxes	324,848	248,571	260,695	274,022	283,227
Group Insurance	382,309	382,309	497,001	537,755	581,851
Employee Savings Plans	136,888	174,519	185,060	195,553	201,809
Total Net Expense	$5,009,684	$5,068,416	$5,407,060	$5,671,390	$5,879,909
Cumulative Percentage Increase 2010 Actual -2013 Forecast		1%	8%	13%	17%
Sources - Actual: OC-148; Requested (Forecasted): CalAm Workpaper "Corp Labor.xls", Payroll Summary Sheet					

4. Cal-Am Requested Incentive Compensation – AW's incentive compensation consists of cash and equity awards based on financial, operational and individual employee performance. Incentive compensation accrued in 2010 is 16.5 percent and 13.3 percent, respectively, of AWSC's and CalCorp's salary expense. Most of the expense is associated with the Annual (cash) Incentive Plan open to most management employees. We were unable to assess the competitiveness of AW's incentive compensation relative to the market because AW claims that it maintains no market benchmark data for total cash compensation (salary and cash incentive pay). Based on the 100 day update, CalAm is requesting customer recovery of $1,247,215 in General Office incentive compensation for the base period (2010) and $1,333,641 for the test year (2012). CalAm's request is that customers fund 100 percent of accrued cash and equity-based incentive compensation.

5. DRA Recommended Incentive Compensation – DRA's Report recommends that customer-funded incentive compensation be based on an alignment of plan incentives with customer benefits. Our analysis of AW's plans showed that approximately 30 percent of Annual Incentive Plan awards and approximately 15 percent of the awards under the longer-term equity-based plans depend on

[122] 2010 ~~salary~~labor and labor-related costs for five of the positions identified by CalAm witness Dana (CalAm Direct Testimony of Jeffery Dana, p.6) total~~s~~ $~~557~~840,000. We have estimated the labor and labor-related cost of a 6th position (that we could not identify) to be $127,000 for a total transferred employee cost of $967,000 in 2010. Amounts that would have been allocated to Arizona, New Mexico and other Western Region states (without the transfer), per the Dana testimony, are 20 percent of a Principal Analyst Rates, 20 percent of a Finance Director and 30 percent of a Financial Analysis II, for a total of $~~108,000~~121,000.

operational performance and customer growth that can be asserted to provide direct customer benefits. The remaining award components depend either on financial performance (primarily benefiting shareholders) or on general individual performance measures.

6. Market Competitiveness of Sampled Management Salaries – We selected a judgment-based sample of 30 AWSC management positions with salaries over $100,000 to compare with market benchmarks. Although AW's salary grades are benchmarked against market data, directly comparable market-based data for many individual management positions does not seem to be available. AW did not provide market-comparable salaries for 12 of the 30 positions in the sample. Of the 18 positions for which market-based data was provided:

   - Average actual salary exceeded the market-comparable 50th percentile for 61 percent (11 of 18) of the positions sampled for which AW provided the requested market-based compensation data.

   - The AW salary grade mid-point associated with the positions exceeded the market-comparable 50th percentile for 72 percent (13 of 18) of the positions.

   - Total actual salaries for the 18 positions ($2,740,931) exceeded total market-comparable salaries ($2,647,801) by 3.5 percent.

   - Total AW salary grade midpoints ($2,786,550) exceeded market-comparable salaries ($2,647,801) by 5.2 percent.

   We cannot draw conclusions from a sample in which 40 percent of the items selected produced no comparable market data. However, assuming the larger population of management positions produced results similar to that of the 18 positions for which data were provided, it suggests AW's salary midpoints are above the market's 50th percentile, but not by a significant percentage. We did not attempt to perform an analysis of the competitiveness of AW's union salaries.

7. Market Competitiveness of Total Cash Compensation and Total Compensation – AW stated that it does not maintain market benchmarking data for total cash compensation or for total compensation (cash and non-cash) for management positions in AWSC.[123] As such, it is not possible even to get a sense of the market competitiveness of AW's total cash compensation or total overall compensation. Such market benchmarking is typically available in compensation surveys conducted by benefits consulting firms ~~such as~~ [redacted] ~~Associates, which performs work for AW in other areas~~. To the extent AW does not have

[123] OC-169-B

information to gauge whether total compensation (total cash and total overall compensation) is within range of market mid-points, we consider it to be a deficiency in AW's employee compensation management procedures.

Summary of Recommendations

1. Base Period Labor and Labor-Related Expenses – ~~-~~Consistent with the Commission's prior order, Overland recommends base period (2010) labor expense, labor-related expenses and incentive compensation (cash and non-cash) based on actual employees at the end of 2010, rather than the authorized positions requested by CalAm, which would charge customers for the labor associated with AWSC positions which are vacant on an ongoing basis.[124] We calculated recommended labor and labor-related expense based on full time equivalent General Office (AWSC and CalCorp) employees as of December 31, 2010.

2. Incentive Compensation - DRA recommends customer-funded incentive compensation based on an alignment of plan incentives with customer benefits. As discussed below, our analysis showed that 30 percent of the awards under the AIP and 15 percent of the awards on the equity-based restricted stock and option incentive plans were based on metrics directly aligned with customer benefits. Based on DRA's recommendation, Overland recommends that customer-funded AIP and equity incentive plan expense be calculated using these "customer benefit" ratios.

3. Market Competitiveness of AW's Employee Compensation – CalAm's General Office expense includes many management employees whose total compensation and benefit packages approach and in some cases exceed $200,000 per year. Testing the competitiveness of compensation to the market (both for utility and general industry compensation markets) is standard industry practice. We recommend the Commission require AW to demonstrate the market competitiveness of its salary, total cash and total overall employee compensation prior to or in conjunction with the filing of its next California rate increase request. Specifically, AW should show, using salary surveys done by a benefits consulting firm ~~such as~~ [redacted] ~~and Associates~~, how its salary, total cash and total overall (cash plus benefits) compensation levels compare with the market, both for AWSC and for CalAm.

[124] In the last case we recommended, and the Commission adopted, labor expense based on actual employees. At the point in time at which employee level was established (May 31, 2008), AWSC's vacancy rate was 9 percent (as calculated from Table 2-2 in our prior report). At the end of 2009, AWSC's vacancy rate was 10.3 percent, and at the end of 2010, the point in time we recommend for calculating base period labor expense, the vacancy rate was 7.8 percent.

4. Requested Additions to the Authorized CalCorp Labor Force – CalCorp's labor expenses have increased dramatically since 2005. In addition to expense increases due to position growth prior to 2009 and to employees transferred from AWSC, CalCorp has added or has proposed to add employees for seven new positions since the most recent rate case authorization. These positions, five of which have been filled as of March, 2011, increase CalAm's requested test year 2012 labor and labor-related O&M expense by $585,000. Although we have not calculated an adjustment to remove the additional CalCorp positions, we recommend the Commission consider whether customer funding of the positions is justified in light of the significant increase in CalCorp staffing that has already occurred.

Salaries and Wages (Labor and Labor Overtime Expense)

CalAm's actual General Office labor expense for 2009 and 2010 and requested labor expense for 2010 through 2013 are summarized below. Overall, CalAm's base period labor expense request is about 3.5 percent higher than actual 2010 expense. Most of this is due to labor expense allocated from AWSC. As discussed below, the primary reason AWSC's labor expense is lower than CalAm's request is that the request includes a significant amount of expense for vacant positions.

While the trend in AWSC's force level is downward, the trend in employees at CalCorp has been upward. In the forecast period CalAm requests a continued increase in CalCorp's employee level, but does not recognize the downward trend in AWSC's employee level. CalAm continues to request labor expense based on a service company labor force level that AWSC has not had since around the end of 2008.

Table 5-3

California American Base Rate Filing 2011-2013 Requested Salary and Wages Expense (AWSC Allocated and California Corporation)						
Salary and Wages (Accounts 501200, 501210 and 501211)	2009 Actual	2010 Actual (As Recorded)	2010 Base Period Request	2011 - Requested Salaries and Wages	2012 - Requested Salaries and Wages	2013 - Requested Salaries and Wages
Acct 501200 - Labor	98,053,179	96,288,126	103,082,731			
Acct 501210 - Labor Non-Sch. Overtime	1,084,941	563,090	-			
Acct 501211 - Labor Overtime	1,806,631	2,006,402	1,108,939			
AW Service Company, Salary and Wages	$ 100,944,751	98,857,618	104,191,670			
Subtract: Business Transformation	1,310,489	2,388,155	1,597,431			
AW Service Company Without BT	99,634,262	96,469,463	102,594,239			
Subtract: Capital Fee Component	10,141,068	9,261,916	10,846,366			
AWSC Mgt Fee Expense	$ 89,493,194	$ 87,207,547	$ 91,747,873	$ 94,592,057	$ 97,543,329	$ 100,508,646
CalAm AWSC Allocation Pct	5.3720%	5.2716%	5.2716%	5.2716%	5.2716%	5.2716%
CalAm AWSC Amount, Expense	4,807,574	4,597,233	4,836,581	4,986,515	5,142,094	5,298,414
CalCorp Labor Expense	2,926,616	3,321,628	3,387,894	3,551,239	3,718,848	3,837,851
CalCorp Labor Overtime	15,112	38,130	12,648	13,091	13,432	13,861
Total CalCorp Salary and Wages	2,941,728	3,359,758	3,400,543	3,564,330	3,732,280	3,851,713
Total CalAm Salary and Wages Expense	$ 7,749,302	$ 7,956,991	$ 8,237,124	$ 8,550,845	$ 8,874,374	$ 9,150,127
Percentage Increase Over 2010 Actual			3.5%	7.5%	11.5%	15.0%

Sources: **Service company component:** OC-72, OC-135, CalAm workpaper SC WP110. It was necessary to extract data from the detailed 2010 budget in CalAm's AWSC revenue requirement workbook in order to extract Salary and Wages amounts, Business Transformation amounts (which are excluded) and AWSC "capital fees." **CalCorp** amounts from Rate Filing Corp Labor spreadsheet (100 day Update)

Labor Expense Regulatory Background – In the prior rate case we recommended annualizing AWSC's and CalCorp's labor expense using actual headcount at the most recent date available to us (May 31, 2008).[125] For AWSC, we noted that this permitted labor expense calculated using an employee base 28 percent increase higher than the level of employees from 2006, during a period when CalAm's customer population barely changed. We also noted that AWSC had a significant vacancy rate, and that the adjustment CalAm made for vacancies accounted for only a fraction of the difference between budgeted and actual force levels.[126] CalAm opposed our recommendation, stating that the employee count should be based on employees actually needed, not an actual count on an "arbitrary date" that will "freeze" employee levels. The Commission accepted our analysis and based its decision on actual May 31, 2008 employees. Since 2008, when CalAm argued against "freezing" employees at actual levels, allowing for 2008 organizational changes that brought additional employees into the service company,[127] AWSC's employee levels have begun to decline. CalCorp's employee levels have continued to increase.

AW made organizational changes in the makeup of the service company during 2008. At the end of 2008, AWSC had 1,652 full time equivalent employees (FTEs). At the end of 2009 it had 1,561 FTEs and at the end of 2010, it had 1,514 FTEs. The functional area declining the most is Customer Service; more specifically, customer call center

[125] Prior Overland Audit Report (Regulatory Audit of 2006 and 2007 General Office Expense and Test Year Revenue Requirement of California American Water Co, Sept. 11, 2008), pp. 2-2
[126] Overland Report, Sept. 11, 2008, p. 2-3
[127] These employees were the result of organizational restructuring, and were not the vacant positions that represented the difference between CalAm's request and Overland's recommendation.

employees; although other functions, including Finance, IT and Regulated Operations have continued to decline.

Analysis of CalAm's Requested Salary and Wages Expense

We reviewed support for CalAm's requested CalCorp and AWSC-allocated labor expense during the forecast period 2010 through 2013. In general, our recommended labor expense is based on actual, filled positions as of the end of 2010, and represents labor expense that the company is actually incurring.[128]

CalAm's requested labor expense is based on budgeted employee positions. Budgets are built using the positions authorized by the company, rather than actual staff; thus, they include expense associated with vacant positions.[129] At the end of 2009, AWSC's vacancy rate was approximately 11 percent (i.e., at the end of 2009 only about 89 percent of AWSC's authorized positions were filled). At the end of 2010, AWSC's vacancy rate was approximately 8 percent. Because it is based on authorized positions, CalAm's requested base period revenue requirement for AWSC includes labor expense associated with employees on AW's payroll, as well hypothetical expense associated with an on-going level of vacant positions.

Although AWSC has a significant ongoing vacancy rate, by the end of 2010 CalCorp's actual labor expense was based on approximately the same level of employees (70 FTEs) as CalAm included in its revenue requirement request (69 FTEs).[130] Moreover, CalCorp had made an employment offer to fill a position new 2011 position that CalAm included in its labor expense request.[131]

AWSC's and CalCorp's actual and budgeted (authorized) positions are summarized below. Approximately 5.2 percent of the expense associated with AWSC's 2010 budgeted positions is charged to California in CalAm's base period request for AWSC. This is the equivalent of about 85 FTEs at the California level.

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[128] Exceptions include: 1) We accepted CalAm's addition of two new positions to CalCorp in 2011, based on the fact that employment offers have been extended; and 2) We believe the downward trend in AWSC's call center force levels, which is based on operational changes that are improving productivity, should be recognized going forward through the forecast period.

[129] AWSC makes a small expense offset adjustment (about $2.5 million) to account for a portion of the labor expense associated with vacancies built into its budget. The adjustment does not begin to cover the expense associated with vacancies that appear to average around 10 percent of authorized expense. In any event, CalAm reversed AWSC's vacancy adjustment in calculating its revenue requirement; thus, CalAm's requested salary expense, as well it request for other expenses (payroll taxes, group insurance, savings plan expenses, etc.) incremental to employees, makes no allowance for vacancies.

[130] OC-134, Attachment 1 (actual employees 12/31/10) and CalAm workpaper spreadsheet "Corp Labor.xls", 100 day update (requested labor expense based on listed employees)

[131] OC-134, Attachment 1

Table 5-4

General Office Employees Full-Time Equivalent Employees					
Category	Budgeted Employees		Actual Employees		
	2009	2010	Dec-08	Dec-09	Dec-10
Total AWSC	1,740	1,642	1,652	1,561	1,514
Total CalCorp	61	68	45	63	70
Total General Office	1,801	1,710	1,697	1,624	1,584

Sources: OC-14, OC-18, OC-19, OC-91, OC-133, OC-134, and CalCorp WPs Exh. A-CC Ch. 2, Table 5

Requested Increase in AWSC's Labor and Related Expenses – A thorough discussion of CalAm's requested labor force levels, labor and related expenses for AWSC is included in Chapter 3.

Requested Increase in CalCorp Labor Expenses – CalCorp's labor and related expenses increased dramatically between 2005 and 2010. Much of the increase occurred between 2008 and 2010. Two separate categories of employee additions have increased CalCorp's labor and labor-related O&M expense since the most recent prior rate case authorization.

- Positions Transferred from AWSC - Six employees were transferred from AWSC. Of approximately $1,019,000 in labor and labor-related expenses (including pension and PBOP expense) transferred, we estimate $~~118~~121,000 in base period 2010 and $13~~1~~5,000 in test year 2012 represents a shift from amounts that would have been allocated to other states in the Western Region (primarily Arizona) had the employees remained in AWSC.[132] The transfers may have been made in anticipation of AW's sale of the Arizona and New Mexico properties, announced in January, 2011. ~~a couple of months ago.~~ If so, the $13~~1~~5,000 cost shift in 2012 represents a direct impact of the sale of these properties on California customers.

- Additional CalCorp Positions - Second, CalAm requested to add labor and labor-related O&M expense for seven additional positions that were not authorized by the Commission in the last rate case. Four of these positions were added in 2009 and 2010, and are fully reflected in the base period (2010) and test year (2012) expense requests. These positions increase CalCorp's test year (2012) O&M by $308,000. CalAm stated that it had extended an offer for employment for a fifth position (Diversity Procurement Manager), in January, 2011. This position increases test year O&M by $1~~24~~19,000. The sixth and seventh positions, forecasted to be added in 2012, increase test year O&M by

[132] Per allocation expense identified in CalAm Direct Testimony of Dana (p.6), the amounts that would have been allocated elsewhere include: 20 percent of the Finance Director, 20 percent of the Principal Rates Analyst, and 30 percent of the Financial Analyst II. Overland did not assess the accuracy of these percentages.

$1~~64~~58,000. In total the seven positions increase test year O&M by $585,000. Their impact on the period 2010-2013 is summarized below.

Table 5-5

California American Water

Requested O&M Expense for Actual and Forecasted Employee **Additions to CalCorp Labor Force** Since the Prior Rate Case Authorization

Position and (Year Added)	Salary	Incentive Pay	DCP and 401K	Payroll Tax	Group Insurance (1)	Total Cost	Capital Pct (2)	Total O&M Expense
2010								
Corp Counsel II (2009)	125,000	25,000	6,563	8,823	10,613	175,998	10%	160,899
Paralegal (2009)	60,008	3,000	5,550	4,730	10,613	83,902	10%	75,812
Mgr - Engineering Planning (2010)	149,702	29,940	3,743	9,181	10,613	203,179	100%	29,940
Mgr - Engineering Project Delivery (2010)	120,000	18,000	9,300	8,750	10,613	166,663	100%	18,000
2010 Operating Expense Impact	**454,710**	**75,941**	**25,156**	**31,484**	**42,452**	**629,743**		**284,651**
2011								
Corp Counsel II (2009)	129,375	25,875	6,792	9,146	13,594	184,782	10%	168,891
Paralegal (2009)	62,108	3,105	5,745	4,892	13,594	89,444	10%	80,810
Mgr - Engineering Planning (2010)	154,942	30,988	3,874	9,517	13,594	212,915	100%	30,988
Mgr - Engineering Project Delivery (2010)	124,200	18,630	10,395	9,071	13,594	175,889	100%	18,630
Diversity Procurement Manager (2011)	80,000	8,000	8,162	6,260	13,594	116,016	0%	116,016
2011 Operating Expense Impact	**550,625**	**86,599**	**34,967**	**38,886**	**67,970**	**779,047**		**415,336**
2012								
Corp Counsel II (2009)	132,739	26,548	6,969	9,480	14,288	190,024	10%	173,676
Paralegal (2009)	63,723	3,186	5,894	5,015	14,288	92,107	10%	83,215
Mgr - Engineering Planning (2010)	158,970	31,794	3,974	9,860	14,288	218,886	100%	31,794
Mgr - Engineering Project Delivery (2010)	127,429	19,114	9,876	9,403	14,288	180,111	100%	19,114
Diversity Procurement Manager (2011)	82,080	8,208	8,374	6,419	14,288	119,369	0%	119,369
Operations Specialist (2012)	65,000	-	7,157	5,113	14,288	91,558	11%	81,487
Ops Engineer for Northern Div (2012)	75,000	7,500	3,714	5,878	14,288	106,380	30%	76,716
2012 Operating Expense Impact	**704,941**	**96,350**	**45,958**	**51,168**	**100,019**	**998,436**		**585,372**
2013								
Corp Counsel II (2009)	136,986	27,397	7,192	9,845	15,460	196,880	10%	179,932
Paralegal (2009)	65,762	3,288	6,083	5,171	15,460	95,764	10%	86,516
Mgr - Engineering Planning (2010)	164,057	32,811	4,101	10,238	15,460	226,668	100%	32,811
Mgr - Engineering Project Delivery (2010)	131,507	19,726	10,192	9,766	15,460	186,651	100%	19,726
Diversity Procurement Manager (2011)	84,707	8,471	8,642	6,620	15,460	123,900	0%	123,900
Operations Specialist (2012)	67,080	-	6,844	5,272	15,460	94,656	11%	84,244
Ops Engineer for Northern Div (2012)	77,400	7,740	3,833	6,061	15,460	110,494	30%	79,668
2013 Operating Expense Impact	**727,500**	**99,434**	**46,886**	**52,973**	**108,220**	**1,035,013**		**606,798**
Total Base Period 2010 Thru 2013	**2,437,776**	**358,324**	**152,968**	**174,511**	**318,661**	**3,442,239**		**1,892,157**

Source: CalCorp "Corp Labor.xls" work book (100 day update), various worksheets
(1) Requested Calcorp Grp Ins divided by total CalCorp employees. (2) Incentive Pay is not capitalized.

<u>2009 Additions to Legal Staff</u> - CalAm states that it added Corporate Counsel II and Paralegal positions in 2009 based on a statement made by DRA that "[i]t would be more prudent and cost-effective for CalAm to hire another attorney to handle their GRC filings."[133] CalAm's deference to DRA's management advice notwithstanding, we believe it is more likely that the positions were added based on a belief that it would help improve the company's rate case outcomes.

It is important to note that although CalCorp added not just one, but <u>two</u> legal employees (an attorney and a paralegal), and although CalAm now has <u>four</u> employees on its legal staff (three attorneys and a paralegal), CalAm's test year rate case expense request, which includes external legal costs, is more than <u>double</u> the level currently authorized for all CalAm districts combined. The legal staff hired into CalCorp has apparently had little impact on CalAm's requested external legal expenses.

[133] CalAm references Exhibit 103 in Application 09-01-013, but provides no page number.

Recommended General Office Labor and Certain Labor-Related Expenses

The general trend has been a decline in force levels at the service company and an increase in CalCorp's labor force. Our recommendation reflects both sides of this trend. CalAm's requested labor expense recognizes an increasing level of employment in California (in CalCorp), but does not recognize the corresponding decline in service company employment. In fact, CalAm's requested labor expense for AWSC is based on a force level of 1,642, a level that AWSC has not actually employed since around the end of 2008.

AWSC - We adjusted requested labor expense allocable from AWSC to reflect actual service company force levels as of year-end 2010. We did not adjust AWSC's salary levels, although, as discussed below, we believe there is some reason to be concerned about AW's employee compensation levels relative to market.

CalCorp – We were not able to conduct a review of the basis for the requested and actual increases in CalAm's labor force, because it would have required a detailed functional review of not just CalCorp, but also of CalAm, AWSC and other components of AW's organization extending back over the past five years, a task beyond the scope of our rate filing review.[134] Thus, our recommended labor expense for CalCorp begins with an assumption, but not a conclusion, that the CalCorp organization and force level is reasonable *per se*.[135]

We did not adjust CalAm's requested CalCorp labor expense, because total expense calculated using year-end 2010 staffing was approximately the same as the amount CalAm requested. We also accepted CalAm's requested addition of three employees to the CalCorp labor force in 2011 and 2012 because:

- By year end 2010, all CalCorp vacancies included in CalAm's base period request were filled.
- The position CalAm requested to be added in 2011 was in the process of being filled (an employment offer had been extended) as of January, 2011 (at the time we reviewed it).
- Only two positions have been requested to be added in 2012, with a combined budgeted O&M impact of approximately $160,000.

Although we did not adjust the labor expense associated with seven new CalCorp positions (from 2009 through 2012) requested by CalAm, we recommend the

[134] A review and recommendations concerning the many complexities that may have affected the growth in CalCorp's staffing could consume hundreds of analysis hours.

[135] The Commission may wish to develop its own conclusions about CalCorp's labor force and cost structure, which grew by more than an order of magnitude between 2006 and 2010.

Commission consider whether these additional positions should be funded by customers in light of the very significant increase in the CalCorp organization that has occurred over the past six years.

Labor-Related Expenses - In addition to labor expense, the recommended labor force level directly affects the following expenses which are budgeted according to authorized headcount:

- Incentive compensation – accounts 501711, 501716 and 501718
- Group insurance – account 504100
- Employee savings plans – accounts 507100 (401k Match) and 508101 (DCP)
- Social Security, Medicare and unemployment taxes (Accounts 685320, 685325 and 685350)

We adjusted requested service company expenses in each of these accounts in proportion with our recommended adjustment to labor expense to reflect AWSC's December 31, 2010 labor force levels.

Incentive Compensation

CalAm's requested base period (2010) incentive compensation expense is 16.5 percent of salaries and wages for AWSC and 13.3 percent of salaries and wages for CalCorp.[136] AW stated it does not maintain any data comparing its total cash compensation (salary plus incentive compensation) to market-comparable industry compensation, so the market comparability of AW's incentive compensation cannot be evaluated.[137] AW's incentive compensation, as reflected in CalAm's revenue requirement, consists of the following plans:

- Annual (Cash) Incentive Plan (AIP) – account 501711
- Equity Award Plan (Restricted Stock Units) – account 501716
- Equity Award Plan (Options) – account 501718

AW accrues incentive compensation expense during the year. In general, the amount budgeted and accrued is based upon meeting 100 percent of the company's financial targets. Accrual amounts may change as the year progresses, based primarily on financial outlook. In the third quarter of 2010 AW increased its AIP accrual by 30 percent (about $2.5 million for AWSC) to reflect an improved 2010 financial outlook.[138]

[136] Incentive compensation for CalAm's district-level employees is not part of General Office expense and was not within the scope of our review.
[137] ~~Response to~~ OC-169
[138] Interview with Mike Maloney – Budget Lead, December 15, 2010. AWSC's share of the additional accrual was $2.5 million.

AIP payments are made in March of the year following the accrual.[139] At around this time, the amount accrued during the prior year is adjusted to reflect actual payouts.[140] Adjustments to reflect differences between the 2009 accrual and payment, together with the additional 30 percent accrued for an improved financial outlook, accounts for most of the difference between the 2010 AIP rate request (based on budget) and 2010 actual AIP expense. Payouts for equity awards occur in increments of one-third of the total award over the subsequent three years.[141]

Actual 2009 and 2010 incentive compensation expense and the amounts CalAm requested from 2010 through 2013 are summarized below. Incentive compensation increased dramatically in 2010. Taking both AWSC's allocation and CalCorp into account, 2010 accrued incentive compensation is more than double the amount accrued in 2009.

Table 5-6

Table
California American Base Rate Filing 2011-2013
Requested Incentive Compensation Expense (AWSC Allocated and California Corporation)

Incentive Compensation (Accounts 501711, 501716 and 501718)	2009 Actual	2010 Actual (As Recorded)	2010 Base Period Request	2011 - Requested Incentive Compensation	2012 - Requested Incentive Compensation	2013 - Requested Incentive Compensation
Acct 501711 – Incentive Compensation	9,811,939	14,249,678	12,105,446			
Acct 501716 – Comp.Exp. Restricted Stock Options	1,933,096	2,127,119	2,725,541			
Acct 501718 – Comp.Exp. – Restricted Stock Units	1,976,410	2,943,813	2,725,541			
Acct 504341 – Comp.Exp. – Defined Contr Supp Exec Retirement Plan Exp	-	88,289	-			
AW Service Company, Incentive Compensation	$ 13,764,704	19,408,899	17,556,528			
Subtract: Business Transformation	436,734	853,132	590,010			
AW Service Company Without BT	13,327,970	18,555,767	16,966,518			
Subtract: Capital Fee Component	1,356,560	1,781,517	1,910,963			
AWSC Mgt Fee Expense	$ 11,971,410	$ 16,774,250	$ 15,055,555	$ 15,522,277	$ 16,006,572	$ 16,493,172
CalAm AWSC Allocation Pct	5.3720%	5.2716%	5.2716%	5.2716%	5.2716%	5.2716%
CalAm AWSC Amount, Expense	643,104	884,271	793,669	818,272	843,802	869,454
CalCorp Incentive Compensation	(99,928)	805,881	453,547	473,225	489,838	505,359
Total CalCorp Incentive Compensation	(99,928)	805,881	453,547	473,225	489,838	505,359
Total CalAm Incentive Compensation Expense	$ 543,176	$ 1,690,152	$ 1,247,215	$ 1,291,497	$ 1,333,641	$ 1,374,813
Percentage Increase/Decrease Over 2010 Actual			-26.2%	-23.6%	-21.1%	-18.7%

Sources: **Service company component:** OC-72, OC-135, CalAm workpaper SC WP110. It was necessary to extract data from the detailed 2010 budget in CalAm's AWSC revenue requirement workbook in order to extract Salary and Wages amounts, Business Transformation amounts (which are excluded) and AWSC "capital fees." **CalCorp** amounts from Rate Filing Corp Labor spreadsheet (100 day Update)

139 ~~Response to~~ OC-22

140 Interview with Mike Maloney – Budget Lead, December 15, 2010. AWSC's share of the 2010 difference (the amount accrued in 2009 that was not actually was $700,000.

141 Id.

Summary of Incentive Plans and Features

The following table summarizes the features of and recent changes to AW's cash-based AIP and equity award plans.[142]

[redacted]

[redacted]

Incentive Compensation Regulatory Background

Incentive compensation has been reduced or removed from CalAm's revenue requirement in each of the prior three rate cases. In Decision 03-02-030, the Commission denied CalAm's request to recover forecasted incentive compensation,

[142] ~~Response to~~ OC-22

noting that the requested amounts were "only estimates", and that CalAm had paid substantially less incentive pay than it had budgeted in two of three historical periods it cited.[143] In the General Office rate case Decision 06-11-050, CalAm agreed in settlement to remove incentive compensation from its rate request. Finally, in Decision 09-07-021, the Commission concluded that the incentive compensation in CalAm's rate request should be reduced from the estimated 100% incentive compensation payout in the test year 2009 to the actual payout rates from 2007. 2007 contained the most recent available data for actual payout rates.[144]

In this case, CalAm argues that incentive compensation should be added back to 2009 authorized recoverable expenses in order to "create a comparable relationship to the request for 2012".[145] CalAm states that the Commission "speculated" that there would either be reduced or no incentive compensation payments made based on American Water's financial position at the time of the previous rate case filing. CalAm notes that payouts were made in 2008 and 2009.[146]

CalAm also states that its requested incentive compensation is based on the assumption that each employee will reach their target performance and be paid 100% of their available amount for individual performance.[147] According to the most recent Annual Incentive Plan Brochure [redacted]

Recommended Incentive Compensation

AIP - DRA has proposed that funding of incentive compensation program should be aligned with the parties that receive the benefits from the goals or metrics achieved in the plan.[149] DRA and Overland reviewed the 2010 AIP Highlights Brochure and found that the determination of the amount funded for the AIP is based 70% on financial goals and 30% on non-financial goals. (See above for list of financial and non-financial goals.) The DRA explains in their report that the shareholders are the direct beneficiaries of American Water meeting their financial goals, while the ratepayers are the direct beneficiaries of American Water meeting their operational (non-financial) goals. Therefore, the DRA recommends that only 30% of the AIP funding be recovered from ratepayers. Overland's recommended adjustment to CalAm's requested AIP reflects DRA's recommended alignment of benefits, and is based on a 70 percent shareholder / 30 percent customer split of actual 2010 AIP expense for the base period.

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[143] Decision 03-02-030, General Office – Salaries, p. 24
[144] Decision 09-07-021, Section 6.3.2.2 pp. 100-101
[145] CalAm Direct Testimony of David Stephenson, pp. 101-105
[146] David Stephenson's Direct Testimony, pp. 101-105
[147] Id.
[148] ~~Response to discovery,~~ OC-22
[149] DRA testimony in A10-07-007

As discussed above, American Water increased their incentive compensation accrual in account 501711 in the third quarter of 2010 because the company was on pace to exceed financial targets to fund 100% of the incentive compensation. Per discussion with AW, the percentage being accrued in 2010 will be based on the assumption that American Water will meet 130% of its financial target.[150] Based on DRA's recommendation, none of the accrual increase is attributable to direct customer benefits and should therefore not be funded by CalAm's customers. In accordance with DRA's recommendation, our calculation of forecast period AIP excludes any expense that exceeds 100 percent of the financial target.

<u>Equity-Based Incentive Awards</u> – Our calculation of equity incentive awards is also consistent with DRA's recommendation that customer funding should be limited to the portion of incentive plan payments aligned with operational goals. Equity awards consist of stock option and performance stock unit (PSU) grants to management employees. Awards are based on a percentage of salary as well as American Water's financial and operational performance. According to the 2010 Equity Award Brochure, 20% of the LTIP award are PSUs and [redacted] The last two components appear to be the only ones based on metrics that directly benefit customers. As such, consistent with DRA's recommendation that customer incentive plan funding be limited to components aligned directly with customer benefits, we calculated the following equity award percentage to be appropriately funded by customers:

[redacted]

Our calculated equity award revenue requirement (AWSC and CalCorp) is 15% of the actual amount accrued during 2010, adjusted for inflation in the forecast years 2011-2013.

Employee Compensation Benchmarking

We attempted to determine whether AW salaries were comparable to equivalent market-based salaries. We requested benchmarking information relating to total compensation

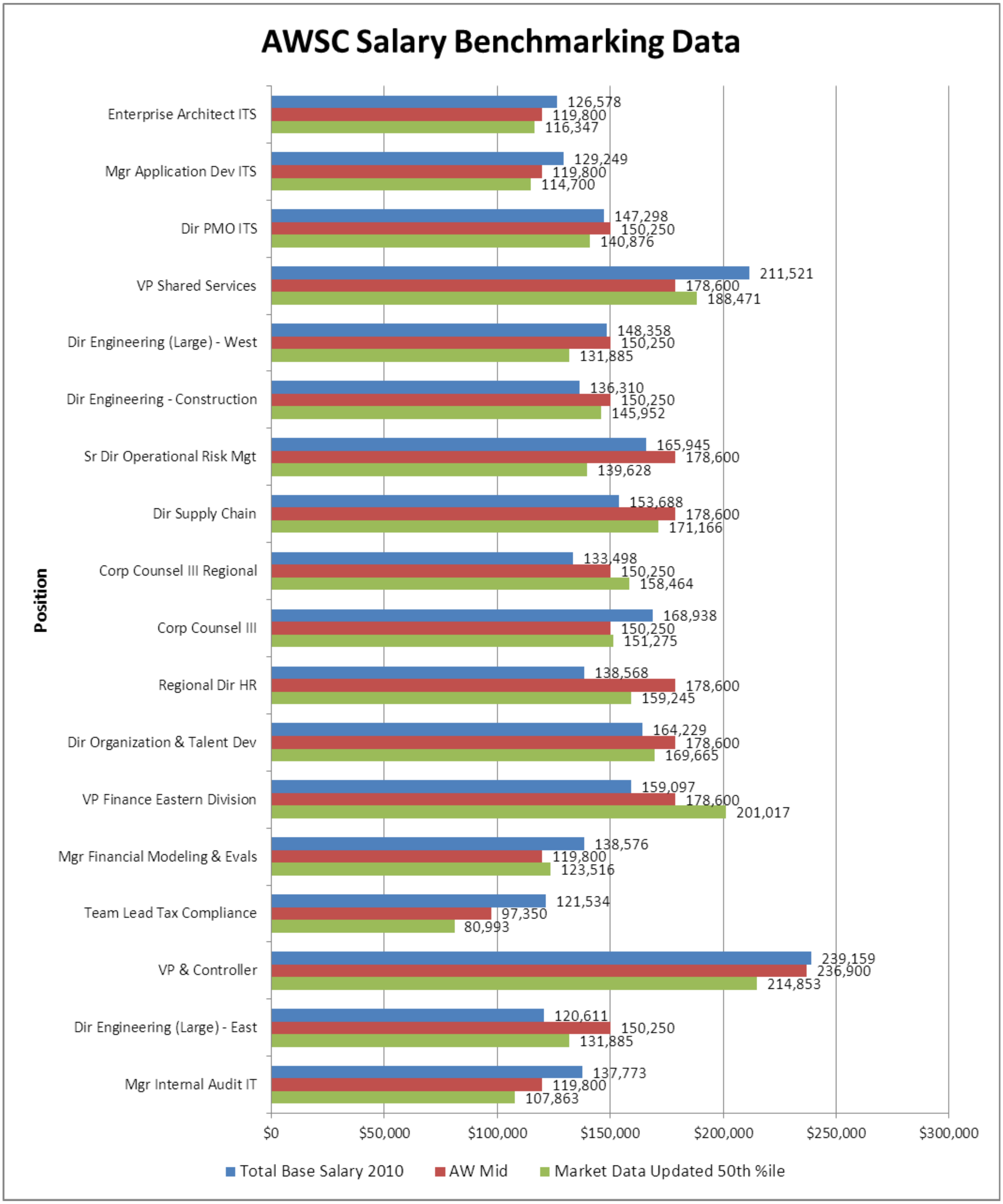
[150] Interview with Mike Maloney – Budget Lead, December 15, 2010.
[151] ~~Response to Discovery,~~ OC-22

(cash and non-cash), total cash compensation (salary plus incentive compensation), and the salary component of cash compensation. Daniel Shallow, Manager of Compensation, indicated American Water does not have available benchmarking information for total compensation or for total cash compensation.[152] CalAm confirmed that AW does not maintain market-comparable data for total cash compensation (generally, salary plus cash incentive compensation).[153] Such data is normally available in salary surveys conducted by benefits consulting companies ~~such as~~ [redacted] ~~& Associates~~. Based on our experience with other companies, it seems unlikely that AW does not have data showing how total cash compensation and total overall compensation compare with the market. However, to the extent it may exist, we were unable to obtain it. To the extent AW does not maintain such data, its practices for maintaining compensation levels consistent with the market are deficient.

AW made available data from which it is possible to compare base salaries to the market for some positions. During a December 16, 2010 interview with Daniel Shallow and follow up discovery requests, we obtained an understanding of the process by which American Water uses the benchmarking data to establish salary bands for each employee grade level.[154] However, AW stated it could not produce the market-comparable salaries for 40 percent of 30 AWSC positions we sampled. To the extent market comparable salaries are, in fact, available for only 60 percent of AW's management positions, the usefulness of even the "salary only" benchmarking data is questionable.

We sampled 30 AWSC management positions to compare both actual salaries and the AW salary range midpoint for the salary grade level to the AW's database containing aggregated market-based compensation data. The sample included 30 employees from AWSC that the company's Workforce Planning Model showed had base salaries of $100,000 or more. We asked CalAm to provide us with the midpoint of the salary range for each position, the updated average of the 50th percentile from the benchmarking sources for each position, and the ratio of the American Water midpoint to the 50th percentile averages from the benchmarking sources. CalAm responded with the information for only 18 of the 30 positions sampled. It said that the company did not have market information for the remaining positions. The results of the sample are shown below.

[152] Interview, Daniel Shallow – Manager Compensation, December 16th, 2010.
[153] OC-169
[154] Interview with Daniel Shallow – Manager Compensation, December 16th, 2010.



Source: ~~Response to Discovery,~~ OC-146

The significant findings from our sample are as follows:

1. AW did not provide (either did not have or did not release) market-comparable salary data for 40 percent (12 of 30) of the positions sampled.

2. Average actual salary exceeded the market-comparable 50th percentile for 61 percent (11 of 18) of the positions sampled for which AW provided the requested market-based compensation data.

3. The AW salary mid-point exceeded the market-comparable 50th percentile for 72 percent (13 of 18) of the positions sampled for which AW provided the requested market-based compensation data.

4. For the 18 samples positions for which AW provided market-comparable salary data:

    - Total actual salaries ($2,740,931) exceeded total market-comparable salaries ($2,647,801) by 3.5 percent.

    - The sum of AW salary midpoints ($2,786,550) exceeded total market-comparable salaries ($2,647,801) by 5.2 percent.

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6. PENSIONS, SAVINGS AND POST-RETIREMENT WELFARE BENEFITS

AW provides retirement benefits to employees under the following plans:

- Defined Benefit Pension Plan
- Post-Retirement Welfare Plan (PBOP)
- 401k and Defined Contribution Plan Retirement Savings (DCP)

Defined benefit pension plan expense is recorded in object account 506100. The amount recorded is based on Accounting Standards Codification (ASC) 715-30 (formerly FAS 87). PBOP expense is recorded in accordance with ASC 715-60 (formerly FAS 106) in object account 505100. Savings plan expenses are recorded in object accounts 507100 (401k match) and 508101 (DCP).

Summary of Findings

1. Summary of Pension Benefits – CalAm provides pension benefits under a defined benefit plan to employees hired before 2006. Employees hired after 2005 do not participate. The company makes all plan contributions and there is no cost to participating employees. Employees hired after 2005 participate in a Defined Contribution Plan (DCP) under which the company contributes 5.25 percent of salary to employee accounts. Employees hired after 2005 also have a higher company-match maximum for 401K contributions.

2. Historical Pension Expense - By closing the defined benefit pension plan to employees hired after 2006, AW has cut the number of covered employees by approximately 2,000 from what otherwise would be covered today.[155] Despite the pension expense savings created by this action, AW's defined benefit pension expense increased substantially in 2008 and 2009, but has since begun to decline:[156]

2007 actual pension expense	$38,968,697
2008 actual pension expense	$39,625,996
2009 actual pension expense	$81,116,478
2010 actual pension expense	$67,249,870

[155] OC-174-A
[156] OC-86, Attachment 1, AW Pension Plan Actuarial Valuation Report, p. MS-5

3. Forecasted Pension Expense ~~-~~– In April~~,~~ 2010, [redacted] AW's actuary, forecast~~s~~ed that the decline in pension expense will continue. By 2015 AW's pension expense should be back to levels below 2007 and 2008, as follows:[157]

2011 forecasted pension expense	$61,500,000
2012 forecasted pension expense	$54,300,000
2013 forecasted pension expense	$47,900,000
2014 forecasted pension expense	$41,500,000
2015 forecasted pension expense	$34,400,000

This forecast appears consistent with the closing of the plan to employees hired after 2005.

4. CalAm-Requested Pension Expense ~~-~~– Notwithstanding AW actuary [redacted] expectation that pension expense will return to the level incurred prior to the 2008 equities crash (from which the market has since recovered), CalAm requests authorization to collect 95 percent more in defined benefit pension expense from California customers in the 2012 test year than it expensed~~actually incurred~~ in 2010.

5. Summary of Post-Retirement Benefits Other Than Pension (PBOP) Benefits – Non-union employees hired before 2002 and union employees hired before 2006 receive medical, dental, life and other insurance benefits under a post-retirement welfare plan. Retiree contributions to plan expenses, once relatively minor, have been raised significantly, and certain medical plan options ("exclusive" and "premium" provider plans) have been eliminated. As of 2011, retirees contribute up to $550 monthly (retiree and spouse) for the Preferred Provider Plan (for pre-Medicare retirees) and $447 monthly (retiree and spouse) for a Medicare Supplement Plan.[158]

6. Historical PBOP Expense – Total AW historical PBOP expense is as follows:[159]

2009 actual PBOP expense	$41,635,934
2010 actual PBOP expense	$38,678,936

In addition to total cost, the per-capita (cost per active participant) also declined, from $11,320 in 2009 to $9,003 in 2010.

7. Forecasted PBOP Expense – In April~~,~~ 2010, AW's [redacted] forecast~~s~~ed a slow decline in PBOP expense over the next several years.[160] This

[157] OC-173, Attachment, AW's actuary~~,~~ [redacted] letter dated April 6, 2010, Exhibit 1
[158] OC-177, 2011 Open Enrollment Letter to Retirees, p.3
[159] OC-86, Attachment 2, AW Retiree Welfare Plan Actuarial Valuation Report, p. MS-1
[160] OC-173, Attachment, AW's [redacted] letter dated April 6, 2010, Exhibit 3

is consistent with the steps discussed above (closing the plan to new employees as much as 9 years ago, increasing retiree contributions, a declining participant base). AW's [redacted] forecasts the following PBOP expenses:

2011 forecasted PBOP expense	$38,000,000
2012 forecasted PBOP expense	$37,300,000
2013 forecasted PBOP expense	$32,700,000
2014 forecasted PBOP expense	$32,500,000
2015 forecasted PBOP expense	$32,400,000

8. CalAm-Requested PBOP Expense - Notwithstanding AW [redacted] expectation that PBOP expense will decline, CalAm requests authorization to collect 55 percent more expense from California customers in the 2012 test year than it expensed~~actually incurred~~ in 2010. For the portion of PBOP expense incurred directly on behalf of California employees (i.e., excluding expense allocations from AWSC), CalAm requests a 2010 base period amount 76 percent higher than the cost CalAm expensed~~actually incurred~~ in 2010.

9. Employee Savings Plans – AW maintains 401k and DCP employee savings plans. The company contributes 5.25 percent of employee salary to the DCP, which is limited to employees who are not participants in the defined benefit pension plan. The company also matches employee contributions to 401k savings plans up to a limit of 2.5 percent of salary for employees who participate in the defined benefit pension plan and up to 4 percent for employees who do not participate in the pension plan.

10. CalAm-Requested 401k and DCP Expense – CalAm requests base period General Office 401k and DCP expense (California-allocated from AWSC and CalCorp) 27.5 percent higher than the amount actually incurred in 2010. For test year 2012, CalAm-requested expense is 42.9 higher than the amount incurred in 2010.

Summary of Recommendations

1. Base Period Pension and PBOP Expense - CalAm's requested test year defined benefit plan pension expense, which is nearly double the amount expensed~~recorded~~ in 2010, should be rejected. Pension expense peaked in 2009 and was lower in 2010. PBOP costs have also peaked and the closure of the plan to new employees beginning 9 years ago is expected to result in declining costs going forward. Given [redacted] forecasts by AW's actuary, there is no basis for increasing pension or PBOP expense funded by California customers in the years 2010 to 2013. We recommend base period

pension and PBOP expense equal to the GAAP amounts expensed~~incurred and recorded~~ in 2010.

2. Pension and PBOP Expense in Forecast Years 2011-2013 - We recommend that the pension expense and PBOP expense reflected in AW [redacted] April~~,~~ 2010 forecasts be reflected in CalAm's revenue requirement.

3. 401k and DCP Expense – There is no support for increasing General Office 401k and DCP expenses by 43 percent between 2010 and test year 2012. CalAm's requested level of expense should be rejected. Instead, base period expense should reflect expense actually incurred in 2010, and the forecast years 2011-2013 should reflect inflation using escalation factors applied to labor.

Pension Expense

AW provides a defined benefit pension plan for union and non-union employees hired prior to January 1, 2006.[161] The union and non-union versions of the plan appear to be substantially alike.[162] Employees make no plan contributions.[163] Normal retirement is age 65. The plan includes provisions for late retirement (up to age 70 ½), for early retirement from ages 55 to 64 for employees whose combined age and service years add to at least 70 and for disability retirement for employees with 10 or more years of service. Participants are fully vested after completing five years of service. Plan benefits are lifetime benefits calculated based on "final average earnings" (monthly earnings for 60 months out of the final 120 months of service that produce the highest average earnings calculation). The normal retirement benefit is divided into two pieces: years of service earned prior to July 1, 2001 and years of service earned after June 30, 2001. The benefit is 1.85% per year of service (service earned prior to 7/1/2001) and 1.6% per year of service (service earned after 6/30/2001) for final average earnings up to the social security wage base ($106,800 in 2010), with a maximum service period of 25 years. For final average earnings that exceed the social security wage base, the benefit rises from 1.85% / 1.6% per year to 2.1%, with a maximum service period of 25 years. For service over 25 years, the benefit is 0.7% of final average earnings for service earned prior to July, 2001 and 1.6 percent of final average earnings for service earned after June, 2001. In 2007 the maximum earnings taken into account under the plan was $225,000. AW's pension plan document provides the following examples of lifetime benefits payable at age 65:

[161] OC-110
[162] Overland did not perform a detailed analysis to discover differences between the union and non-union plans.
[163] OC-110, Summary Plan Description of the Pension Plan For Employees of American Water Works Company, Inc., (Union and Non-Union versions), p.1

- Retirement at Age 60, 25 years benefit service (with 10 years as of July, 2001), $52,000 final average earnings: $32,364 (62 percent of highest 60 months' final average salary)[164]

- Retirement at Age 60, 35 years of service (with 15 years on or after July 1, 2001), $97,500 final average earnings: $59,760 annually (62 percent of highest 60 months' final average salary)[165]

Taking into account the benefits calculated on earnings over the social security wage base, assuming final average earnings of $200,000 (instead of $97,500), the employee in the second example noted above would receive lifetime benefits of approximately $113,000 annually.[166]

The pension plan has several payment options. The examples above assume a life annuity (payments of 100 percent of benefits over the life of the retiree). Other options include a contingent annuity in which monthly payments are reduced, but with one-half, two-thirds or 100 percent of the reduced payments continuing for the life of a beneficiary, and a term-based guaranteed payment option of five, 10 or 15 years.

CalAm's Requested Pension Expense Revenue Requirement - The table below summarizes CalAm's actual and requested pension expense for the years 2009 to 2013. CalAm's requested test year 2012 pension expense is almost double the pension expense actually recorded in 2010. As discussed below, [redacted] [redacted] AW's actuary~~,~~ is forecasting pension expense to decline during the period 2011-2015.

[164] Response to OC-110, Summary Plan Description of the Pension Plan for Employees of American Water Works Company, Inc. and Its Designated Subsidiaries, For Non-Union Employees, As in Effect January 1, 2006, p.5.
[165] Id. p.6.
[166] $59,760 + [(200,000 – 97,500) x .021 x 25 years]

Table 6-1

California American Base Rate Filing 2011-2013 Actual and Requested Pension Expense (AWSC Allocated, California Corporation and District Combined)						
Defined Benefit Pension Exp. Acct. 506100	2009 Actual	2010 Actual (As Recorded)	2010 Base Period Request	2011 - Requested Pension Exp.	2012 - Requested Pension Exp.	2013 - Requested Pension Exp.
AW Service Company, Acct 506100	$ 18,912,218	$ 14,667,929	$ 17,048,987	$17,577,574	$18,125,994	$18,677,079
Subtract: Business Transformation	136,016	195,020	248,918	256,635	264,622	272,667
AW Service Company Without BT	18,776,202	14,472,909	16,800,069	17,320,938	17,861,372	18,404,411
Subtract: Capital Fee Component	1,473,095	1,389,526	1,899,769	1,958,669	2,019,623	2,081,026
AWSC Mgt Fee Expense, Acct 506100	$ 17,303,107	$ 13,083,383	$ 14,900,300	$ 15,362,269	$ 15,841,749	$ 16,323,386
CalAm AWSC Allocation Pct	5.3720%	5.2716%	5.2716%	5.2716%	5.2716%	5.2716%
CalAm AWSC Amount, Expense	929,523	689,704	785,484	809,837	835,114	860,504
CalCorp, Acct. 506100, Expense	354,733	292,499	445,000	600,000	647,000	497,000
CalAm District, Acct 506100, Expense	2,050,753	1,690,971	2,572,600	3,468,000	3,739,600	2,873,300
Total CalAm Pension Expense	$ 3,335,009	$ 2,673,174	$ 3,803,084	$ 4,877,837	$ 5,221,714	$ 4,230,804
Percentage Increase Over 2010 Actual			42.3%	82.5%	95.3%	58.3%

Sources: **Service company component:** OC-72, OC-135. It was necessary to extract data from the detailed 2010 budget in CalAm's AWSC revenue requirement workbook in order to extract AWSC Pension expense (account 506100) amounts, Business Transformation amounts (which are excluded) and AWSC "capital fees." **CalCorp and CalAm District** amounts from Rate Filing Exh. A-CC Ch. 3 Table 9 (100 day Update)

The progression from actual 2010 pension expense to a level nearly twice as high in CalAm's test year request begins with a 2010 base period request that is 42 percent higher than the pension expense actually recorded in 2010. On top of the base period CalAm layers another significant increase for 2011and a smaller increase for 2012. The amounts in the table show there is a significant difference between the 2011 increase requested for the service company and the increase requested for California. Although AWSC and California employees are subject to the same pension plan, in percentage terms CalAm's requested 2011 increase for California-incurred pension costs is more than 10 times the increase requested for the AWSC:

Pension Expense	2010 Request	2011 Request	Increase
Allocation from AWSC	$ 785,484	$ 809,837	3.1 %
Incurred by CalAm	$3,017,600	$4,068,000	34.8 %

CalAm provides almost no support in its testimony for the requested pension expense increase, and no explanation for why California-incurred pension expense should rise 10 times more than pension expense incurred by the service company. The only thing we were able to find in CalAm's direct testimony was the statement "pension contributions have also risen dramatically due to the decline in the value of plan assets which was driven by the decline of the stock market in 2008 and early 2009." [167] Notwithstanding this statement, as shown in the table above, actual pension expense declined in 2010 compared with 2009. As discussed below, AW's [redacted] forecasts this decline will continue in 2011, 2012 and 2013.

AW [redacted] Pension Expense Forecast - We asked CalAm to provide forecasts of pension expense that AW's [redacted] provided to the

[167] CalAm Direct Testimony of Jeffrey Dana, p.18

company in 2010. These projections show that FAS 87 pension expense for AW is expected to decline over the period forecasted in CalAm's rate request. This is summarized below, based on an [redacted] [redacted] April~~,~~ 2010 forecast by AW's actuary.~~.~~

Table 6-2

American Water's FAS 87 (ASC 715-30) Pension Expense 2010 Actual and 2011-2013 As Forecasted by AW's Actuary							
	2010 Actual	2011		2012		2013	
Expense	Amount	Amount	Pct. Chg.	Amount	Pct. Chg.	Amount	Pct. Chg.
AW Qualified Pension Plan Expense	$ 67,200,000	$ 61,500,000	-8.5%	$ 54,300,000	-11.7%	$47,900,000	-11.8%
AW Pension Plan After Purchase Accour	58,000,000			53,100,000	-8.4%	46,100,000	-13.2%
Source: OC-173-Q001- Attachment, Exhibit 1, April 2010 Forecast							

AW's [redacted] [redacted] predicts the downward trend to continue, to $41.5 million in 2014 and $34.4 million in 2015, as pension-eligible employees hired before 2006 are replaced by employees who do not participate in the plan. In response to a data request concerning the steps AW has taken to reduce its defined benefit pension expense and liabilities, CalAm stated that "the closing of the plan [as of January 2006] has reduced the number of covered employees by more than 2,000 from what it would have covered had the change not been made."[168]

Post-Retirement Welfare Benefits Other Than Pension (PBOPs)

AW provides medical, dental and vision plan benefits to non-union employees hired before 2002 and to union employees hired before 2006. Beginning in 2011, medical plan options were reduced from several plan options to a PPO plan (for retirees not yet eligible for Medicare) and a Medicare Supplement Plan.[169] Prior to 2011, pre-Medicare retirees, along with active AW employees, could select from three different medical plans.

CalAm's Requested PBOP Expense Revenue Requirement - The table below summarizes CalAm's actual and requested PBOP expense for the years 2009 to 2013. As discussed below, the actuary used by [redacted] [redacted] forecasts declining PBOP expenses for AW for the period 2011 through 2015. The~~owers~~ [redacted] forecast from AW's actuary notwithstanding, CalAm is requesting customer pay 55 percent more in the 2012 test year than CalAm expensed~~actually incurred~~ in 2010.

[168] OC-174
[169] OC-177, Attachment 1

Table 6-3

Table California American Base Rate Filing 2011-2013 Actual and Requested Post-Retirement Benefits Other Than Pension (PBOPs) Expense (AWSC Allocated, California Corporation and District Combined)						
PBOP Expense Account 505100	2009 Actual	2010 Actual (As Recorded)	2010 Base Period Request	2011 - Requested PBOP Exp.	2012 - Requested PBOP Exp.	2013 - Requested PBOP Exp.
AW Service Company, Acct 505100	$ 4,057,680	$ 3,607,392	$ 3,568,370	$3,679,004	$3,793,789	$3,909,131
Subtract: Business Transformation	29,383	59,580	51,707	53,310	54,969	56,640
AW Service Company Without BT	4,028,297	3,547,812	3,516,663	3,625,694	3,738,820	3,852,491
Subtract: Capital Fee Component	361,107	340,621	390,913	403,033	415,575	428,210
AWSC Mgt Fee Expense, Acct 505100	$ 3,667,190	$ 3,207,191	$ 3,125,750	$ 3,222,661	$ 3,323,244	$ 3,424,281
CalAm AWSC Allocation Pct	5.3720%	5.2716%	5.2716%	5.2716%	5.2716%	5.2716%
CalAm AWSC Amount, Expense	197,001	169,070	164,777	169,886	175,188	180,514
CalCorp, Acct. 505100, Expense	45,973	29,493	52,000	51,000	50,000	44,000
CalAm District, Acct 505100, Expense	889,927	570,915	1,006,600	988,200	969,800	849,300
Total CalAm PBOP Expense	$ 1,132,901	$ 769,478	$ 1,223,377	$ 1,209,086	$ 1,194,988	$ 1,073,814
Percentage Increase Over 2010 Actual			59.0%	57.1%	55.3%	39.6%

Sources: **Service company component:** OC-72, OC-135. It was necessary to extract data from the detailed 2010 budget in CalAm's AWSC revenue requirement workbook in order to extract AWSC PBOP expense (account 505100) amounts, Business Transformation amounts (which are excluded) and AWSC "capital fees." **CalCorp and CalAm District** amounts from Rate Filing Exh. A-CC Ch. 3 Table 7 (100 day Update)

Most of the requested increase over 2010 actual expense occurs in the 2010 base period, in which CalAm requests PBOP expense almost 60 percent more than the amount actually expensed~~incurred~~. Also, as with pension expense, even though CalAm's retirees participate in the same plan as service company retirees, CalAm's increase request is disproportionately weighted toward expense incurred by CalAm:

PBOP Expense	2010 Actual	2010 Request	Increase
Allocation from AWSC	$ 169,070	$ 164,777	-2.6 %
Incurred by CalAm	$ 600,408	$ 1,058,600	+76.3 %

AW [redacted] [redacted] PBOP Expense Forecast - We obtained forecasts of pension expense that AW's [redacted] [redacted] provided to the company in 2010. These projections show that FAS 106 pension expense for AW is expected not to increase, but to decline, over the period forecasted in CalAm's rate request. This is summarized below based on an AW actuary's [redacted] [redacted] April~~,~~ 2010 forecast.

Table 6-4

American Water's Retiree Welfare Plan Expense 2010 Actual and 2011-2013 As Forecasted by AW's Actuary						
Expense	2010 Actual Amount	2011		2012		2013
		Amount	Pct. Chg.	Amount	Pct. Chg.	Amount	Pct. Chg.
AW PBOP Expense	$ 38,700,000	$ 38,000,000	-1.8%	$ 37,300,000	-1.8%	$32,700,000	-12.3%

Source: OC-173-Q001- Attachment, Exhibit 3, April 2010 Forecast

[redacted] [redacted] ~~f~~Forecasts by AW's actuary indicate that this trend will continue beyond 2013, with expense of $32.3 million in 2015. [redacted] [redacted] ~~f~~forecast by AW's actuary of a downward trend in PBOP expense is consistent with the steps CalAm states that AW has taken to reduce plan expense, including:[170]

- Closing the retiree welfare plan to non-union employees hired after 2001 and union employees hired after 2005.

- Increasing retiree contributions. As of 2011, medical plan rates for retiree and dependent (spouse) are $550 monthly for the PPO plan and $447 for the Medicare Supplement plan.

- Eliminating "Premium" and "Exclusive Provider" medical plans (for both active and retired employees).

- A 2007 dependent eligibility audit.

With respect to the 2011 changes, in a letter sent to retirees, AW stated that "[t]he company can no longer totally absorb these [cost] increases as they ultimately must be passed along to our customers through higher rates, and our rates need to remain competitive in the marketplace." Although AW took steps to reduce its PBOP cost, and AW's [redacted] expects this to result in declining expense, CalAm requests that it be authorized to charge California customers for significantly higher levels of PBOP expense than it actually incurred in 2010.

401K and Defined Contribution Employee Savings Plans

AW has a tax-deferred 401K employee savings plan under which it matches a portion of employee contributions. According to company testimony, for employees hired before 2006, AW contributes 50 percent of the first 5 percent of salary (a maximum of 2.5 percent of salary). For employees hired after 2005, the company match is 100 percent of the first 3 percent contributed by the employee, and 50 percent of the next 2 percent (a maximum match of 4 percent).[171]

In addition to the savings match provided under the 401K plan, as a replacement for the defined benefit plan that was closed to employees hired after 2005, AW has a Defined Contribution Plan (DCP) for employees hired after 2005. AW contributes 5.25 percent of employee salary under the DCP. Employees have individual accounts under the DCP and may choose from several options to invest company-contributed amounts.[172]

The table below summarizes actual savings plan (401K and DCP) expenses for 2009 and 2010 and the amounts CalAm requested in the forecasted years 2010-2013:

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[170] OC-175 and OC-177, Attachment 1
[171] CalAm Direct Testimony of Jeffrey Dana, p.21
[172] OC-110, Attachment 4

Table 6-5

California American Base Rate Filing 2011-2013 Actual and Requested 401K Savings Match and DCP Expense AWSC Allocated and California Corporation (General Office Only - District Level Expense NOT INCLUDED)						
PBOP Expense Account 505100	2009 Actual	2010 Actual (As Recorded)	2010 Base Period Request	2011 - Requested PBOP Exp.	2012 - Requested PBOP Exp.	2013 - Requested PBOP Exp.
AWSC 401K (507100) & DCP Exp. (508101)	$ 3,876,320	$ 4,168,184	$ 4,349,781	$4,484,642	$4,624,562	$4,765,163
Subtract: Business Transformation	74,785	151,127	69,952	72,121	74,365	76,626
AW Service Company Without BT	3,801,535	4,017,057	4,279,829	4,412,521	4,550,197	4,688,537
Subtract: Capital Fee Component	408,868	385,673	461,148	475,446	490,242	505,146
AWSC Mgt Fee Exp., Accts 507100 & 508101	$ 3,392,667	$ 3,631,384	$ 3,818,681	$ 3,937,075	$ 4,059,956	$ 4,183,391
CalAm AWSC Composite Allocation Pct	5.3720%	5.2716%	5.2716%	5.2716%	5.2716%	5.2716%
CalAm AWSC Amount, Acct. 507100 & 50810	182,254	191,432	201,306	207,547	214,025	220,532
CalCorp, Accts 507100 & 508101	123,256	136,888	174,519	185,060	195,553	201,809
CalAm District, Acct 507100 & 508101						
Total General Office 401K & DCP Expense	$ 305,510	$ 328,320	$ 375,825	$ 392,607	$ 409,578	$ 422,341
Percentage Increase Over 2010 Actual			14.5%	19.6%	24.7%	28.6%
Sources: **Service company component:** OC-72, OC-135. It was necessary to extract data from the detailed 2010 budget in CalAm's AWSC revenue requirement workbook in order to extract AWSC amounts, Business Transformation amounts (which are excluded) and AWSC "capital fees." **CalCorp** amounts from OC-73, OC-148 and Rate Filing workpaper CC Exp 107.						

Increases in CalCorp Savings Plan (401K and DCP) Expenses

Apart from expense requested for vacant positions, the 2010-2013 forecasted increase in allocated service company savings plan expense reflects annual composite inflation of about 3.1 percent, proportional with inflation in service company labor expense, and appears reasonable. However, for CalCorp (and possibly for the districts) CalAm has proposed something significantly higher, and disproportionately higher than its proposed increases in CalCorp labor expense.[173] CalCorp's actual 2010 savings plan expense, the requested increases, and comparable CalCorp labor expense data are summarized below.

Table 6-6

CalCorp 401K and DCP Employee Savings Expense Compared with CalCorp Labor 2010 Actual and 2010-2013 Forecasted (Requested)							
		2010 Base Period		2011 Forecast		2012 Test Year Forecast	
Item	2010 Actual Expense	Amount	Increase Over 2010 Actual	Amount	Increase Over 2010 Actual	Amount	Increase Over 2010 Actual
Requested CalCorp 401K Exp. (Acct 507100)	$61,246	$78,317	27.9%	$83,232	35.9%	$87,126	42.3%
Requested CalCorp DCP Exp. (Acct 508101)	75,642	96,202	27.2%	101,828	34.6%	108,429	43.3%
Total Requested CalCorp Savings Plan Expense	$136,888	$174,519	27.5%	$185,060	35.2%	$195,555	42.9%
Requested CalCorp Labor Expense (Salary & Overtime) (Accts 501200, 501210, 501211)	$3,359,758	$3,400,543	1.2%	$3,564,330	6.1%	$3,732,280	11.1%
Source: OC-173-Q001-Attachment, Exhibit 2							

[173] Unlike pension and PBOP expenses, CalAm did not include district-level savings plan expenses in its General Office revenue requirement. As such, Overland did not review CalAm's requested district-level savings plan increase.

As shown in the table, CalAm requests a~~n increase in~~ test year increase ~~labor~~ of 11.1 percent in labor expense, compared with what was incurred in 2010. However, for savings plan expense, CalAm wants customers to fund an increase nearly four times as high (42.9 percent). The problem is primarily confined to the base period: CalAm's requested 2010 (base period) CalCorp savings plan expense is 27.5 percent higher than the expense CalCorp actually incurred in 2010. After the base period, the requested increases in savings plan expenses are proportional with requested labor increases.[174]

The only information we found in the rate filing that relates to the requested increase is the following:

> The increased 401K match and Defined Contribution Plan for employees hired after December 31, 2005 compensate for the fact that they aren't eligible for the pension plan.[175]

What CalAm seems to be suggesting (without providing any specific support) is that as older pension-eligible employees are replaced by employees eligible for DCP and higher 401K matching, savings plan expenses should rise. While the upward trend in savings plan expense, and the corresponding downward trend in defined benefit pension expense (which, interestingly, CalAm does not recognize) are both true, the savings plan increase is clearly not the exponential increase CalAm has requested. CalAm's requested 2010 base period savings plan expense for CalCorp is 27 percent higher than actual 2010 expense. CalAm's requested 2010 increase, to the extent it exceeds an amount proportional with a change in labor expense, is contradicted by the actual expense AWSC and CalAm incurred in 2010 and should be rejected.[176]

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[174] For example, 2011 requested savings plan expense, $185,040, is 6 percent higher than 2010 requested expense of $174,519. This is proportional with the 6.1 percent requested increase for 2011 in CalCorp labor expense.

[175] CalAm Direct Testimony of Jeffrey Dana, p.21

[176] The savings plan expense trend noted in Dana's direct testimony is also true for the service company. However, unlike CalCorp, CalAm's forecasted increase in savings plan expense for the service company is proportional to the increase in forecasted labor expense.

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7. GROUP INSURANCE EXPENSE

Group insurance consists of amounts recorded in AW account 504100 for the costs of AW's employee medical, prescription drug, dental, vision, life, accidental death and dismemberment and disability insurance programs. AW is self-insured, meaning they fund an insurance trust account with company and employee contributions and use the funds to pay claims relating to insurance programs. AW's medical plan is administered by Horizon Blue Cross / Blue Shield and covers approximately 6,100 employees.[177]

CalAm's rate-requested group insurance expense includes the following components:

- Service company group insurance expense, recorded in account 504100, included in management fees allocated to CalAm.[178]

- Group insurance expense for California Corporation (CalCorp) employees (Exh. A-CC, Ch. 2, Table 3 and w.p. CC Exp-107).

- Group insurance expense for CalAm district-level employees (Exh. A-CC, Ch.3, Table 1 and Table 3; w.p. CC Exp-107).

Summary of Findings

1. CalAm's Requested Group Insurance Increase - CalAm's test year (2012) requested group insurance expense is 53.6 percent higher than actual 2010 expense. Requested 2013 group insurance expense is 67.9 percent higher than actual 2010 expense.

2. Impact of CalAm's Request on the Effective Composite Inflation Rate - CalAm's application of separate inflation rates to group insurance expense raises CalAm's effective composite inflation rates during the period 2011 through 2013 above the rates obtained in DRA / Water Division escalation memos. For example, the DRA / Water Division composite escalation factors, based on the April 2010 schedule CalAm used to prepare its revenue requirement, are 3.1 percent for 2011 and 2012 and 3.0 percent for 2013. Even though it begins with the DRA/ Water Division rates, CalAm's procedure, with its separate, much higher inflation for group insurance, effectively raises the composite inflation rate on AWSC's

[177] OC-214-B, Attachment

[178] AWSC's group insurance expense cannot be directly referenced in the rate filing, because the filing and related support presents service company costs on a functional (departmental), rather than an account, basis. To the best of our knowledge, the only place CalAm's calculation of the California share of service company group insurance expense for the period 2010-2013 can be found is the table below in this report.

revenue requirement to 4.9 percent in 2011, 3.6 percent in 2012 and 3.4 percent in 2013. ~~We did not calculate the impact on CalCorp and CalAm, but the effect on California composite inflation is similar.~~

3. Medical Inflation in Existing Escalations - In addition to raising overall composite inflation rate, applying a separate rate to group insurance expense effectively double counts the medical component of inflation, because medical inflation is already included in the DRA / Water Division inflation rate applied to all payroll, pension and benefits costs. Specifically, the labor component of DRA / Water Division inflation is based on Bureau of Labor Statistics (BLS) Consumer Price Index (CPI) data that incorporates medical products and services inflation into the price index.

4. Group Insurance for Vacant Positions - CalAm's base period (2010) group insurance revenue requirement is higher than actual (recorded) 2010 group insurance expense primarily because the base period request includes insurance expense for employees who were not actually on AW's payroll in 2010. Specifically, the base period revenue requirement is calculated using budgeted employees for AWSC and requested authorized employees for CalAm, including CalCorp employees. The employees included in the revenue requirement request are about 7 percent higher than the employees actually on the payroll.

5. Components of CalAm's Requested Group Insurance Increase - CalAm's 2011, 2012 and 2013 group insurance expense requests are significantly higher than 2010 actual expenses (40.3 percent, 52.8 percent and 67.1 percent higher, respectively). The group insurance expense levels requested in these years are based on medical cost increases (which include both inflation and increased medical service utilization) and increased contributions to AW's medical insurance trust account.

6. Basis for the Requested Increase in 2011 - According to CalAm, about half of the extraordinarily high 30 percent increase requested for 2011 (compared with the base period request) is the result of a deficiency in AW's medical insurance trust account, caused, according to CalAm, by the lack of an increase in the rate at which the trust account was funded during the 2008-2010 period. For 2009 alone, we estimate AW's actual funding was about $20 million below what had been budgeted. The 2009 and 2010 under-funding, to the extent it occurred, that gave rise to the asserted trust account deficiency flowed to 2009 and 2010 pre-tax earnings.

7. CalAm Medical Insurance Cost Increases vs. Industry Trend - [redacted] ~~d~~Data provided by AW shows the company~~AW~~ experienced medical cost increases above the utility industry trend in 2007 and 2009. For 2008, a 2007 audit of dependent coverage eligibility resulted in medical inflation significantly below

trend (essentially, no inflation during 2008). [redacted] ~~-~~AW's forecast, upon which CalAm's requested 2011-2013 increases are based, predicts that AW will continue to experience higher medical cost increases than the utility industry. Specifically, setting aside the impact of the new federal health care legislation, [redacted] predicts that its~~AW's~~ medical cost increases will be 32 percent above the industry trend in 2010 (10.8 percent vs. 8.2 percent), and 26 percent above the industry trend for 2011 (10.3 percent vs. 8.2 percent).

8. AW vs. Utility Industry Group Insurance Cost - The most recent historical data available ~~from~~ [redacted] ~~-~~(for 2009) shows that the medical insurance cost-per-employee incurred by AW, at $10,246, was 20 percent higher than that incurred by the average utility, at $8,520 per employee.

9. Employee Contributions to Group Insurance - In 2009 AW employees contributed only about half as much to their medical insurance costs (17.8 percent of gross cost) as the average utility industry employee (32.3 percent). In 2010 AW began to increase employee contributions, and additional increases took effect in 2011. [redacted] predicts these changes will bring AW employees to a 23 percent share of gross medical costs for 2011. Assuming the [redacted] ~~-~~2011 projection is accurate, at 23 percent, the medical cost share paid by AW employees will remain well below the 2009 average of 32 percent for the utility industry, a percentage that has probably increased since 2009.

Summary of Recommendations

1. Limit Increases in Group Insurance to Normal Composite Inflation - Overland recommends group insurance expense escalation using the DRA / Water Division inflation rate normally applied to labor and labor-related costs (payroll, pensions and employee benefits), as discussed in Commission Decision 04-06-018. CalAm's extraordinarily high group insurance inflation rate should be rejected for the following reasons:

   - It raises CalAm's effective composite inflation rate well above approved rates documented in DRA / Water Division escalation memos. As noted above, CalAm's requested procedure would raise the service company's overall composite inflation by about 1.8 percent in 2011, 0.6 percent in 2012 and 0.4 percent in 2013 above the amounts reflected in DRA / Water Division escalation memos.

   - It double-counts medical inflation, which is already included in Commission-sanctioned inflation rates; specifically, in the approved BLS CPI-U rate applied to labor, pension and benefits costs.

- Allowing AW to pass along above-industry trend medical cost increases to customers discourages AW from controlling the costs or even bringing them in line with the cost trend experienced by the rest of the utility industry.

- It is unclear whether [redacted] medical cost forecasts reflect the steps AW took in 2011 to control costs, including raising employee contributions to insurance and eliminating "premium" and "exclusive" provider plans. CalAm ~~refused~~ declined to provide 2011 budgets which would have shown what it actually projecting to spend on group insurance in 2011.

- Approximately half of the increase requested for 2011 is based on an asserted need to replenish AW's medical insurance trust account, which apparently was not funded to maintain parity with rising costs in 2009 and 2010. As a matter of standard ratemaking practice, expenses attributable to past periods should not be passed through to future rates. In this case, AW's failure to adequately fund its health insurance trust account in 2009 and 2010 allowed it to shift expenses to future periods, thereby increasing 2009 and 2010 reported earnings. These expenses, which should have been recorded in 2009 and 2010 (and would have been, had the medical insurance trust account been adequately funded), should not be shifted to California ratepayers in future years.

- In part, [redacted] forecasted cost trend rates are significantly higher in 2011 because of the predicted impact of new federal health legislation. In fact, federal health legislation makes up more than a third of AW's requested medical cost increase rate for 2011. The [redacted] forecast appears to make no allowance for benefit reductions in other areas or increased employee insurance contributions, either of which might be used to pay for the new federally-mandated benefits.

- [redacted] ~~expertise notwithstanding,~~ Overland believes forecasting the cost impact of a law before the law goes into effect is speculation.

2. Memorandum Account Considerations - CalAm has requested a memorandum account to track the additional costs related to the federal health care reform law. DRA has recommended against adopting this request. Before granting a memorandum account for the costs associated with the new legislation, we recommend the Commission consider the following additional points:

   - A process by which a company is permitted to "bank" and recover costs from others (customers) in future periods diminishes the incentive the company might otherwise have to control and minimize such costs. As noted above, AW's forecasted medical cost inflation is above the industry trend, apart from the impact of the new federal health care legislation. AW's employees contribute less to their medical costs than do employees in the average utility. AW has not demonstrated the ability to hold its medical costs in line even with the utility industry average, let alone with utilities in the top performance quartile. CalAm is asking the Commission to permit it to charge California customers for a 67 percent increase in group insurance expense over a three-year period. Adding a health care memorandum account will most likely not incentivize AW to bring its costs down to more sustainable annual increases; rather, the more likely impact will be to further increase the amount of medical cost CalAm's customers must fund through their water rates.

- Extracting the components of medical cost attributable to a new piece of legislation is likely to be difficult, if not patently subjective. Should the Commission grant CalAm's request for a memorandum account, Overland recommends the Commission specifically define the elements to be tracked and the precise methodology by which they are to be calculated.

- As an alternative to requiring CalAm's customers to pay additional health care costs stored up in a memorandum account, the Commission could require that AW absorb the costs associated with the new health care legislation. This would provide AW with an incentive to find offsets and efficiencies. As an alternative to AW shareholders absorbing the entire increase, AW could share the increase with its employees by balancing the increased benefits required by the federal legislation with offsetting benefit reductions in other areas or with increased employee insurance contributions. As noted above, as recently as 2009, the contributions made by AW employees to medical costs were about half the utility industry average, and remain below average even with the increases adopted for 2011.

Discussion of CalAm's Requested Group Insurance Revenue Requirement

CalAm's group insurance, as recorded in 2010, and as requested for base year 2010 and forecast years 2011-2013, is summarized below. With the requested increase, group insurance expense comprises 11 percent of CalAm's test year 2012 General Office revenue requirement. It is important to note that for the service company, the percentage increases CalAm "officially" requests (30 percent for 2011 and 8.2 percent for 2012 and 2013) are understated because they are *in addition to* annual composite inflation increases already built into the Company's revenue requirement schedules for AWSC.

Table 7-1

Table
California American Base Rate Filing 2011-2013
Requested Group Insurance Expense (AWSC Allocated, California Corporation and District Combined)

Group Insurance Account 504100	2009 Actual	2010 Actual (As Recorded)	2010 Base Period Request	2011 - Requested Group Insurance	2012 - Requested Group Insurance	2013 - Requested Group Insurance
AW Service Company, Acct 504100	$15,001,396	$14,686,162	$15,696,879			
Subtract: Business Transformation	101,609	154,459	127,483			
AW Service Company Without BT	14,899,787	14,531,703	15,569,396			
Subtract: Capital Fee Component	1,479,079	1,395,171	1,233,276			
AWSC Mgt Fee Expense, Acct 504100	$13,420,708	$13,136,532	$14,336,120	$18,986,091	$21,046,674	$23,691,233
CalAm AWSC Allocation Pct	5.3720%	5.2716%	5.2716%	5.2716%	5.2716%	5.2716%
CalAm AWSC Amount, Expense	720,960	692,505	755,743	1,000,871	1,109,496	1,248,907
CalCorp, Acct. 504100, Expense	381,355	362,593	390,500	507,700	549,300	594,400
CalAm District, Acct 504100, Expense	2,095,704	1,801,732	1,940,400	2,522,500	2,729,300	2,953,100
Total CalAm Group Insurance Expense	$3,198,019	$2,856,830	$3,086,643	$4,031,071	$4,388,096	$4,796,407
Percentage Increase Over 2010 Actual			8.0%	41.1%	53.6%	67.9%

Sources: **Service company component:** OC-72, OC-135, CalAm workpaper SC WP110 (Note: the annual percentage changes in employee cost can be computed from data on page 93). It was necessary to extract data from the detailed 2010 Budget sheet in CalAm's AWSC revenue requirement workbook in order to extract Group Ins. expense (account 504100) amounts, Business Transformation amounts (which are excluded) and AWSC "capital fees." **CalCorp and CalAm District** amounts from Rate Filing Exh. A-CC Ch. 3 Table 3 (100 day Update)

CalAm's Requested Group Insurance Expense Increase

The progression from 2010 actual to 2013 requested expense consists of the following:

- 2010 requested base period expense is 8.0~~7.2~~ percent higher than 2010 actual (recorded) expense.

- 2011 requested expense is 30.6~~30.8~~ percent higher than 2010 requested base period expense and 41.1~~40.3~~ percent higher than 2010 actual expense.

- 2012 requested expense is 7.6~~8.9~~ percent higher than 2011 requested expense and 53.6~~52.8~~ percent higher than 2010 actual expense.

- 2013 requested expense is 10.6~~9.4~~ percent higher than 2012 requested expense and 67.9~~67.1~~ percent higher than 2010 actual expense.

- In addition to CalAm's "official" increase request of 30 percent for 2011, and 8.2 percent for 2012 and 2013, the AWSC group insurance amounts also include additional composite inflation, averaging about 3.1 percent, built into AWSC's revenue requirement schedules.

CalAm's Request for Separate Inflation Treatment for Group Insurance

There are two issues involving CalAm's separately-requested group insurance inflation increase.

1. Effect of Adding Separate Group Insurance Inflation to Composite Inflation Using DRA / Water Division Rates - The first problem with CalAm's procedure is that it raises the effective composite inflation rate embedded in all CalAm schedules from 2011 through 2013 above the approved inflation rate contained in periodic DRA / Water Division escalation letters. Base period (2010) amounts should be adjusted for inflation according to escalation rates and weighting methods published in DRA / Water Division letters. In its rate filing CalAm applied inflation using DRA / Water Division methods and rates. However, in addition, CalAm separately applied much higher rates to group insurance, effectively raising the overall composite inflation rate above the rates adopted in DRA / Water Division escalation memorandums. The table below, which shows CalAm's requested AWSC revenue requirement, demonstrates that the impact of applying a separate group insurance inflation rate on the service company.

Table 7-2

CalAm's Revenue Requirement for American Water Service Company Impact of Group Insurance Inflation Request on Overall Composite Inflation Request						
Year	Starting Amount	Composite Inflation Rate Using DRA Memo (1)	AWSC Request Using DRA Composite Inflation Rate	Additional Requested Group Insurance Expense	AWSC Request With Additional Grp Ins Expense	Composite Inflation Rate w/ Additional Grp Ins Inflation
2011	$ 229,906,514	3.10%	$ 237,034,510	$ 4,219,316	$241,253,826	4.94%
2012	237,034,510	3.12%	244,430,909	5,402,376	249,833,285	3.56%
2013	244,430,909	3.04%	251,862,560	6,720,416	258,582,976	3.50%

Source: CalAm's AWSC Revenue Requirement Workbook, Sheets SC WP 103R, SC WP104R and SC WP 105R
(1) April, 2010 Escalation Memorandum

2. Medical Inflation in Commission-Approved Rates – In addition to the mathematical impact on the composite rate of adding separate group insurance inflation, there is the issue of "double counting" medical inflation. Medical costs are already embedded in the inflation rate used to adjust payroll, benefits and pension expense in the DRA / Water Division memorandum, and therefore should not be separately adjusted. The wage component of the DRA / Water Division inflation is based on the BLS Consumer Price Index for All Urban Consumers (CPI-U). The figures below are an excerpt of medical inflation from the CPI-U published for January 2011.[179] It shows that medical costs are already included in the rate used to inflate AWSC's and CalAm's costs. As of January, 2011, medical care comprised 6.6 percent of the CPI-U index.

[179] Bureau of Labor Statistics website, http://www.bls.gov/news.release/cpi.t01.htm

Medical care..............................	6.627
Medical care commodities (1)............	1.633
Medical care services.....................	4.994
Professional services....................	2.830
Hospital and related services............	1.703

CalAm's Support for Requested Group Insurance Inflation

To explain its increase CalAm asserts the following:[180]

- CalAm states that AW has not increased the amount the company paid into group insurance since 2007.
- CalAm states that AW has restructured health care options to encourage employees to use "in-network" health service providers.
- CalAm states that "excess reserves" in AW's insurance trust are projected to be depleted by year-end 2010 and a large increase is needed to bring trust contributions up to an amount consistent with current health care costs.
- CalAm states that a new "mental health parity" requirement, the federal health care reform law and the addition of same-sex dependent coverage are all expected to increase costs.

Overland's Review of CalAm's Requested Group Insurance Expense Increase

We reviewed support for CalAm's stated basis for group insurance increases. Following is our analysis of the requested group insurance inflation increases, year-by-year. Despite the fact that CalAm's 2012 test year expense request is almost 53 percent higher than its 2010 actual expense, very little of the supporting information discussed below is included in CalAm's rate filing or direct testimony. We developed it through discovery and interviews.

Group Insurance Cost Definitions – In order to understand how AW estimates and funds group insurance expense, it is important to understand the following three cost terms:[181]

[180] CalAm testimony of Jeffrey Dana, pp.25-27
[181] Phone interview, Robert Sievers, February 16, 2011

- Gross Cost – The total cost of benefits, including administration. Sources of funding for gross cost include 1) company plan contributions; 2) employee plan contributions and 3) employee out-of-pocket payments.

- Funding – The portion of total benefits cost funded by insurance (everything except out-of-pocket expenses). Funding can be viewed as company plus employee plan contributions, or as gross cost minus employee out-of-pocket payments.

- Net Cost – The company-paid portion of funding (total funding minus employee payroll contributions, or gross cost minus employee contributions and out-of-pocket payments).

The balance recorded in group insurance expense account 504100 is net cost. As described by AW, AW's group insurance funding is debited to group insurance expense based on a funding rate designed to match combined employee and company trust contributions. Employee payroll contributions are credited against group insurance expense, leaving net cost as the account balance.

Budgeted vs. Actual Group Insurance Expense – The table below summarizes amounts included in the budget and recorded by CalAm and AWSC in 2009 and 2010 for group insurance expense (account 504100). As discussed above, these amounts reflect AW's net group insurance cost (the portion funded by AW). Noteworthy is the fact that at the time of the 2009 budget, AW planned to fund its insurance trust at a much higher level (almost \$20 million for AWSC and \$3 million for CalAm) than it later decided (\$15 million for AWSC and about \$2 million for CalAm), a funding rate which it held steady through 2010.

Table 7-3

American Water Service Company and California American Water
2009 and 2010 Budgeted and Actual Group Insurance Expense
Object Account 504100

Item	2009 Budget	2009 Actual	2010 Budget	2010 Actual	2010 Pct Chg (Actual Exp.)
AWSC	$ 19,753,603	$ 15,001,396	$ 15,696,879	$ 14,686,162	-2.1%
CalAm	$ 3,020,032	$ 2,032,307	$ 2,241,708	$ 2,164,325	6.5%

Sources: OC-72 & 73 (2009), Cal-Am's SC revenue requirement wp; OC-135 (2010)

2010 Base Year Requested vs. 2010 Actual Expense - CalAm's base year group insurance expense request (AWSC, California Corporation and CalAm combined) is 7.2 percent higher than 2010 actual expense. In the service company, in which the base period request is based on the 2010 budget, the difference between requested expense and 2010 actual expense is primarily the result of expense budgeted for vacant employee positions. For CalCorp and the rest of CalAm, the base period group insurance request is 7.7 percent higher than actual primarily because it is based on 291 employees CalAm requested for authorization, rather than the actual level of employees on which 2010 group insurance funding was based. CalAm indicated that as of February, 2010, it had 271 employees in the California "group insurance bill."[182]

2011 Projected vs. 2010 Base Period Expense – CalAm's requested 2011 group insurance expense is 30.8 percent higher than 2010 base period expense and 40.3 percent higher than 2010 actual expense. The 2011 requested expense level is based on the following:

- An amount CalAm says its employee benefits consultant~~,~~ [redacted] recommended should be in its group insurance trust fund to meet 2011 claims.

- An assumed trust fund balance as of year-end 2010.

- A forecasted health care cost trend rate of 15.6 percent which includes:
    - An industry (cost increase) trend rate of 8.2 percent
    - An additional AW-specific "experience and migration rate" of 2.1 percent. This represents the amount by which AW's general health care cost increase is expected to exceed the industry average due to higher-than-average utilization.
    - An additional 4.5 percent attributable to implementation of the new federal health reform law (3.0 percent for "preventative care" and 1.5 percent for adult dependent care up to age 26).
    - An additional 0.8 percent for dependent coverage for same-sex domestic partners, which AW appears to have added to its plans in 2011.

AW's Health Care Cost Trend Rate – The following table summarizes [redacted] data provided by AW's health care consultant concerning industry and AW health care costs for the years 2007 through 2009 and the forecasted years 2010 and 2011. It is important to understand that the cost trend rate is not just medical price inflation. It is the product of price inflation and increase service utilization.

[182] CalAm workpaper CC-Exp 133

Table 7-4

Table American Water Actual and Forecasted Health Care (Medical and Prescription Drug) Cost Trend Rates (1)									
	2007 Actual		2008 Actual		2009 Actual		2010 Forecast		Forecast
Item	Union	Non-Union	Union	Non-Union	Union	Non-Union	Union	Non-Union	Combined
Actual / Projected Trend									
Utility Industry Cost Trend Rate	8.5%	8.5%	8.5%	8.5%	8.2%	8.2%	8.2%	8.2%	8.2%
Additional AW-Specific Cost Increase	9.3%	11.5%	-5.7%	-11.4%	5.9%	-0.1%	2.6%	1.5%	2.1%
Subtotal AW Cost Trend Before Additional Asserted Impacts	17.8%	20.0%	2.8%	-2.9%	14.1%	8.1%	10.8%	9.7%	10.3%
Additional Asserted Impacts									
Federal Mental Health Legislation							1.5%	1.5%	
Federal Health Reform Act									4.5%
Same Sex Dependent Benefits									0.8%
Subtotal Additional Impacts							1.5%	1.5%	5.3%
Total AW-Calculated Trend Rate	17.8%	20.0%	2.8%	-2.9%	14.1%	8.1%	12.3%	11.2%	15.6%
Source: OC-214-B (1) Cost trend rates are the product of increased service utilization and price inflation.									

2007-2009 Actual Medical Cost Increase - AW's lower-than-industry experience in 2008 is the result of a one-time audit of dependent coverage eligibility.[183] Apart from 2008, AW's experience has been above the industry trend. It was significantly above the industry trend in 2007 and, for union employees, significantly above trend in 2009.

2010-2011 Forecasted Medical Cost Increase - [redacted] ~~forecasts~~ AW's data predicts that AW will continue to experience above-industry trend medical cost inflation in 2010 and 2011. Notwithstanding [redacted] 2010 forecast, as shown above, actual results for 2010 show AWSC and CalAm actually recorded (funded) less group insurance expense in 2010 than it did in 2009, and the 2009 funding level was significantly below the amount budgeted.[184] Over one-third of AW's 2011 forecasted health care inflation rate is associated with implementing the new federal health care reform law for which AW has no actual cost experience.

Calculation of the 30 Percent Increase for 2011 – Despite being significantly above industry trend ~~(according to~~ [redacted] AW's projected 2011 health care inflation trend explains only about half (15.6 percent) of CalAm's request 2011 group insurance increase. In a set of spreadsheets provided in response to OC-214-B, AW provided various calculations related to group insurance funding. As best we can develop it from the spreadsheets, the "bottom line" calculation of the requested 2011 increase (which CalAm says is 30 percent), is summarized below. Numbers in bold font are as provided by AW; numbers not in bold are calculated by Overland based on the amounts provided by AW.

[183] As discussed in CalAm testimony of Dana. During this timeframe many large companies conducted audits to determine dependent eligibility. For example, plans typically require adult children to be full-time students, with coverage for students usually ending at age 22. Plan coverage for participants found to be ineligible is terminated.

[184] The key reason for the small decline in 2010 appears to be expense incurred at approximately the same rate per employee, but for fewer employees.

Table 7-5

American Water Calculation of 2011 Per Capita Group Insurance Funding Requirement					
		Company		Employee	
Item	Total	Amount	Pct	Amount	Pct
Actual Funding Rate, 2010	**$ 12,114**	**$ 10,408**	86%	**$ 1,706**	14%
Increase	**1,653**				
Required 2010 Funding Rate	**13,767**				
Increase	**2,124**				
Required 2011 Funding Rate, Before Adjustments to Increase the Trust	**15,891**				
Adjustments to Increase the Trust Account Balance to "Minimum Required"	**328**				
Final Required 2011 Funding Rate	**16,219**	13,530	83%	2,689	17%
Final 2011 Rate Increase Over 2010	**33.89%**	**30.00%**		57.62%	
Source: OC-214-B Attachment and 2/16/2011 discussion with Robert Sievers, AW V.P. Finance & Accounting					

As explained Robert Sievers, a 30 percent increase in AW's funding achieves a required 33.9 percent increase in required funding because of increased employee contributions, making the employee cost increase larger, percentage-wise, than the company's.

We cannot reconcile the "actual" 2010 per-capita company amount shown in the table, $10,408, with the 2010 service company budget, which averages $9,679 per employee, or with actual 2010 AWSC funding per-capita, which is about the same as in the budget. When looking at "required" 2010 and 2011 funding, it is important to note that these amounts are based on 1) a projected cost trend, 2) a projection that AW will continue to under-perform in cost control relative to the industry, 3) the predicted impact of the federal health care law and "mental health parity," and 4) a projected "required" trust account balance. Overland cannot directly address the calculation of these amounts, which AW says were made by its health benefits consultant,~~-~~ [redacted] but we note that, at the least, they are subject to potential forecast error.[185]

Reconciling CalAm's Requested 30 Percent 2011 Group Insurance Increase with AW's [redacted] ~~-~~Projected 15.6 Medical Cost Rate~~Trend~~ – The portion of the requested 2011 expense increase that exceeds the health care inflation trend is roughly equivalent to the difference between the "actual" ($12,114) and "required" ($13,767) 2010 per-capita funding rates shown in the table above. According to CalAm, the reason it needs an increase in 2011 that is approximately twice the [redacted] forecasted 15.6 percent

[185] For example, aside from inflation, one of the key factors driving [redacted] ~~-~~"required funding" in 2011 is "required [trust account] reserves." Extrapolating from actual data as of July 31, 2009, AW's data [redacted] ~~-~~predicts~~ojected~~ "required reserves" of $10.4 million for December 31, 2010 and $11.6 million for 2011. During our February 16, 2011 interview, we asked Robert Sievers for the *actual* trust account balance as of December 31, 2010. He stated he did not know the balance. We then asked whether it was higher or lower than [redacted] the $10.4 million projection. He acknowledged it was higher and we later determined it was $15.3 million (OC-236). To the extent the actual trust balance is higher than the amount projected at a point in time, the projected funding required may also be higher than the actual funding needed to bring the trust balance to the required level.

medical cost ~~trend~~ rate is that it has not increased its funding rate since 2007.[186] According to CalAm, a trust account had sufficient funds at least partly due to better-than-expected claims experience caused by a dependent audit in 2007. The surplus allowed AW to maintain the 2007 insurance funding level "despite increasing health care costs." [187]

In 2009, AW's budgeted health insurance funding for the service company ($19.7 million) was 31 percent higher than the amount actually funded ($15.0) million. A similar relationship between budgeted and actual expense can be seen at the CalAm level. AWSC's and CalAm's financial data also shows that actual health care funding for the service company did not increase in 2010; in fact, for AWSC it was slightly less ($14.6 million) than in 2009.[188] The statistics appear to support CalAm's assertion that medical insurance funding was inadequate, at least in 2009 and 2010. However, even if [redacted] calculation of the "required" trust reserve is assumed to be reasonable, it does not necessarily support the component of CalAm's requested 2011 increase that exceeds inflation <u>because it seeks to make up for funding deficiencies attributable to prior periods in a future test year</u>.

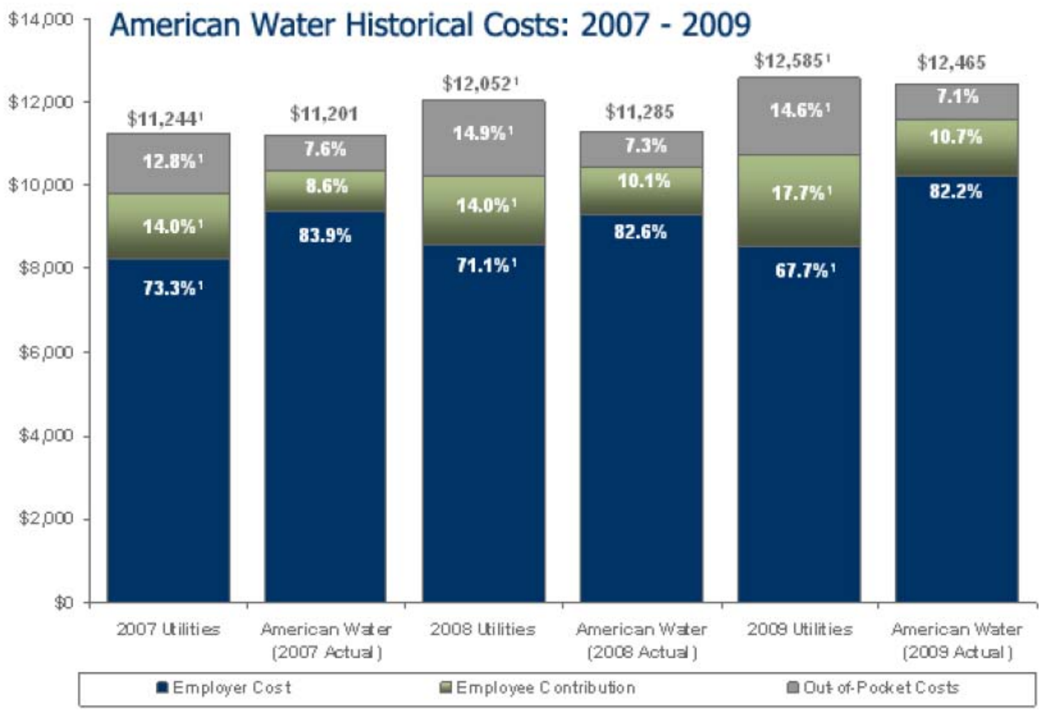
Overland submits that instead of making the decision to hold funding at 2008 levels in 2009 and 2010, AW should have funded the amounts it actually budgeted in 2009, which were likely also based on similar [redacted] calculations of projected medical costs. AW should have recognized that the favorable impact of its 2007 dependent audit was non-recurring (and its 2009 group insurance budget suggests that it did, at least at the time the budget was prepared). We estimate that if AW had funded the amounts it budgeted, group insurance expense would have been about $20 million higher in 2009 for the company as a whole, before allocation to capital.[189] Instead, the difference between 2009 budgeted and actual group insurance expense flowed to pre-tax income, effectively shifting the expense to future periods. Had both 2009 and 2010 been funded at levels required to stay even with AW's rising health care costs, it seems unlikely that a 30 percent funding increase would be needed in 2011 to bring the trust account into balance with required reserves.

AW's Group Insurance Costs vs. The Utility Industry

In an employee newsletter dated August 12, 2010, AW provided some statistics comparing AW's gross cost (company contributions, employee contributions and

[186] CalAm testimony of Dana, p.25
[187] Id.
[188] This was due mainly, if not entirely, to a decreasing labor force level.
[189] For AWSC, which has about 25 percent of AW's total employees, 2009 budgeted group insurance expense was about $5 million higher than the amount actually funded. $5 million / 25% = $20 million. CalAm (including CalCorp) has about 4.5 percent of AW's total employees. 2009 budgeted group insurance for CalAm was about $1 million higher than the amount actually funded. $1 million / 4.5% = $22.2 million.

employee out-of-pocket costs) with those of the utility industry for the period. The results, shown in the chart below, demonstrate that while combined overall (employee and company) insurance cost per capita is close to the average for the utility industry, AW's company cost was higher than the industry average, because AW's employees paid only about half, as a percentage of gross cost, of the amount paid by employees in the average utility. For instance, in 2009, employees of the average utility paid 32.2 percent of total health benefits costs, through payroll deductions and out-of-pocket payments, while AW's employees paid an average of 17.8 percent of gross health insurance costs. As a result, although AW's benefits consultant calculated AW's 2009 gross costs to be $12,465 per employee, about the same as the industry average of $12,565, the cost borne by AW, $10,246 per employee, was 20 percent higher than the $8,520 borne by the average utility. This disparity actually increased from 2007, when AW's cost was 14 percent higher than the average utility.



Source: OC-235

AW took some steps in 2010 and 2011 to increase the total share of costs paid by employees. Attachment 7-1 provides a summary of AW medical, dental and prescription drug benefits from 2008 through 2011. Among the noteworthy changes between 2008 and 2011:

- Beginning in 2009, payroll contributions by non-union employees hired before 2006 were raised to the same level as employees hired after 2005.

- In 2010, non-union employees began contributing to plans based on the specific dependents covered in their plans. Two contribution schedules (single and family) were expanded to four (single, employee w/ spouse, employee w/ children and family).

- In 2011, contributions to the standard Preferred Provider Option plan (80 percent coverage after deductible) increased from $60 to $85 monthly for non-union employees, and from $128 to $238 for family coverage. Slightly different increases were also adopted for union employees.

- In 2011, “Premium” PPO (90 percent coverage after deductible) and “Exclusive Provider” (HMO-type) plans were eliminated. The Exclusive Provider plan covered 100 percent of expenses after an employee co-payment.

As noted above, even after these changes, the share of gross costs to be paid by employees in 2011, estimated to be 23 percent, is significantly lower than the industry average employee share was in 2009. It is likely that just as AW increased its employee contribution since 2009, so did the average utility; thus, it is not clear that AW has gained ground on the industry-average company-paid percentage of total health costs.

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American Water Company

Summary of Employee Health Plans and Employee Contributions

Plan	Benefits	2008		2009		2010		2011	
		Non-Union	Union	Non-Union	Union	Non-Union	Union	Non-Union	Union
		Post-2005	Post-2005	Post-2005	Post-2005	Post-2005	Post-2005	Post-2005	Post-2005
		OC-111 At. 1	OC-111 At. 2	OC-111 At. 3	OC-111 At. 5	OC-111 At. 9	OC-111 At. 10	OC-111 At. 11	OC-111 At. 12
PPO Standard	Covered Expenses percentage	80%	80%	80%	80%	80%	80%	80%	80%
PPO Standard	Annual Deductible, Single	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	None	None
PPO Standard	Annual Deductible, Family	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000	None	None
PPO Standard	Maximum Out-of-pocket, Single	$3,500	$3,500	$3,500	$3,500	$3,500	$3,500	$1,750	$1,750
PPO Standard	Maximum Out-of-pocket, Family	$10,500	$10,500	$10,500	$10,500	$10,500	$10,500	$3,500 per person	$3,500 per person
PPO Standard	Lifetime Maximum	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited
PPO Standard	Out-of-Network Services	Pays less, details not available	Pays less, details not available	60%, higher deductibles	Pays less, details not available	60%, higher deductibles	Pays Less	50% after a $200 single / $600 family deductible	50% after a $200 single / $600 family deductible
PPO Standard	EMPLOYEE CONTRIBUTION.- SINGLE	$60	$42	60	$52	$60	$60	$85	$95
PPO Standard	EMPLOYEE CONTRIBUTION.-EE + SPOUSE	N/A	N/A	N/A	N/A	$140	N/A	$187	N/A
PPO Standard	EMPLOYEE CONT.- EE + CHILDREN	N/A	N/A	N/A	N/A	$129	N/A	$196	N/A
PPO Standard	EMPLOYEE CONT.- FAMILY	$148	$94	148	$110	$148	$126	$238	$243
PPO Premium	Covered Expenses percentage	100%	100%	90%	100%	90%	100%	No Longer Exists	No Longer Exists
PPO Premium	Annual Deductible, Single	$0	$0	$0	$0	$0	$0	"	"
PPO Premium	Annual Deductible, Family	$0	$0	$0	$0	$0	$0	"	"
PPO Premium	Maximum Out-of-pocket, Single	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	"	"
PPO Premium	Maximum Out-of-pocket, Family	$3,000	$3,000	$3,000	$3,000	$3,000	$3,000	"	"
PPO Premium	Lifetime Maximum	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	"	"
PPO Premium	Out-of-Network Services	Pays Less	Pays Less	Pays Less	Pays Less	Pays Less	Pays Less	N/A	N/A
PPO Premium	MONTHLY EMPLOYEE CONT.- SINGLE	$72	$57	72	$68	$69	$77	N/A	N/A
PPO Premium	EMPLOYEE CONTRIBUTION.-EE + SPOUSE	N/A	N/A	N/A	N/A	$159	N/A	N/A	N/A
PPO Premium	EMPLOYEE CONT.- EE + CHILDREN	N/A	N/A	N/A	N/A	$147	N/A	N/A	N/A
PPO Premium	MONTHLY EMPLOYEE CONT.- FAMILY	$178	$120	178	$141	$178	$160	N/A	N/A
Exclusive Provider (EPO)	Covered Expenses percentage	100%	100%	100%	100%	100%	100%	No Longer Exists	No Longer Exists
Exclusive Provider (EPO)	Annual Deductible, Single	$0	$0	$0	$0	$0	$0	"	"
Exclusive Provider (EPO)	Annual Deductible, Family	$0	$0	$0	$0	$0	$0	"	"
Exclusive Provider (EPO)	Maximum Out-of-pocket, Single	Co-pay Plan	Co-pay Plan	Co-pay Plan	Co-pay Plan	Co-pay Plan	Co-pay Plan	"	"
Exclusive Provider (EPO)	Maximum Out-of-pocket, Family	Co-pay Plan	Co-pay Plan	Co-pay Plan	Co-pay Plan	Co-pay Plan	Co-pay Plan	"	"
Exclusive Provider (EPO)	Lifetime Maximum	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	Unlimited	"	"
Exclusive Provider (EPO)	Out-of-Network Services	Not Applicable	Not Applicable	Not Applicable	Not Applicable	Not Applicable	Not Applicable	"	"
Exclusive Provider (EPO)	EMPLOYEE CONTRIBUTION - SINGLE	$74	$62	74	$73	$69	$83	N/A	N/A
Exclusive Provider (EPO)	EMPLOYEE CONTRIBUTION.-EE + SPOUSE	N/A	N/A	N/A	N/A	$158	N/A	N/A	N/A
Exclusive Provider (EPO)	EMPLOYEE CONT.- EE + CHILDREN	N/A	N/A	N/A	N/A	$146	N/A	N/A	N/A
Exclusive Provider (EPO)	EMPLOYEE CONTRIBUTION - FAMILY	$182	$126	182	$148	$182	$168	N/A	N/A

PUBLIC ERRATA VERSION

Attachment 7-1

American Water Company
Summary of Employee Health Plans and Employee Contributions

Plan	Benefits	2008		2009		2010		2011	
		Non-Union	Union	Non-Union	Union	Non-Union	Union	Non-Union	Union
		Post-2005	Post-2005	Post-2005	Post-2005	Post-2005	Post-2005	Post-2005	Post-2005
		OC-111 At. 1	OC-111 At. 2	OC-111 At. 3	OC-111 At. 5	OC-111 At. 9	OC-111 At. 10	OC-111 At. 11	OC-111 At. 12
Vision Plan (EyeMed)	Covered Expenses pct. (eye exams)	100%, $15 co-pay	100%, $15 co-pay	100%, $15 co-pay	100%, $15 co-pay	100%, $15 co-pay	100%, $15 co-pay	100%, $15 co-pay	100%, $15 co-pay
Vision Plan (EyeMed)	Frames	100%, $50 co-pay	100%, $50 co-pay	100% up to $200, $50 co-pay, 80% above $200	100% up to $200, $50 co-pay, 80% above $200	100% up to $200, $50 co-pay, 80% above $200	100% up to $200, $50 co-pay, 80% above $200	100% up to $200, $50 co-pay, 80% above $200	100% up to $200, $50 co-pay, 80% above $200
Vision Plan (EyeMed)	Frequency	24 months	24 months	24 months	24 months	24 months	24 months	24 months	24 months
Vision Plan (EyeMed)	Out-of-network benefits	Available	Available	Available	Available	Available	Available	Available	Available
Vision Plan (EyeMed)	EMPLOYEE CONTRIBUTION	Included in Medical	Included in Medical	Included in Medical	Included in Medical	Included in Medical	Included in Medical	Included in Dental	Included in Medical
Presecription Drug	Employee Contribution Generic Retail	10%	10%	10%	10%	10%	10%	0%	0%
Presecription Drug	Employee Cont. Preferred Brand Retail	20%	20%	20%	20%	20%	20%	20%	20%
Presecription Drug	Employee Cont. Non-Preferred Brand Retail	20%	20%	20%	20%	20%	20%	20%	20%
Presecription Drug	Employee Contribution Generic Mail Order	$14	$14	$14	$14	$14	$14	0%	0%
Presecription Drug	Employee Cont. Preferred Brand Mail Order	$30	$30	$30	$30	$30	$30	20%	20%
Presecription Drug	Employee Cont. Non-Preferred Brand Mail	$70	$70	$70	$70	$70	$70	20%	20%
Presecription Drug	EMPLOYEE CONTRIBUTION	Included in Medical	Included in Medical	Included in Medical	Included in Medical	Included in Medical	Included in Medical	Included in Medical	Included in Medical
Dental Standard	Annual Deducitble Single	$100	$100	$100	$100	$100	$100	$50	$50
Dental Standard	Annual Deducitble Family	$200	$200	$200	$200	$200	$200	$100	$100
Dental Standard	Preventative Care Covered Expense Pct.	80%	80%	80%	80%	80%	80%	100%	100%
Dental Standard	Calendar Year Benefit Limit	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	$1,500	$1,500
Dental Standard	Orthodontia	Not Covered	Not Covered	Not Covered	Not Covered	Not Covered	Not Covered	50% aftr deductible	50% aftr deductible
Dental Standard	EMPLOYEE CONTRIBUTION	Included in Medical	Included in Medical	Included in Medical	Included in Medical	Included in Medical	Included in Medical	$10, $22, $23, $28	Included in Medical
Dental - Premium Plan	Annual Deducitble Single	$50	$50	$50	$50	$50	$50	No Longer Exists	No Longer Exists
Dental - Premium Plan	Annual Deducitble Family	$100	$100	$100	$100	$100	$100	"	"
Dental - Premium Plan	Preventative Care Covered Expense Pct.	80%	80%	80%	80%	80%	80%	"	"
Dental - Premium Plan	Calendar Year Benefit Limit	$1,000	$1,000	$1,000	$1,000	$1,000	$1,000	"	"
Dental - Premium Plan	Orthodontia	$1,500 Lifetime	$1,500 Lifetime	$1,500 Lifetime	$1,500 Lifetime	$1,500 Lifetime	$1,500 Lifetime	"	"
Dental - Premium Plan	EMPLOYEE CONTRIBUTION	Included in Medical	Included in Medical	Included in Medical	Included in Medical	Included in Medical	Included in Medical	"	"

Source: OC-111

8. REGULATORY (RATE CASE) EXPENSE

This chapter covers CalAm's requested rate case expense, which includes the following amounts:[190]

2010	$1,393,400
2011	$1,393,400
2012	$2,798,400
2013	$2,798,400

Summary of Findings

1. Test Year Amount - CalAm's requested test year 2012 rate case expense, $2,798,400, is based on three year amortization of total rate case expense of $8,395,000. The request is more than double the amount CalAm is currently authorized to collect, $1,242,000.[191]

2. Recovery for Multiple Proceedings – CalAm acknowledges that it included in its rate case expense request the costs for two general rate case proceedings (2010 and 2013) and two cost of capital proceedings (2011 and 2014). CalAm stated that it did this "because of the uncertainty surrounding the Commission's treatment of regulatory expenses."[192]

3. Components of Rate Case Expense - The primary components of CalAm's rate case expense include outside legal expenses, outside consultants, customer notices and printing and mailing of the rate filing.[193] It also includes certain amounts charged to the rate case by AWSC employees in the Shared Services function. Rate case expense does not include the expense of CalCorp's 11-employee regulatory staff, which is included in requested CalCorp labor and labor-related expenses.

4. Analysis of CalAm's Requested Rate Case Expenses – Many of the expenses or expense amounts included in CalAm's request are questionable. Specifically:

    - Many of the services CalAm requests to pay an outside attorney to perform should be performed internally now that CalAm has increased its legal staffing to four professionals.

[190] CalAm Rate Filing, Exh.A-CC, Ch.3, Table 1
[191] CalAm Rate Filing, Exh.A-CC, Ch.3, Table 1
[192] CalAm Direct Testimony of David Stephenson, p.20
[193] CalAm Direct Testimony of Stephenson, p.6

- Many of the services CalAm requests to pay outside consultants to perform appear to be work that CalAm's staff of seven technical rate employees should perform.

- The added cost of services proposed for work done by the service company's Shared Services Center (SSC) appears to already be accounted for in the amounts charged by the SSC to CalAm through management fees. The management fees are based on a complete AWSC (and complete SSC) budget. The budgeted expenses of the SSC are completely distributed in CalAm's requested AWSC revenue requirement and no budgeted expenses are set-aside to be charged through a separate mechanism.

- The requested expenses to provide rate case notices to customers appear to be dramatically overstated, and do not take into account the possibility of incorporating notices into customer bills at much lower cost.

- The requested expenses for printing and mailing the rate filing, equal to the cost of a small house for each of two rate cases, appear to be dramatically overstated and unnecessary in light of current electronic document technology.

5. Additional Expense of CalAm's Regulatory Staff – In addition to rate case expense, CalAm's request for CalCorp O&M expense includes the cost of a regulatory staff consisting of 11 employees (four legal staff and seven technical rates staff). The requested test year 2012 labor and labor-related expense of this staff of 11 professionals is $1,891,800, excluding office overheads.

6. Combined Requested Rate Case and Regulatory Staff Expense – When CalAm's requested annual rate case expense and annual regulatory / legal staffing expense is combined, it totals $4,690,000 in test year 2012, or approximately $27.20 per customer, excluding office and other non-labor overheads associated with the regulatory staff.

Recommended Rate Case Expense

Our recommendation for customer funding for rate case expense is based on Commission-authorized expense, rather than CalAm's $8.4 million ($2.8 million amortized) request. Specifically, we recommend basing rate case expense on currently authorized regulatory expense, reduced by an amount to recognize the savings in outside legal expenses attributable to the newly-hired staff. Our recommended rate case expense is $810,000 in base period 2010 and $848,000 in test year 2012. Our calculation process is as follows:

~~5.~~1. We estimated the outside legal component of currently authorized regulatory expense by calculating the ratio of outside legal expenses to total regulatory expense in CalAm's request ($1,978,700 per case / $4,180,177 per case).

~~6.~~2. We reduced estimated outside legal services by 75 percent to recognize the replacement of outside legal services with the newly-hired internal legal staff.

~~7.~~3. We subtracted this amount from currently authorized regulatory expense to obtain recommended authorized expense, before inflation.

~~8.~~4. We escalated the resulting recommended authorized amount for the years 2010 through 2013.

Table 8-1

California American Water Overland Recommended Rate Case (Regulatory) Expense	
Regulatory Expense	2009 Amount
2009 Authorized Rate Case Expense	$ 1,242,200
2010 Legal Fees Ratio to Total Expenses	47.34%
Estimated Authorized Outside Legal Fees	$ 587,999
Recommended Reduction in Legal Fees - Pct	75.00%
Recommended Reduction in Legal Fees - Amt	$ 440,999
Outside Legal Fees Recommended for Authorization	147,000
Recommended Non-Legal Rate Case Expenses	654,201
Recommended Regulatory Expense, 2009 (Before Escalation)	$ 801,201
Recommended Regulatory Expense, 2010	$ 809,693
Recommended Regulatory Expense, 2011	$ 826,535
Recommended Regulatory Expense, 2012	$ 848,190
Recommended Regulatory Expense, 2013	$ 871,770
~~2~~ Source: CalAm Workpaper Exh. A- CC Ch 3 Table 1(100 day update)	

We believe our calculation of recommended expense is conservative in that it attributes no savings to efficiencies that should be realized from consolidating separate district-level and General Office cas~~t~~es into a single rate proceeding. Our recommended adjustment to CalAm's requested regulatory expense is summarized below.

Table 8-2

Application of California American Water for Rate Increase (U210W) Summary of Overland's Recommended Adjustment to CalAm's Request Adjustment #14: Rate Case (Regulatory) Expense				
	2010	2011	2012	2013
CalCorp Total Recommended	809,693	826,535	848,190	871,770
CalCorp Total Requested by CalAm	1,393,392	1,393,392	2,798,395	2,798,395
Recommended Adjustment - CalCorp	$ (583,699)	$ (566,857)	$ (1,950,205)	$ (1,926,625)
Escalation:				
CalCorp		2.08%	2.62%	2.78%

Currently Authorized Rate Case Expense

CalAm's current regulatory expense authorization is summarized below.

Table 8-3

California American Water 2009 Authorized Regulatory (Rate Case) Expense Per Company	
Jurisdiction	2009 Authorized
Coronado	$ 79,300
Village	79,400
Los Angeles	217,500
Monterey Water	350,000
Monterey Wastewater	28,700
Sacramento	467,200
Larkfield	20,100
Total Authorized Per CalAm	$ 1,242,200
Source: CalAm Rate Filing Exh. A-CC, Ch. 3, Table 1	

Analysis of CalAm's Requested Rate Case Expense

The following table summarizes the components of CalAm's requested rate case expense for the 2012 test year. The discussion below contains our analysis of the major components of this expense.

Table 8-4

California American Water Company Estimate of Rate Case (Regulatory) Expense		
Expense	2010 Actual Amount	3 Year Amort.
Rate Consultant	$ 145,637	
EMA Consulting	115,597	
Legal Fees (Outside Counsel)	1,978,700	
SSC Labor	219,903	
SSC Expenses	66,011	
Travel Expenses Witness Training	90,707	
Witness Training	34,000	
Printing and Mailing	846,000	
Cost of Capital	683,622	
Total First Case	$ 4,180,177	$ 1,393,392
Inflation	246,631	
Total Second Case (Includes Inflation)	4,426,808	
In-house Attorney Savings	(211,800)	
Add First Case (Above)	4,180,177	
Total Both Cases, With Savings	$ 8,395,185	$ 2,798,395
Source: CalAm Workpaper CC Exp 115		

Legal Fees - A large portion of CalAm's requested rate case expense relates to external legal expenses ($1.98 million total times two rate cases, ex-inflation, $1,319,000 amortized per year, ex-inflation).[194] ~~T~~ CalAm's request~~s~~ includes approximately $4 million in outside legal expense despite the fact that it has increased its own internal legal staff to better support the rate case process. As explained by CalAm:

> California American Water has opened an office in San Francisco near the Commission and plans to retain two full-time regulatory attorneys and a regulatory paralegal for that office. . . . California American Water opened the San Francisco office and added the internal legal positions in an effort to reduce outside legal expenses.[195]

CalAm completed the process of hiring additional legal staff in 2010. In addition, CalAm also filled a vacant "Corporate Counsel III" position in 2010. In total, CalAm's California-dedicated legal staff now includes four professionals (three attorneys and one paralegal) with a total requested test year labor and labor-related O&M expense of $665,000 ($166,250 per employee) in test year 2012. However, in calculating its requested rate case expense, CalAm's credited internal legal staff with reducing outside legal expenses by only $70,600 annually ~~in annually~~[196]

In evaluating CalAm's request for ~~nearly~~ $1.3 million annually in outside legal rate case expense, the Commission should consider that CalAm has also included in its requested

[194] As discussed below, CalAm's rate case expense request also contains an additional $208,000 for legal fees attributed to two cost of capital proceedings.

[195] CalAm Direct Testimony of Stephenson, p.5

[196] $211,800 / 3 years

labor and related expenses for CalCorp a full complement of legal employees, including two that CalAm said that it hired "in an effort to reduce outside legal expenses."[197]

Consulting Fees - Requested rate case expense includes $522,000 ($261,000 times two cases, $174,000 amortized per year) for outside consultants. Of this, $29~~2~~1,000 ($145,637 x 2 cases, ex-inflation, $97,~~,3~~100 amortized per year, ex-inflation) relates to a former AW employee (James Harrison) for activities such as "reviewing prior orders and comments of DRA," "revis[ing] the previous applications [to incorporate] comments of all parties and the Commission" and "manag[ing] most of the workload of all cases until department staff is available to devote time to the cases."[198] We question the need for customer funding for a former employee to "manage most of the workload of all cases until department staff is available" when, as shown in table 8-7 below, CalAm is also requesting more than $1.2 million annually in test year O&M expense for seven technical rate specialists, including a Rate Director, a Senior Manager Rates, a Principal Analyst Rates and three Financial Analysts (Rates).

CalAm rate case expense request also includes $232,000 ($116,000 time two cases, $77,300 amortized per year) for the cost of a consultant (EMA Consulting) to "organize, launch and manage preparation of the rate case during the time when California American Water had many other active filings before the Commission."[199] The duties attributed to EMA (organize, launch and manage the preparation of the case) seem to duplicate the duties CalAm lists to justify the cost of Mr. Harrison. They also seem to be activities that CalAm's staff of seven rate case technicians, with an average test year-requested labor and labor-related cost of $1~~75~~81,000 per employee[200], should be able to provide themselves.

AWSC Shared Services Center Labor and Expense - ~~-~~CalAm's requested rate case expense includes $572,000 ($286,000 times two cases, ex-inflation, $190,600 amortized per year, ex-inflation) for labor and expense incurred by AWSC's Shared Services Center (SSC). As described by CalAm, this includes "labor costs directly charged to California American Water by the Shared Services Center . . . for work related to general cases" and "expenses of the SSC employees who may charge time to the case."[201] CalAm provided worksheets which purport to contain amounts charged by the SSC to the rate case, but the amounts do not tie or seem to relate directly to the amounts requested. CalAm asserts that the SSC incurred $119,787 in labor and $46,187 ($165,974 total) in expense associated with the current rate case through year-end 2009.[202]

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197 CalAm Direct Testimony of Stephenson, p.5

198 CalAm Direct Testimony of Stephenson, pp. 14-15

199 CalAm Direct Testimony of Stephenson, p.15

200 Per Table 8-7: $1.265 million for 7 technical rate professionals / 7 = $180,714. Charges to capital reduce the O&M impact to approximately $175,000 per employee.

201 CalAm Direct Testimony of Stephenson, p.16

202 OC-127 and OC-128

Apart from rate case expense, CalAm's requested expense for AWSC management fees for the SSC is $1,009,928 in base period 2010 and $1,199,785 in test year 2012. These amounts are based on the SSC's entire 2010 budget (with no amounts removed to be charged separately through rate case expense). Embedded within the amounts charged by the SSC to CalAm are direct charges of $96,085 in base period 2010 and $105,275 in test year 2012.[203] For 2010, these amounts include charges to rate case project work (in other states in 2010) and these amounts are part of the SSC's total 2010 budget from which California SSC cost assignments and allocations were made.[204] In other words, AWSC's management fees already fully account for the entire cost expected to be incurred by the SSC. Given the fact that, in two separate rate cases, we have not seen any amounts for California rate case expense withheld for separate rate case expense recovery from the SSC total budgeted amounts, we find no basis on which to conclude that the SSC expenses included separately in requested rate case expense have not already been accounted for in both authorized and requested AWSC management fees.

Printing and Mailing – CalAm states that printing and mailing costs, totaling $1,~~8~~692,000 ($846,000 times two cases, ex-inflation, $~~630,700~~564,000 amortized per year, ex-inflation) consist of "printing and mailing of applications" ($129,000 per case) "mandated rate case notification and communication requirements" ($505,000 per case), which include mailing three notices and various other costs, and "voluntary rate case notification and communication" ($212,000 per case), which include public meetings, open houses and rate case videos and brochures.[205]

Table 8-5

Requested Rate Case Expense Printing and Mailing Expenses per Case (1/2 of Total Requested)	
CalAm-Calculated Pro Forma Expense	Amount
Rate Case Application Printing	$ 129,000
Print and Mail 3 Different Notices	505,000
Public Meetings / Open Houses	130,000
Rate Case Video and Brochure	60,000
Publication Notification	35,000
Various Other	(13,000)
Total Authorized Per CalAm	$ 846,000
Source: OC-123-A	

We are not familiar enough with California notification requirements to know how much CalAm must expend to make its rate increase intentions public. However, we would make the following observations:

[203] CalAm's AWSC Rate Filing work papers SC WP 102R and SC WP 104R
[204] OC-165, Attachment
[205] OC-123

- CalAm says it is required to send three different notices for one rate case. If this is the case, it may be reasonable for the Commission to consider whether one or two notices would get the job done.

- CalAm says it costs more than 80 cents to send each notice. Aside from the fact that elsewhere CalAm calculates the postage associated with notices to be half this amount, we question whether this is reasonable in light of the ability to insert notices in customer bills. Elsewhere in the CalCorp portion of its filing, CalAm has requested additional postage expense to provide monthly, rather than bi-monthly billing. Given monthly billing it seems unlikely CalAm could not provide rate case notices to its customers through bill inserts at a cost of a couple of cents per notice. CalAm calculated its notice printing / mailing expense as follows:

  3 notices X 80 cents X 175,000 customers (about 3,000 more customers than CalAm has or is projecting to have) + $30,000 for "inflation and other adjustments" = $450,000

- Given that emailed Adobe documents have become the transmission format of choice for most information, CalAm's requested $129,000 expense to print copies of its rate filing seems not only high, but off-the-charts high. In the unlikely event that the Commission does require CalAm to print enough copies of the rate case to cover the cost of a small house (and we doubt this is the case), we recommend the Commission consider whether it would be reasonable change its requirements to reflect current technology. If it is not the case, we recommend the Commission instruct CalAm to replace needless paper with electronic documents, and deny its requested $129,000 in copying charges.

Cost of Capital Proceedings – In addition to the legal and consulting costs discussed above, CalAm's requested rate case expense includes $1,367,200 ($~~684,~~683,~~0~~600 per case, ex-inflation, times two cases, $455,700 amortized per year, ex-inflation) for the "legal expenses" and "consultants' estimated cost", as well as customer notice costs, for cost of capital proceedings in two rate case cycles (2011 and 2014).[206] CalAm workpapers show that this consists of the following components:

[206] CalAm Direct Testimony of Stephenson, pp. 24-25

Table 8-6

Requested Rate Case Expense Cost-of-Captial Proceeding Exp. Per Case (1/2 of Total Amount Requested)	
CalAm-Calculated Pro Forma Expense	Amount
Manatt Legal Fees	$ 208,035
Cost of Equity Consultant	138,000
Print and Mail Two Notices	309,337
Newspaper Advertising	14,000
Employee Expenses	14,250
Total Authorized Per CalAm	$ 683,622
Source: CalAm workpaper CC Exp 124	

For the cost of capital proceedings, the cost of sending customer notices ~~cost~~ is 90 cents instead of 80 cents per notice (40 cents for mailing and 50 cents for "setup"). Almost half of the total cost of capital proceeding expense is associated with customer notices. CalAm should find a way to notice customers of cost of capital proceedings (assuming it is required by the Commission) through bill inserts, rather than incurring a large separate mailing cost which, even if properly calculated, would still total about $68,000 (40 cents postage X 170,000 customers) per proceeding.

With its fully-staffed legal function of four professionals, for which CalAm has requested $665,000 annually in labor and related expenses in 2012, CalAm should be able to internally supply the legal resources necessary to make it through a cost of capital proceeding. As for the remaining costs, the one that seems legitimately necessary to conduct the proceedings is the cost of equity consultant. However, it remains unclear why CalAm would think it is reasonable to recover the cost of two separate proceedings in one rate cycle (three-year) amortization period.

Additional Expense Requested for CalAm's Regulatory Staff

Apart from and in addition to requested rate case expense, CalAm is requesting $1.9 million in labor and labor-related expenses for its in-house regulatory staff, consisting of 11 employees. This is embedded in the labor, benefits, pensions and other post-retirement benefits expenses requested to fund CalCorp.[207] We have extracted the expenses associated with the California regulatory staff to emphasize that they are separate from and in addition to the $2.8 million annual test year rate case expense request.

[207] Rate Filing Ex. A-CC, Ch. 2, Table 1 and Ex. A-CC Ch. 3, Table 1

Table 8-7

California American Water
Requested Test Year 2012 Labor and Related Expenses - CalCorp Regulatory Staff

Position	Salary	Incentive Pay	DCP and 401K	Payroll Tax	Group Insurance (1)	Pension & PBOP (3)	Total Cost	Capital Pct (2)	Total O&M Expense
Financial Analyst III (Rates)	$90,262	$9,026	$2,257	$7,045	$14,288	$46,080	$168,959	$0	$168,959
Senior Manager Rates	131,146	26,229	13,442	9,457	14,288	-	194,563	0%	194,563
Financial Analyst II (Rates)	79,675	7,968	-	6,235	14,288	46,080	154,246	10%	139,618
Financial Analyst I (Rates)	60,130	3,006	-	4,740	14,288	46,080	128,244	0%	128,244
Princ Analyst Rates	111,873	16,781	4,475	8,698	14,288	46,080	202,195	0%	202,195
Financial Analyst II (Rates)	70,940	7,094	-	5,567	14,288	46,080	143,969	0%	143,969
Director Rates	166,253	33,251	3,325	9,966	14,288	46,080	273,162	10%	249,171
Corp Counsel II	132,655	26,531	6,964	9,478	14,288	-	189,917	10%	173,578
Corp Counsel II	132,739	26,548	6,969	9,480	14,288	-	190,024	10%	173,676
Paralegal (N)	63,723	3,186	5,894	5,015	14,288	-	92,107	10%	83,215
Corp Counsel III	178,401	35,680	18,201	10,142	14,288	-	256,713	10%	234,609
Total 2012 O&M Expense	$1,217,796	$195,300	$61,528	$85,823	$157,172	$276,477	$1,994,097		$1,891,796

Sources: CalCorp "Corp Labor.xls" w ork book (100 day update), CA Corp Exhibit A.xls and CA-Corp_Exp_WP-100-115.xls (various w orksheets). (1) Requested Calcorp Grp Ins divided by total CalCorp employees. (2) Incentive Pay is not capitalized. (3) Calculated based on 2012 CalCorp-requested pension and PBOP expense divided by total CalCorp pension-eligible (32) and PBOP-eligible (11) employees.

ATTACHMENT A

ROBERT F. WELCHLIN, CPA
Senior Manager

General

Regulatory consultant to the telecommunications, cable, electric and gas industries. Manage operational, financial and regulatory audits, reviews of rate filings and cost studies in the energy utility, telecommunications and cable industries. 30 years of industry experience.

Education

- Master of Business Administration, St. Edwards University
- Bachelor of Science, Accounting and Business Administration, Eastern Illinois University,

Representative Experience

Electric and Gas

- FirstEnergy's Acquisition of Allegheny Energy – Project Lead In charge of the review of the merger synergies and the likely impacts of the merger on Potomac Electric Maryland service company cost distributions. This work was on behalf of the Staff of the Maryland Public Service Commission (2010), Calculated the discounted cash flow value of net regulated synergies attributable to Potomac Maryland customers. Recommended post-merger review of the impact of allocation procedures on regulated Maryland utility operations (2010).

- Connecticut Natural Gas Management Audit – Participated as a Technical Manager in a diagnostic management audit of CNG for the Connecticut Department of Public Utility Control. Areas of responsibility included transactions with and services exchanged with Southern Connecticut Gas, Energy East and other affiliates, human resources (staffing, compensation, labor relations and performance appraisal processes), customer service and call center operations, dispatch, field operations and appliance services, meter operations, distribution sales and marketing, supply chain management, fleet operations, facilities management, security and external relations. (2010)

- Constellation Energy / Electricite de France Joint Nuclear Venture – Reviewed and provided testimony concerning the potential impact of the proposed CE / EDF joint nuclear venture, CENG, on corporate and other centralized costs allocated to CE's regulated utility subsidiary, Baltimore Gas & Electric. (2009)

- Atlantic City Electric Affiliate Relationships and Management Audit – Participated as a Technical Manager in an affiliate relationships and management audit of Atlantic City Electric, a subsidiary of Pepco Holdings, Inc. (PHI) on behalf of the New Jersey Board of Public Utilities. Areas of responsibility included allocations of corporate and shared utility costs from PHI Service Company, transactions with affiliates including Atlantic Southern Properties and Millennium Account Services, compliance with New Jersey's Electric Discount and Energy Competition Act (EDECA), and the management of various functions, including information technology, fleet, stores and supply chain, security, facilities, real estate and records management. (2009)

- Exelon / PSEG Merger – Assisted the New Jersey Board of Public Utilities in review of the proposed merger of Exelon (Commonwealth Edison, Pennsylvania Energy) with PSEG (Public Service Electric & Gas). Responsible for the review of the impact of combining the two holding companies' service companies (the companies that provide managerial, technical and administrative services to associated companies) on the New Jersey genco and utility. (2005-2006)

- Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas Regulatory Audits – Project Manager for audits of the affiliate relationships and cost allocations of Elizabethtown Gas, New Jersey Natural Gas, and South Jersey Gas conducted on behalf of the New Jersey Board of Public Utilities (BPU). The audits examined whether each Company maintained a strict separation of risks, functions, and assets between their regulated utilities and unregulated affiliates to comply with BPU Standards. The audits also documented each Company's cost allocation methodologies and results for a two-year period. (2002-2003)

- Sempra Energy – Project Manager for a review of the costs of Sempra Energy's holding company. The review, conducted on behalf of the Utility Consumer Action Network (UCAN) was a part of the review of Sempra Energy's rate application with the California Public Utilities Commission (A.02-12-027 and A.02-12-028). (2003) Performed a similar review in the subsequent rate applications of subsidiaries, San Diego Gas & Electric Company and Southern California Gas Company (A.06-12-009 and A.06-12-010). (2007)

- Kansas Pipeline Company - Directed the cost of service component of the initial FERC "Section 7" cost of service and base rate filing of Kansas Pipeline, which had been exempt from FERC rate regulation prior to 1997. Submitted and defended testimony on behalf of Kansas Pipeline before the FERC covering the overall cost of service filing, the historical basis for the calculation of acquisition premium and company's test year operations and maintenance expenses (1998 – 2000).

- Pacific Gas and Electric 1999 General Rate Case - Reviewed projected test year administrative and general expense levels and allocation of costs between the utility and affiliates. Submitted and defended testimony on behalf of the California Public Utilities Commission (1998).

- Pacific Gas and Electric Audit of Inter-Company Relationships and Transactions - Managed an audit of PG&E's compliance with regulatory requirements and internal control over relationships and transactions between the utility and its unregulated affiliates on behalf of the California Public Utilities Commission. (1998).

- Southern California Gas Performance Based Ratemaking (PBR) Filing - Conducted a review of 1994 and 1995 base margin costs. Submitted testimony on behalf of the California Public Utilities Commission. Issue areas included operations and maintenance expenses, corporate allocations, employee and executive compensation, post-retirement benefits, and savings from restructuring and force reduction programs (1996).

- Missouri Gas Energy Rate Case - Submitted cost of service testimony on behalf of Mid-Kansas Partnership and Riverside Pipeline, L.P. in connection with Missouri Gas Energy's base rate filing. Issues included deferred gas safety costs, merger-related savings and weather normalization (1996).

- Western Resources / Kansas Power and Light Rate Case - Conducted a rate case audit and submitted and defended cost of service testimony on jurisdictional cost allocations, operations and maintenance expenses and pension expenses on behalf of the Kansas Corporation Commission (1992).

- Montana Dakota Utilities and Mountain Fuels - Conducted focused management audits of the gas supply operations of two western local distribution utilities for the Wyoming PSC. Assessed the management and organization of each company as it related to gas supply, the degree to which supply options were optimized, the potential impact of FERC Order 636, and the relationships between the LDCs and their pipeline and production affiliates (1992).

- Big Rivers Electric Cooperative - Reviewed fuel receiving and inventory policies and coal contract terms in connection with a focused management audit of fuel procurement for the Kentucky PSC. (1993).

- Illinois Power Company (Illinova) - Performed internal operational audits of nuclear and fossil fuel procurement, natural gas procurement and delivery, various corporate, power plant and service area operations, and nuclear plant construction contracts. (1980 to 1983).

Telecommunications

- Frontier (Citizens) Telecommunications Regulatory Audit - Directed a California statutory regulatory audit of Citizens' California PUC financial reporting and shareable earnings, including transactions between Citizens, its Connecticut-based parent company and its affiliates. (2004-2005).

- Pacific Bell Regulatory Audit – Directed a California statutory regulatory audit of Pacific Bell's California PUC financial reporting, including transactions between Pacific Bell, its parent company (SBC) and its affiliates and subsidiaries. (2001-2002).

- Roseville Telephone Regulatory Audit - Directed and conducted a regulatory audit of the company's compliance with affiliate and non-regulated activity transaction rules and reviewed the company's calculation of earnings shareable with customers under the California PUC's New Regulatory Framework rules. Submitted and defended testimony on the audit on behalf of the CPUC (1999- 2000) Performed a followup audit of 2001-2003 regulated earnings (2004).

- New York Telephone Loop Study - Directed a study of NYT's subscriber loop network. Coordinated the effort of a multi-disciplined team that included regulatory, network operations, engineering and data processing specialists. The major work products included an inventory of subscriber facilities, determination of facility utilization in different geographic regions, determination of the relative accuracy of the major databases containing network facility information, and verification of billing records with installed facilities (1991).

- AT&T Review of Affiliate Transactions - Conducted a review of the affiliate management and accounting relationships among the subsidiaries of AT&T. Documented significant transactions and allocations through the AT&T organization that affected AT&T Communications. Examined policies and procedures that affected the Communication subsidiary's decision to use internal sources of supply and the corporate entity's allocation of costs to subsidiaries (1990).

- Bay Area Teleport - Conducted a review of the impact of local exchange carrier price flexibility on competitive access in California (1988).

- GTE - Analyzed Indiana local exchange rates and developed a computer model to distribute the carrier's revenue requirement over a matrix of local services and rate groups (1989).

Water

- California American Water Company Regulatory Audit and Rate Case – Twice technical Manager for the regulatory audit of California American Water Company's general office activities and costs, including unregulated activities, cost allocations, and affiliate transactions. Submitted revenue requirements testimony covering CalAm's projected test years covering the O&M expenses of functions allocated from the national, regional and state levels to the district operations for which CalAm was seeking an increase in rates. (Two rate case cycles (2008-2010 GRC, work performed in 2008 and 2011-2013 GRC, work performed in 2010-2011).

Cable

- Late Payment Costs - Analyzed costs imposed on cable systems by late-paying customers and prepared studies to quantify the additional costs of handling past due accounts. (1995 through 2001).

- Cost of Service (Revenue Requirements) – The rates of most US cable systems were "re-regulated" for a time during the 1990s. Cable systems could choose two forms of regulation, one price-based (limiting rates to existing prices plus inflation) and one cost of service-based, based on traditional historical test year ratemaking principles. Analyzed cable system costs and prepared cost-of-service rate studies for cable companies, including two of the nation's largest cable systems (TCI Chicago and DCLP). Developed cost-of-service methodologies to properly account for affiliate relationships and corporate and divisional cost allocations to the cable systems. Analyzed incremental cost of service under FCC Form 1235 rules for a group of systems calculating the revenue requirement impact of upgrading system capacity upgrades (1994-1998).

- Franchise Issues - Developed financial models to determine the financial and potential rate impact of franchise requirements for system upgrades and rebuilds. In 1997, coordinated the financial aspects of a franchise proposal submitted by the Company by a California local franchise authority (1995 and 1997).

- Programming Costs - Developed a database application to calculate programming cost increases on a cable-system basis to comply with FCC requirements (1994).

Work History

1996 - Present: **Overland Consulting**
Senior Manager. Plan, supervise and perform telecommunications and energy industry consulting projects, including audits, on behalf of public utility commissions and other government agencies.

1993 - 1996: **KPMG Peat Marwick LLP**
Senior Manager. Information, Communications and Entertainment Line of Business. Developed and managed cable TV, and telecommunications and industry consulting engagements.

1987 - 1993: **LMSL, Inc., Overland Consulting**
Manager. Conducted audits of energy and telecommunications companies; sponsored testimony in regulatory proceedings. (LMSL is a predecessor firm of Overland Consulting).

1984 - 1986: **Public Utility Commission of Texas**
Senior Staff Accountant. Reviewed electric, telephone and water utility rate and regulatory filings and sponsored cost of service testimony in rate hearings.

1980 - 1983: **Illinois Power Company**
Senior Internal Auditor. Planned, directed and performed operational and financial audits of the company's headquarters departments, power stations and service offices. Prepared the annual department operating plan and drafted the report to the Audit Committee of the Board of Directors for approval by the Director of Internal Auditing. Coordinated work with external auditors.

Certifications

Illinois CPA Certificate No. 31763, University of Illinois, February 18, 1982.
Kansas CPA Certificate No. 9821
Kansas Practice Permit No. 3349
Member, American Institute of CPAs

CHADWICK B. EPPS, CPA
Consultant

General

Mr. Epps holds a Master's of Accountancy degree from Truman State University. He has over three years of public accounting experience with a "Big 4" accounting firm and another year of industry experience with a natural gas and NGL midstream operation.

Education and Professional Certification

- B. S. in Accounting, Spanish Minor, Truman State University, May 2003, graduated Summa Cum Laude;
  Master's of Accountancy, Truman State University, August 2004
- Passed Uniform CPA Examination October 2004,
  Missouri CPA certificate #2005010551

Representative Experience

Electric and Gas

- FirstEnergy/Allegheny Energy Merger – Assisted as a Consultant with determining the Maryland allocation of merger savings and cost-to-achieve analyses relating to the FirstEnergy/Allegheny merger for the Maryland Public Service Commission (2010)

- Public Service Enterprise Management Audit – Participated as a Consultant in a management audit and audit of affiliate transactions of PSEG for the New Jersey Board of Public Utilities. Areas of responsibility included finance, executive management and corporate governance, external relations, strategic planning, risk management, energy efficiency, operations and appliance services. (2009-2010)

Work History

2009-Present:	***Overland Consulting*** – Consultant. Assists in conducting regulatory audits and valuation studies of electric, gas, railroad and telecommunications companies.
2008-2009	**Inergy LP** – Accounting Manager. Managed the accounting function for three natural gas and NGL storage facilities
2004-2008:	***KPMG –*** Senior Associate. Ran various multi-person audit teams in various industries for public and private companies.