California State Auditor

April 2015

Apple Valley Area Water Rates

Differences in Costs Affect Water Utilities' Rates, and One Utility May Have Spent Millions of Ratepayer Funds Inappropriately

Report 2014-132

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California State Auditor

Elaine M. Howle State Auditor
Doug Cordiner Chief Deputy

April 30, 2015 2014-132

The Governor of California
President pro Tempore of the Senate
Speaker of the Assembly
State Capitol
Sacramento, California 95814

Dear Governor and Legislative Leaders:

As requested by the Joint Legislative Audit Committee, the California State Auditor presents this audit report concerning water rates in the Apple Valley area of Southern California. The audit compared the rates and factors affecting the rates of four water utilities: Apple Valley Ranchos Water Company (Apple Valley Ranchos), Golden State Water Company (Golden State), Hesperia Water District (Hesperia), and the Victorville Water District (Victorville). Two of the utilities—Apple Valley Ranchos and Golden State—are privately owned water utilities (private utilities) and two—Hesperia and Victorville—are publicly owned water utilities (public utilities) that their local governments run.

This report concludes that a variety of cost factors and differences in costs among the utilities contributes to the variations in the four utilities' water rates but, overall, the two private water utilities had higher costs and therefore higher rates. A key factor that contributes to the differences in costs among the water utilities is the inherent difference between private and public water utilities. For example, the two private water utilities incur costs that the public utilities do not, such as income and property taxes. Public utilities, on the other hand, receive revenues from additional sources, such as property taxes. Because of their different cost structures, water rates for the two private utilities have increased in recent years. While rates for Hesperia and Victorville have remained relatively stable, rates for Apple Valley Ranchos and Golden State increased between January 2011 and June 2014 by 16 percent and 18 percent, respectively.

Although Victorville kept its water rates low, in part, by deferring maintenance, it implemented an increase in August 2014 and is likely to increase its rates in 2015. However, it might not have needed to raise rates if it had not undertaken some inappropriate transactions. Specifically, beginning in 2009, Victorville loaned $21.9 million in water customer revenues to an agency of the city of Victorville in two loans. During the same time, Victorville borrowed $20 million from the Southern California Logistics Airport Authority, paying a higher interest rate than it received on the funds it loaned. Although all three loans were repaid in March 2013, Victorville paid $4.6 million in unnecessary interest expense. Victorville used the $20 million it borrowed plus another $11 million in water district revenues to construct an industrial wastewater treatment plant (wastewater plant), which was completed in December 2010. The wastewater plant has served primarily one commercial customer—a beverage manufacturing plant. As of June 2014 Victorville had received only $4.5 million to repay its costs of building the wastewater plant. Because it has received so little repayment of its construction costs in the years since the wastewater plant was built, we do not believe that Victorville's investment in the wastewater plant was a prudent use of water district funds.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA
State Auditor

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Summary

Results in Brief

Apple Valley is a rural community of 71,000 in the high desert north of San Bernardino and adjacent to the cities of Victorville and Hesperia. The water supplies of these three communities come from groundwater, which accumulates naturally in local aquifers beneath the land's surface and is obtained from wells that local water utilities own and operate. Most of Apple Valley's residents receive their water from two privately owned water utilities (private utilities): Apple Valley Ranchos Water Company (Apple Valley Ranchos) and Golden State Water Company (Golden State). Those residing in the adjoining cities of Victorville and Hesperia receive their water from publicly owned water utilities (public utilities) that those two local governments run.

A variety of cost factors and differences in costs among the utilities contributes to the variations in the four utilities' water rates. We compared the utilities' average annual costs per connection, or customer, to make comparisons between the differently sized water utilities. Overall, the two private water utilities had higher costs and therefore higher rates. Specifically, for the three-year period we reviewed, Apple Valley Ranchos and Golden State had average annual costs of $1,108 and $1,035 per connection, respectively. In comparison, the two public water utilities had lower average annual costs per connection, with the Hesperia Water District (Hesperia) at $702 per connection and the Victorville Water District (Victorville) at $829 per connection. Golden State had the highest costs per connection in several categories, such as personnel and operations costs, in part because Golden State's service area has a smaller number of connections to share the costs. Although the two public utilities had higher costs in other categories such as water purchases, their overall costs per connection were lower than those of the private utilities.

A key factor that contributes to the differences in costs among the water utilities is the inherent difference between private and public water utilities. For example, the two private water utilities, Apple Valley Ranchos and Golden State, incur costs that the public utilities do not, including income and property taxes. In 2011 through 2013, Apple Valley Ranchos' annual average costs for income and property taxes were $154 per connection. Although public utilities may receive revenues such as property taxes and connection fees paid by its customers, these amounts are not incorporated directly into customers' rates and do not appear on their bills. In addition, state law allows private utilities the opportunity to receive a reasonable return on their investment in the water utility, if the California Public Utilities Commission (commission) so approves. This return

Audit Highlights . . .

Our review of water rates charged by four water suppliers in the Apple Valley area—Apple Valley Ranchos Water Company (Apple Valley Ranchos), Golden State Water Company (Golden State), Hesperia Water District (Hesperia), and the Victorville Water District (Victorville) highlighted the following:

- *Because of their different cost structures, water rates for the privately owned water utilities (private utilities)—Apple Valley Ranchos and Golden State—have increased in recent years, while rates for the publicly owned water utilities (public utilities)—Hesperia and Victorville—have remained stable.*
  - *The private utilities incur costs such as income and property taxes.*
  - *The public utilities receive revenues from additional sources, such as property taxes and connection fees.*
- *The four water utilities have taken cost-saving measures, but two have not determined the cost savings resulting from any of their efforts.*
- *Victorville undertook questionable decisions:*
  - *It loaned $21.9 million in water district money to the city of Victorville. It also borrowed $20 million, paying a higher interest rate than it received on the funds it loaned, incurring $4.6 million in unnecessary interest expense.*
  - *It used some water ratepayer revenues to construct an industrial wastewater treatment plant, which may be unlawful, and has received little repayment of its costs.*

on investment is a component of the costs included in the water rates that customers pay. For example, in 2013 Apple Valley Ranchos received a return on its investment of $3.6 million, or $198 per connection.

Customers' bills from Apple Valley Ranchos and Golden State also include other charges not found on the bills of public utility customers. State law authorizes—and the commission encourages—private utilities to offer rate assistance programs. Both Apple Valley Ranchos and Golden State offer a low-income rate assistance program to certain demographics of their water customers. For example, Golden State's low-income customers can receive a monthly credit of $8, while customers who do not benefit from the program pay 92 cents per month to fund that program. The public utilities we reviewed do not currently offer rate assistance. In fact, state law prohibits public utilities from using revenues from water rates to offer rate assistance programs like those the private utilities offer. However, the public utilities are not prohibited from using revenues from other sources to offer these programs.

Public utilities also receive revenues from additional sources, such as taxes based on the assessed value of properties in their service area. These additional revenue sources help public utilities offset their costs and therefore can contribute to lower monthly water rates for their customers. For example, Victorville received $502,000 in property taxes in fiscal year 2012–13, offsetting 2 percent of its costs. Victorville also received an average of $1.4 million during fiscal years 2010–11 through 2012–13 in connection fees from new development, equating to 5 percent of its costs.

The four water utilities have taken measures to reduce their costs and to keep rates reasonable. Because higher costs can contribute to increases in water rates, we expected that the water utilities would be able to demonstrate the savings achieved by their efforts to reduce costs. Although each water utility we reviewed indicated that it had taken numerous steps to reduce costs to consumers, such as pumping at off-peak times, two of them had not determined the cost savings resulting from any of the measures. However, in response to our discussions, one of the two utilities subsequently determined amounts for some of its cost-saving efforts. When the water utilities do not quantify their efforts, they are missing an opportunity to demonstrate to customers that they are taking steps to keep costs down, especially in those instances where they are seeking rate increases.

Because of their different cost structures, water rates for the two private utilities have increased in recent years, while rates for the public utilities have remained relatively stable. Specifically, rates for a unit of water for Apple Valley Ranchos and Golden State have increased between January 2011 and June 2014 by 16 percent and

18 percent, respectively, while rates for Hesperia and Victorville remained mostly unchanged. The public utilities' rates have stayed low not only because of lower costs. For example, the City of Hesperia has invested in water rights that it leases to the Hesperia Water District at costs lower than it could purchase or lease from others, and it has also reduced its administrative charges to the water district.

Although Victorville has kept its water rates low in part by deferring routine maintenance, it implemented a rate increase, initially approved for 2010 but deferred until 2014, and it is likely to increase its rates beginning in 2015. However, it might not have needed to raise rates if it had not undertaken some inappropriate transactions. Specifically, beginning in 2009, Victorville loaned $21.9 million in water customer revenues to an agency within the city of Victorville (city) in two loans, which resulted in harm to the customers, or ratepayers. Although it is not unlawful for a water district to loan ratepayer money or otherwise invest it in a prudent manner, it cannot do so if loaning that money impairs its ability to perform the functions for which the ratepayer revenue was collected. During the time that the two loans to the city were outstanding, Victorville borrowed $20 million from the Southern California Logistics Airport Authority (Airport Authority) at a higher interest rate. In March 2013 the city repaid the $21.9 million in loans it had received from Victorville in 2009 plus interest of nearly $400,000; in turn, Victorville paid off its $20 million loan from the Airport Authority plus $5 million in interest. As a result, Victorville incurred more than $4.6 million in unnecessary interest expense. During the same time that the loans were outstanding, Victorville postponed routine maintenance and repairs and scheduled asset replacement. In April 2014 the deferred maintenance resulted in an inspection letter by the California Department of Public Health for insufficient maintenance and inspections. Also in 2014, Victorville increased its water rates, in part because it stated that it needed to address the deferred maintenance; and it is likely to have an additional increase in rates that it might not otherwise have needed.

Victorville used the $20 million from the Airport Authority, along with $11 million in water district revenues, to construct an industrial wastewater treatment plant (wastewater plant), which was completed in December 2010 for a total of approximately $31 million. The wastewater plant has served primarily one commercial customer—a beverage manufacturing plant. An agreement between the city and the beverage manufacturer requires an annual minimum payment of $1.95 million from the beverage manufacturer for use of the wastewater plant, but none of the amount is contractually obligated to Victorville so it can recoup its costs for building the plant. However, the city is providing a portion of the funds it receives from the beverage manufacturer to

Victorville. Specifically, as of June 2014, the city had allocated only $4.5 million to Victorville to repay its costs of building the wastewater plant, including $2.2 million from the beverage manufacturer. In addition, although Victorville contracted in 2010 with a power plant to sell its reclaimed water from the wastewater plant, it has not yet received any revenue from the sale of reclaimed water. Nonetheless, because it has received so little repayment to recover its costs in the years since the wastewater plant was built, we do not believe that Victorville's investment in the wastewater plant was a prudent use of water district funds. Further, the use of the $11 million in ratepayer revenues, which includes water delivery fees and connection fees, to construct the wastewater plant may have violated provisions of state law limiting the use of water delivery fee revenues to the purposes for which they were collected.

Recommendations

To assist low-income water customers, the two public utilities—Hesperia and Victorville—should work with their respective governing bodies to consider the feasibility of using revenues from sources other than water rates to implement rate assistance programs.

To show water customers that they are working to keep rates reasonable, water utilities should document any cost-saving efforts and quantify, to the extent possible, any specific cost savings achieved from their respective efforts.

To ensure that it does not use revenues from ratepayers for inappropriate purposes, by October 2015 Victorville should establish a policy to prohibit transfers or loans of water utility revenue for nonwater district purposes.

Agency Comments

Apple Valley Ranchos agreed with our recommendation that it quantify its cost-saving efforts. Golden State believes that the recommendation to document and quantify future cost-saving efforts does not acknowledge the commission's rate-making process, in which costs and operations are reviewed. Hesperia disagreed with our recommendation that it implement a low-income assistance program, stating its rates are already lower than another utility in the area. It also disagreed with our recommendation that it quantify its cost-saving efforts, stating that it focused its limited resources on efficiently providing water. Victorville did not specifically address the recommendations we directed to it and instead expressed dissatisfaction with the audit process.

Introduction

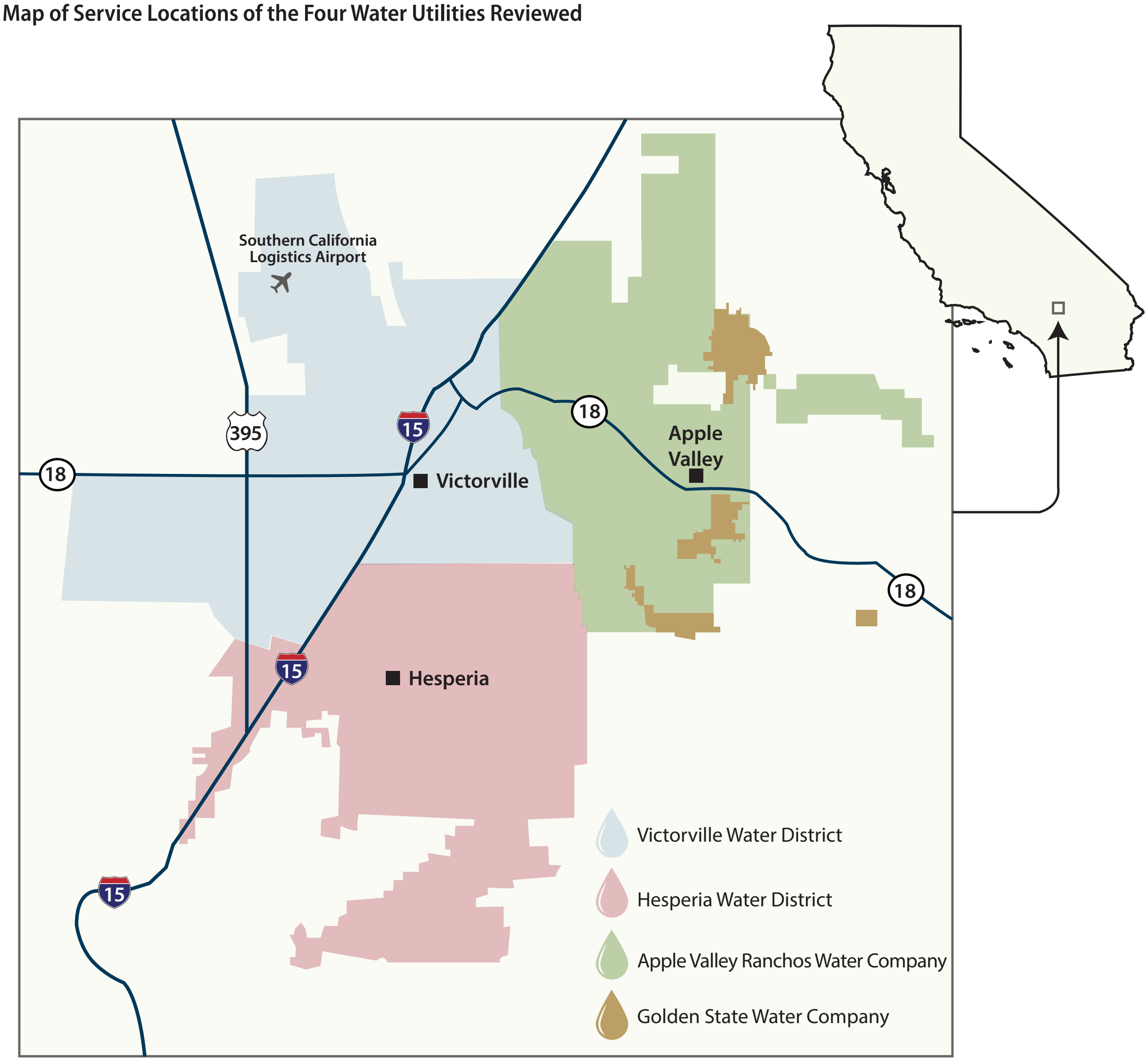
Background

Apple Valley is a rural community of 71,000 in the high desert north of San Bernardino and adjacent to the cities of Victorville and Hesperia. The water supplies of these three communities come from groundwater, which accumulates naturally in local aquifers beneath the land's surface and is obtained from wells that local water utilities own and operate. More than 80 percent of Apple Valley's residents receive their water from Apple Valley Ranchos Water Company (Apple Valley Ranchos), a privately owned utility company (private utility). Golden State Water Company (Golden State), also a private utility, serves most of the rest of Apple Valley's residents. Residents of the adjoining cities of Victorville and Hesperia receive their water from publicly owned water utilities that these two local governments run (public utilities). Water customers within an existing service area cannot select their water utility; their home or business location determines which of these four utilities, or another of the smaller utilities in the area, provides their water service. Figure 1 on the following page shows the service area of the four water districts we reviewed.

Table 1 on page 7 provides an overview of the characteristics of the four water utilities we reviewed. As previously identified, two are public utilities, and two are private utilities and thus subject to state regulation. Each of the four water utilities primarily serves residential customers.

Apple Valley Ranchos and Golden State are subsidiaries of larger companies. Apple Valley Ranchos' parent company, Park Water Company, operates several water utilities in California and Montana. Its corporate headquarters in Downey, California, provides administrative support such as accounting, legal assistance, and regulatory assistance to its operations. Similarly, Golden State is a subsidiary of American States Water, headquartered in San Dimas, California. Golden State combines its operations in California into three regions and for two of those regions it sets a standard rate for all customers in those regions. Golden State's Apple Valley customers represent 3 percent of Golden State's Region III, which also includes service in areas such as Orange County and Barstow. However, the information in this report applies only to its Apple Valley area customers. The Victorville Water District (Victorville) was formed in 2007 through the merger of two water districts: the Baldy Mesa Water District and the Victor Valley Water District, as well as water assets owned by the city of Victorville.

Figure 1
Map of Service Locations of the Four Water Utilities Reviewed



Source: California State Auditor's analysis of maps provided by the four water utilities.

Table 1
Characteristics of Water Utilities in and Around Apple Valley

	APPLE VALLEY RANCHOS WATER COMPANY	GOLDEN STATE WATER COMPANY (GOLDEN STATE)*	HESPERIA WATER DISTRICT (HESPERIA)	VICTORVILLE WATER DISTRICT (VICTORVILLE)
Type of Ownership	Privately owned	Privately owned	Publicly owned	Publicly owned
Population served	61,700	8,700	90,200	115,500
Service connections	19,200	2,900	26,200	35,100
Number of wells	24	11	18	36
Sources of Water				
Groundwater	100%	100%	100%	100%
Other	-	-	-	-
Types of Services Offered				
Residential	91%	95%	96%	95%
Nonresidential	9%	5%	4%	5%
Service area	50 square miles	6.4 square miles	74 square miles	85 square miles
	Most of Apple Valley and some adjoining areas	Four small areas in and near Apple Valley	City of Hesperia and small adjoining areas	City of Victorville and some adjoining areas

Sources: California State Auditor's review of 2010 urban water management plans and other documents and information obtained from the water utilities.

* Golden State sets rates in regions, with a standard rate for each customer in the region where Apple Valley is located. Its Apple Valley customers represent 3 percent of the nearly 99,000 customers in its Region III, which serves customers from Orange County to Barstow.

Fundamental Differences Between Public and Private Water Utilities

In California, water utilities are either operated by a public utility or a private utility that the California Public Utilities Commission (commission) regulates. While both types offer the same service, as Table 2 on the following page illustrates, several fundamental differences exist between public and private utilities, including their governance, the process to increase water rates, and their access to different revenue sources.

The governance of water utilities varies depending on the type of utility. Public utilities are governed by a publicly elected board of directors. Under state law, the board of directors has the authority to collect the funds necessary to cover the utility's operations and maintenance costs. In the cities of Victorville and Hesperia, the city council members serve concurrently as members of the board of directors of the respective water districts. On the other hand, private utilities are directly owned by investors. The commission regulates all privately owned utilities that provide service to the public, including water utilities. The commission divides utilities into different classes based on their size and provides different rules for each class. The two private utilities we reviewed are Class A utilities and our report discusses commission requirements related to only that type of utility.

Table 2
Summary of Fundamental Differences Between Private and Public Utilities

	PRIVATE UTILITIES	PUBLIC UTILITIES
Governance	Regulated by the California Public Utilities Commission	Report to a publicly elected governing body
Process to increase rates	File an application for a general rate case every three years	Comply with Proposition 218 requirements
Impact of taxes	Pay property and income taxes; receive no tax revenues	Do not pay property or income taxes; can receive property tax revenues
Have balancing accounts	✓	✗
Are allowed to make a profit	✓	✗*
Are allowed to use revenue earned from water service to provide low-income ratepayer assistance programs	✓	✗†

Sources: The California Constitution, the California Public Utilities Code, and the California Government Code.
✓ = Yes
✗ = No
* Public utilities' revenues may not exceed the funds required to provide the services to the ratepayers, although that may include a reasonable surplus.
† Public utilities cannot use water revenue collected from ratepayers to offer a subsidy to another ratepayer. However, a public utility can offer a low-income ratepayer assistance program through other funding sources such as the city's general fund.

In addition to differences in governance, public and private utilities must follow different processes to increase their rates. Public utilities must comply with Proposition 218 when seeking rate increases.[1] Proposition 218 protects customers, known as *parcel owners*, from unreasonable rate increases by limiting the authority of local government agencies to impose property‑related assessments, fees, and charges, including increases in water rates. Specifically, Proposition 218 requires that public utilities provide parcel owners with written notice of any proposed rate increase in advance of a public hearing at which the board of directors decides whether to approve the rate increase. This notice must explain the amount of and purpose for any rate increase and the basis upon which the increase is calculated. Proposition 218 also prohibits public utilities from increasing rates if a majority of parcel owners submit written protests against the proposed rate increase.

On the other hand, private utilities must justify their proposed rates by presenting information on their costs to the commission during general rate case proceedings, which take place every three years. During the rate case proceeding, the commission determines the fair and reasonable amount of revenue that is necessary for the utility to cover its costs and generate a reasonable return on its investment. The rate case proceeding also provides an opportunity

1 Proposition 218, which voters approved in the November 5, 1996, statewide general election, amended the California Constitution to add the requirements described in this paragraph.

for the public to provide input into the rates the utility charges. The commission requires private utilities to track certain revenues and expenses approved by the commission and to track actual revenue collected using balancing accounts. If the utility over-collects, it must issue a surcredit to ratepayers. If it under-collects, it can add a surcharge to customers' bills. Balancing accounts help ensure that the utility receives the revenue it needs to operate but that customers are not overcharged.

Another major difference between public and private utilities is the tax collected and paid. Public utilities may directly receive tax revenues, such as a portion of property tax revenues. Additionally, unlike public utilities, which are not required to pay property or income taxes, private utilities pay federal and state taxes on their income as well as local property taxes.

A further significant difference between public and private utilities involves the responsibility to pay for water connections in new development. State law allows public utilities to charge connection fees to the developers of new homes and buildings to pay for the costs of the new pipes, meters, and additional water resources. The cost of new water infrastructure is therefore incorporated into the costs of the new homes or buildings rather than being added to water rates. Conversely, the commission does not generally allow private utilities to charge customers connection fees. The commission does allow private utilities to pay developers for the cost of new infrastructure that the developers build for a period of up to 40 years—these costs are passed on to customers through their water rates.

The ability to help low-income ratepayers is another difference between private and public utilities. State law authorizes—and the commission encourages—private water utilities to establish a low-income ratepayer program. Private utilities are allowed to fund such programs by including a charge on the bill of those customers not receiving assistance. Under Proposition 218, however, a publicly run water district may not use revenue derived from water fees to offer reduced rates to low-income ratepayers. Public utilities can offer such programs but must fund them through other revenue sources, such as the city's general fund.

Water Sources and Costs

All four water utilities we reviewed obtain water by pumping groundwater from natural aquifers within the Mojave Groundwater Basin (Mojave basin). The cost of pumped groundwater includes the electricity to power the pumps, the chemicals to treat the water, and the maintenance of the pumps and infrastructure. The four water utilities we reviewed supply their customers only with pumped groundwater.

Water utilities that pump more than their allowance of groundwater incur additional costs. The Mojave basin, in which Apple Valley and the cities of Hesperia and Victorville lie, is an adjudicated basin. Adjudication is a legal process that determines the right to water (water rights) in the basin.[2] In the Mojave basin, each party to the adjudication is allocated a certain amount of the natural water supply that it can pump each year before having to purchase or lease either water or water rights from another entity. A court-appointed watermaster is responsible for verifying the amount of water each water district pumps and for monitoring compliance with established water rights. The purchase or lease of water rights from another rights holder within the basin enables a utility to continue to pump water from its wells after it has pumped its annual allowance.

All four water utilities that we reviewed pumped more groundwater than their allowance during 2011 through 2013, and therefore they had to either use carryover credits, which is their unused allowance from the prior year; purchase or lease water rights from others; or purchase water from the watermaster to make up for pumping more than their allotments.

Factors That Contribute to Water Rates

Common factors that contribute to differences in water rates include the characteristics of the service area and its source of water. For instance, as shown in Table 3, the nature of a water utility's service area can have an impact on its rates. Service areas with a dense population of service connections allow water utilities to disperse their fixed costs over a larger number of water customers, resulting in lower overall monthly bills whereas service areas with fewer service connections can have higher monthly bills because the water utilities must spread their fixed costs across fewer customers.

2 Water rights are a type of property right gained either through ownership of property that contains water or through historical productive use of a water source. For example, an individual could gain water rights by owning property containing a river or overlaying groundwater. An individual with an older claim to water will typically trump the rights of an individual with a newer claim. Water rights allow the owner to use a certain amount of water. Holders of water rights may sell or lease their right to another.

Table 3
Significant Factors That Contribute to Water Rates

FACTOR	RATES WILL TEND TO BE: HIGHER IF	LOWER IF
Sources of water	Imported	Groundwater
Energy costs	Higher elevation	Lower elevation
Service area characteristics	• Low-density population • Remote • Fewer service connections	• High-density population • Accessible • More service connections
Maintenance needs of infrastructure	More maintenance	Less maintenance
Water quality needs	More treatment	Less treatment
Pays taxes and fees	Yes	Few or none
Receives property tax revenues	No	Yes

Sources: California State Auditor's review of a 2010 study by the California Water Association titled *An Analysis of the Differences in Water Rates of Investor-Owned Water Utilities and Government-Owned Water Utilities*.

Water Bills

The water bill a customer receives is made up of many components. It typically includes the rate the customer pays for each unit of water he or she uses. The text box describes water units and common uses of water. Most of the utilities we reviewed use tiered rates, which increase the water rate with increased usage. The water bills for the four utilities we reviewed also include a flat service charge. Water bills also may include other charges and credits. A surcharge is an additional amount billed to customers and covers things such as under-collected revenue from estimated amounts needed to cover the water utility's costs. A surcredit is an amount that is paid back to the ratepayer when the utility has over-collected revenue to cover its costs. Table 4 on the following page displays an example of the common charges that make up a bill and an example of how the items add up to the water bill's total.

Water Usage and Units

- The unit, a term commonly shown in water bills, is "hundred cubic feet." One hundred cubic feet is the equivalent of 748 gallons of water.
- The residential average monthly water usage in the Apple Valley region for 2011 through June 2014 was 14.9 units, or 14.9 hundred cubic feet of water per month, or approximately 11,140 gallons per month.
- Some common uses of water include a shower, which uses 17 gallons on average; a toilet, which uses 3.6 gallons per flush; and a washing machine, which may use between 14 and 45 gallons of water per load on average depending on its efficiency.
- Water usage of the water districts is tracked in acre-feet. One acre-foot is 435.6 hundred cubic feet or 325,851 gallons.

Sources: Water bills from each of the water utilities, annual reports by the Mojave Groundwater Basin watermaster, and estimates of water usage from the Alliance for Water Efficiency.

Table 4
Example of the Components of a Water Bill

WATER USAGE			EXAMPLE BILL AT 15 UNITS (HUNDRED CUBIC FEET)
TIER	USAGE (IN UNITS)	RATE	TOTALS
1	0–10	2.50	$25 (10 x 2.50)
2	11–20	3.00	15 (5 x 3)
3	Over 20	3.50	0

Service Charges, Surcharges, and Surcredits		
Monthly service charge	$15	$15
Surcharges (per unit)		
Surcharge 1	0.50	7.50 (15 x 0.50)
Surcharge 2	0.75	11.25 (15 x 0.75)
Surcredits (per unit)		
Surcredit 1	-0.25	-3.75 (15 x -0.25)
	Total	**$70**

Source: Example developed by the California State Auditor based on the water utilities' bills and rate schedules.

Recent Legislation

In 2014 the Legislature passed and the governor approved Assembly Bill 1739 (Chapter 347, Statutes of 2014), Senate Bill 1168 (Chapter 346, Statutes of 2014), and Senate Bill 1319 (Chapter 348, Statutes of 2014) with the intent to regulate groundwater across the State. These newly enacted statutes require each water basin to prepare a groundwater sustainability plan classifying each basin as high, medium, low, or very low priority and to establish reporting requirements for groundwater pumping. The new statutes also authorize the California Water Resources Control Board to designate water basins as probationary if they do not meet certain requirements and to impose a plan to address those issues. In total, the statutes require the management of groundwater rights throughout the State. The earliest that the statutes require a groundwater sustainability plan to go into effect is 2020. Because groundwater rights in and around Apple Valley have already been adjudicated, the impact of the recent statewide legislation in this region may be low.

In November 2014 California voters approved $7.5 billion in bonds to fund water quality, water supply, and infrastructure projects throughout the State. Examples of future projects could be additional reservoirs, water recycling, and stormwater capture. When we asked the four utilities we visited about the impact of the bonds, Hesperia and Apple Valley Ranchos indicated that they were optimistic that they would be eligible for loans or grants for future projects from these bond funds.

Scope and Methodology

The Joint Legislative Audit Committee directed the California State Auditor to perform an audit of water rates charged by four water suppliers serving customers in and around Apple Valley—Apple Valley Ranchos, Golden State, the city of Hesperia, and the city of Victorville—as they relate to the process to establish water rates, the reasons for any recent rate increases, significant factors that contribute to rates, and causes for differences in rates. Table 5 on the following page lists the objectives and the methods we used to address them.

In performing this audit, we obtained electronic data files extracted from the utilities' information systems. The U.S. Government Accountability Office, whose standards we are statutorily required to follow, requires us to assess the sufficiency and appropriateness of computer-processed information that we use to support our findings, conclusions, or recommendations. We did not perform accuracy and completeness testing on these data because this audit is a one-time review, and testing the number and variety of data systems used in this audit would be cost-prohibitive. However, to gain some assurance of the reliability of the data, we compared computer-processed information we obtained from three of the four entities to audited financial statements and other documents that the private utilities submitted to the commission where possible and found that the data were consistent with reported financial information. Because its Apple Valley customers represent only 3 percent of one of Golden State's regional systems, it does not report financial information for its Apple Valley operations separately. We did not review the process which Golden State used to extract Apple Valley-specific data from its consolidated financial information and verify the consolidated financial information to its financial statements because the audit is a one-time review. As a result, we assessed the data from all the entities to be of undetermined reliability for the purpose of calculating the average residential monthly water bill and the average annual cost per connection by category, district, and time period. Although this determination may affect the precision of the numbers we present, we found sufficient evidence in total to support our findings, conclusions, and recommendations.

Table 5
Audit Objectives and the Methods Used to Address Them

	AUDIT OBJECTIVE	METHOD
1	Review and evaluate the laws, rules, and regulations significant to the audit objectives.	Reviewed relevant laws, regulations, and other background materials applicable to the four water utilities we reviewed.
2	For a time period to be determined by the California State Auditor, and to the extent possible, evaluate the process each water supplier used to establish its water rates and the reasons for any recent rate increases.	• For the four water utilities reviewed, we identified, documented, and summarized the water rates charged and the rate structures in effect during 2011 through June 2014. • Identified and documented changes in water rates over this period to determine whether the utilities followed state law and regulations for the changes in rates.
3	Identify and analyze the significant factors that contributed to each water supplier's rates and, to the extent possible, assess the causes of major differences between the suppliers' rates.	• Reviewed accounting records of the water utilities to identify significant factors contributing to water rates. • Interviewed key staff to understand water rates. • Compared the factors that contribute to rates at the four water utilities we reviewed. • Because its Apple Valley customers represent only 3 percent of one of Golden State Water Company's (Golden State) regional systems, Golden State does not report financial information for its Apple Valley operations separately. Therefore, we worked with Golden State to estimate amounts applicable to Apple Valley. • Because some water utilities have different rates for different classes of water customers, we focused our review on the water utilities' largest group of customers—the single-family residential customer.
4	Review and assess any other issues that are significant to water rates in Apple Valley.	Interviewed relevant staff and reviewed related documents to determine the nature of certain transactions between the Victorville Water District and the city of Victorville to determine the appropriateness of transactions involving water district revenues.

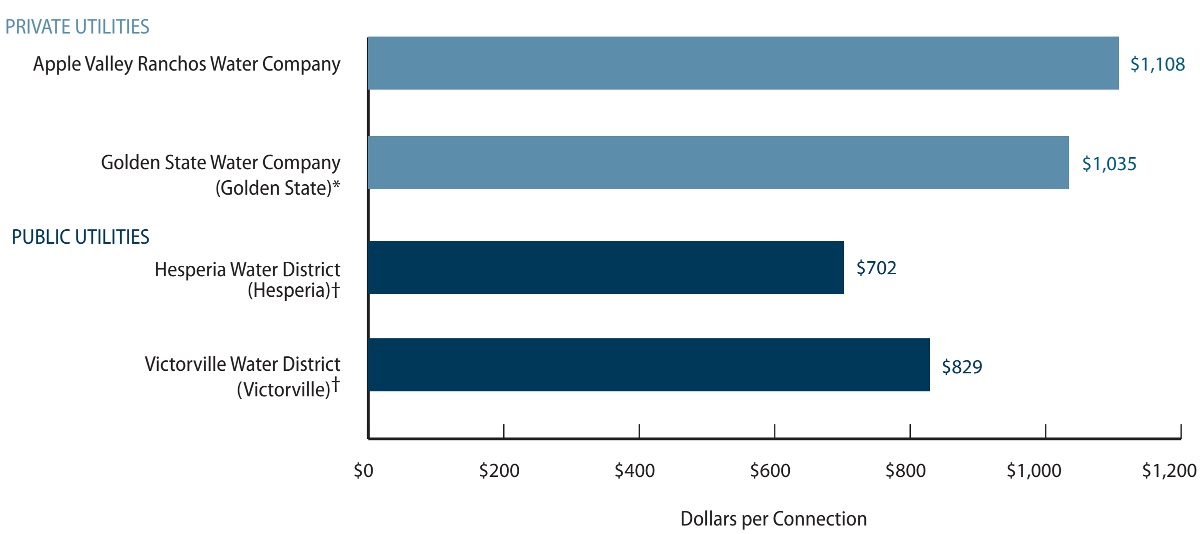
Sources: California State Auditor's analysis of Joint Legislative Audit Committee audit request number 2014-132, and information and documentation identified in the table column titled *Method*.

Audit Results

Water Utilities Charge Different Water Rates Based on the Different Costs They Each Incur

Numerous cost factors and differences in the amount of costs contribute to the variations in the water rates of four water utilities in the Apple Valley area. Although the four water utilities we reviewed—Apple Valley Ranchos Water Company (Apple Valley Ranchos), Golden State Water Company (Golden State), Hesperia Water District (Hesperia), and Victorville Water District (Victorville)—have similar types of expenditures, the costs they incurred varied. Since each water utility serves a different number of customers, in Figure 2 we compare the costs between them using the total average annual cost on a per service connection (connection) basis. As Figure 2 illustrates, the total average annual cost per connection is higher for the two privately owned water utilities (private utilities)—Apple Valley Ranchos and Golden State—than for the publicly owned water utilities (public utilities).

Figure 2
Water Utilities' Annual Average Cost on a Per Connection Basis
2011 Through 2013



Sources: California State Auditor's analysis of each utility's relevant cost factors as reported in audited financial statements, annual regulatory reports, or other financial documents.

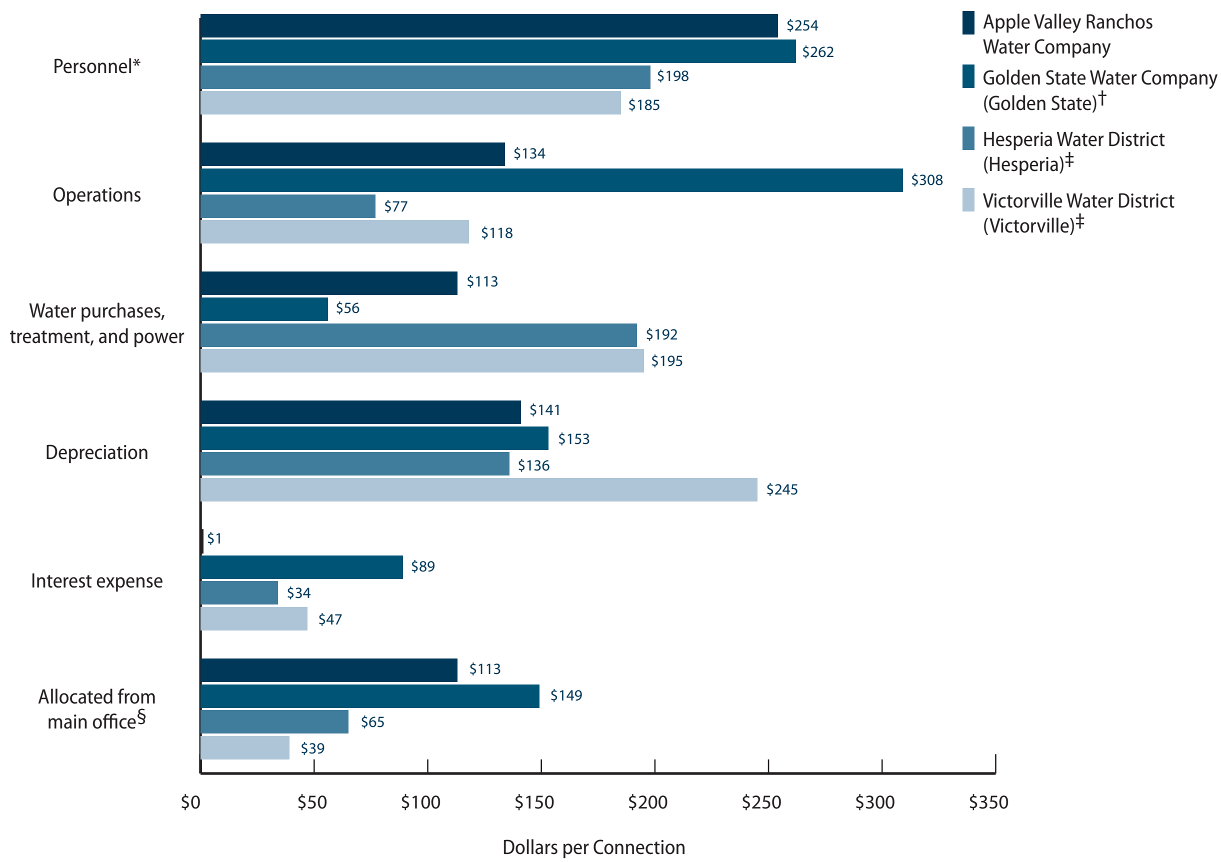
Note: The amounts above represent all costs and other factors that make up water rates, such as personnel costs, return on investment, and depreciation. See figures 3 and 6 and Table A for a more detailed breakdown of these amounts.

* Because its Apple Valley customers represent only 3 percent of one of Golden State's regional systems, Golden State does not report financial information for its Apple Valley operations separately. Therefore, we worked with Golden State to estimate amounts applicable to Apple Valley.

† Hesperia and Victorville operate on a fiscal year that begins July 1. The fiscal years presented above are 2010–11 through 2012–13.

Several cost categories varied widely among the different utilities. Figure 3 compares the categories that made up the average annual cost per connection during 2011 through 2013 for each of the four water utilities. Table A beginning on page 42 of the Appendix displays the cost breakdowns for each of the three years that are combined in Figure 3.

Figure 3
Water Utilities' Annual Average Cost Per Connection by Category
2011 Through 2013



Sources: California State Auditor's analysis of each utility's relevant cost factors as reported in audited financial statements, annual regulatory reports, or other financial records.

* Personnel costs include salaries and benefits, including postemployment benefits and payroll taxes.

† Because its Apple Valley customers represent only 3 percent of one of Golden State 's regional systems, Golden State does not report financial information for its Apple Valley operations separately. Therefore, we worked with Golden State to estimate amounts applicable to Apple Valley.

‡ Hesperia and Victorville operate on a fiscal year that begins July1. The fiscal years presented above are 2010–11 through 2012–13.

§ Costs allocated from the main office include the costs of general and administrative services provided by a water utility's headquarters or city office, such as accounting, human resources, and information technology.

As Figure 3 shows, Golden State had the highest costs per connection in several of the categories that were applicable to all four utilities[3]. Specifically, Golden State's personnel costs, operations costs, interest expense, and allocations from the main office were higher than for the other utilities because Golden State's service area has a smaller number of connections. As discussed in the Introduction, service areas with a lower number of connections can have higher costs because the water utility must spread its fixed costs across fewer customers. In addition, Golden State's operations costs are higher because its Apple Valley service area is dispersed, and it serves its customers through four systems that are not interconnected, thus requiring more infrastructure and related costs for each connection.

Another difference is Apple Valley Ranchos' significantly lower interest expense compared to the other utilities. Its parent company, Park Water Company, issued long-term debt and made the funds available for Apple Valley Ranchos, thus allowing the subsidiary to benefit from purchasing power and to obtain debt at a lower cost. Additionally, Figure 3 shows that the costs of water purchases, treatment, and power are higher for both of the public utilities—Hesperia and Victorville—at $192 and $195 per connection, respectively. As we discuss on page 20, the two public utilities had higher water costs because they significantly exceeded their allowed water usage and had to purchase or lease additional water rights. Victorville also had higher depreciation costs, in part, because it constructed an industrial wastewater treatment plant, which we discuss further beginning on page 37. Depreciation provides an estimate of the decline in value of an asset and the need to set aside funds to replace that asset.

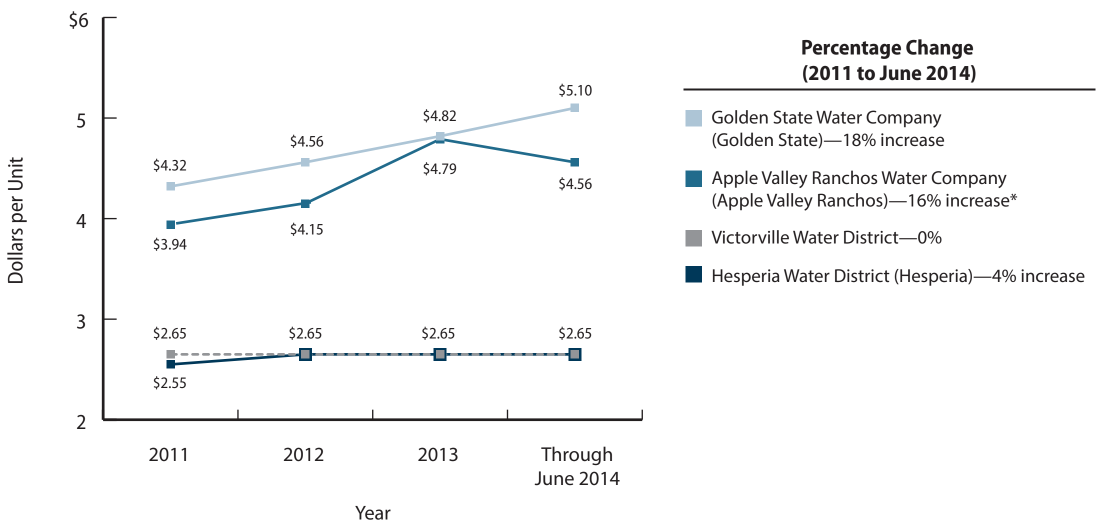
Personnel costs per connection were one of the largest cost categories for each of the four water utilities we reviewed, accounting for 24 percent to 30 percent of operating costs. As shown in Figure 3, these annual costs ranged from $185 to $262 per connection for the four water utilities. The two public utilities had lower personnel costs per connection because of the cities' financial difficulties in past years that extended into the period of our review. Specifically, because of cash shortages in 2008, the city of Hesperia implemented pay reductions for all city employees, including the water district staff. Similarly, in fiscal year 2008–09, the city of Victorville shifted full-time employees, including water district employees, to a four-day, 36-hour workweek and canceled future cost of living increases. Personnel costs include the cost of benefits, which averaged between 26 percent and 30 percent of personnel costs for the three years we reviewed and were not substantially different among the four water utilities.

Personnel costs per connection were one of the largest cost categories for each of the four water utilities we reviewed.

3 Figure 6 on page 23 shows additional costs that are applicable to only the private utilities. When all costs are considered, Apple Valley Ranchos has the highest costs, as shown in Figure 2 on page 15.

Because each utility has different costs, they charge different rates to customers to cover their costs. Although the rates of the private utilities we reviewed increased from 2011 to June 2014, with Apple Valley Ranchos' consumption rate per unit of water increasing 51 cents or 22 percent and Golden State's increasing 54 cents or 17 percent, the rates of the public utilities we reviewed remained relatively stable. The consumption rate is the rate a customer pays per unit of water. Figure 4 displays the residential standardized effective rate, or what a unit of water costs for each of the four utilities, and takes into consideration the consumption rate plus all of the charges that go into a bill such as the monthly service charge, surcharges, and other fees.[4] Because some water utilities have different rates for different classes of water customer, we focused our review on the water utilities' largest group of customers—the single-family residential customer.

Figure 4
Residential Standardized Effective Rate Per Unit of Water
2011 Through June 2014



Sources: California State Auditor's analysis of water utilities' rate schedules and related documents for residential meters 5/8, 3/4, or 1 inch, depending on the utility.

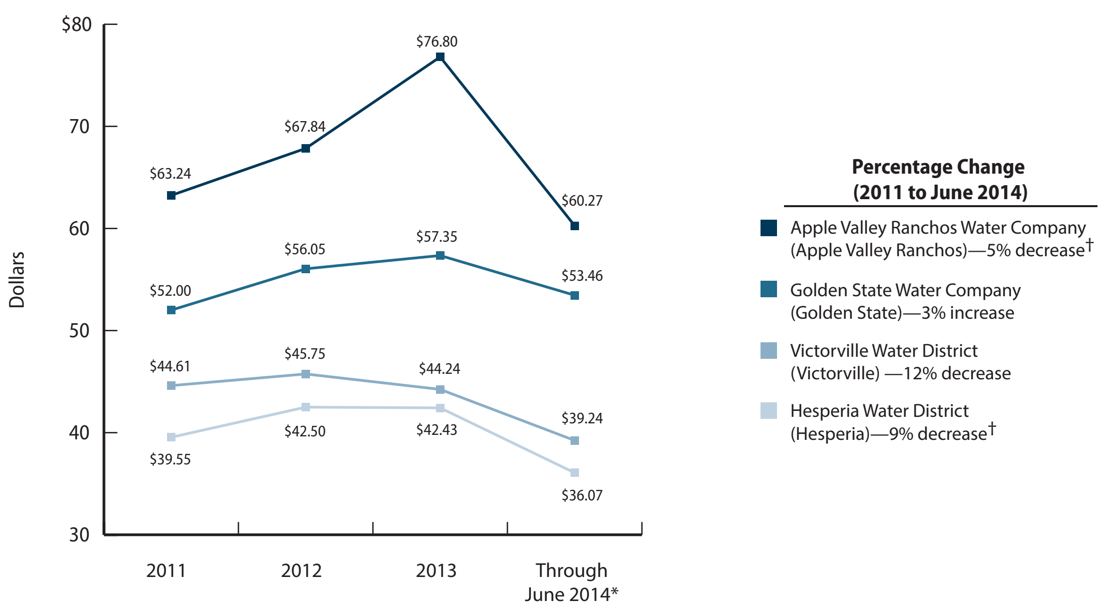
Note: The *effective rate* combines the standard rate per unit of water with all other charges included on a customer's bill, such as monthly service charges and surcharges, and takes into consideration tiered rates. The privately owned water utilities—Apple Valley Ranchos and Golden State—have surcharges and surcredits, and the amounts above reflect the average amount of surcharges and surcredits in effect during each year. One unit of water is equivalent to one hundred cubic feet of water or 748 gallons. The effective rate can vary with consumption as a result of tiered rates. For the purposes of this figure, we assumed a consumption rate of 14.9 hundred cubic feet, the average consumption of the four utilities, which ranged between 11 and 18 hundred cubic feet.

* Apple Valley Ranchos' rate decreased in 2014 because some of the previous years' surcharges expired and it issued a one-time surcredit of $3.14 per customer to refund an over-collected balance from 2013. The standard rate per unit of water and the service charge did not decrease.

4 One unit of water is equivalent to one hundred cubic feet of water or 748 gallons.

The water bill a customer receives is affected by more than just rates. Even when rates increase, customers may be able to lower their bills by using less water. For example, Apple Valley Ranchos' water rate increased by 16 percent between 2011 and June 2014, as shown in Figure 4. However, the average customer's bill decreased by 5 percent, as shown in Figure 5, due in part to reduced water use. Similarly, the average bill for customers in Victorville decreased by 12 percent, even though the rate remained the same. Figure 5 displays the costs of an average residential monthly water bill for each of the four utilities. As Figure 5 illustrates, Apple Valley Ranchos had the highest average monthly residential water bill, even though it did not have the highest standardized effective rate, as shown in Figure 4. During 2011 through June 2014, Apple Valley Ranchos' average monthly residential water bill was $12 higher than Golden State's because Apple Valley Ranchos' customers used, on average, 42 percent more water per month than Golden State's customers. Similarly, Victorville's customers used 13 percent more water on average than Hesperia's customers during 2011 through June 2014, resulting in an average monthly bill that was $3 higher for Victorville's residential customers, even though the effective rate was substantially the same.

Figure 5
Average Residential Monthly Water Bill
2011 Through June 2014



Sources: California State Auditor's analysis of water utilities' rate schedules and related documents for residential meters 5/8 or 3/4 inch, depending on the utility.

Note: The average monthly water bill amounts include all charges on a typical bill. The bill amounts reflect the average residential customer's consumption by utility for each year. Bills for Apple Valley Ranchos and Golden State include the average of surcharges and surcredits in effect during each year. The public utilities—Victorville and Hesperia—do not have surcharges or surcredits.

* Water usage in and around the Apple Valley area typically increases in the second half of the year, which could increase the average for 2014.

† Although the amount presented above is monthly, Apple Valley Ranchos and Hesperia bill bi-monthly.

When customers conserve water, utilities may need to raise rates to generate the revenue necessary to cover their fixed costs, such as for salaries and required maintenance.

The amount of water used is important because it can affect the amount that customers pay. Because of extremely dry weather conditions since 2012, in January 2014, the governor encouraged Californians to conserve water. Although conservation plays an important role in preserving scarce resources, water utilities are also reliant on customers paying for water to cover the utilities' costs to obtain and deliver the water to their customers. More than 70 percent of each of the four utilities' costs are fixed, such as salaries and required maintenance. These fixed costs generally do not decline when customers use less water. Therefore, when customers conserve, utilities may need to raise rates to generate the revenue necessary to cover their costs. Specifically, in its recent rate case proposal, Apple Valley Ranchos listed, as one justification for its need to raise rates, lower water sales forecasts, resulting in a decrease in its revenue estimates, which it indicated contributed substantially to the amount of the rate increase requested.

Water Costs and Water Rights Affect Water Rates

Water costs of the water utilities vary widely depending on the utility's water rights and customer demand. As described in the Introduction, the Apple Valley area lies within an adjudicated basin, which means it has been through the legal process that determines each party's right to water (water rights) within the basin. Specifically, Apple Valley, Hesperia, and Victorville are within the Mojave Groundwater Basin, which has a court-appointed watermaster who is responsible for verifying the amount of water each water district pumps and monitoring their compliance with established water rights. Each utility's water rights are based on property rights or historical claims to water use, and not on the current number of customers or demand. If customer demand exceeds a utility's water pumping allowance, the utility typically must purchase or lease water or water rights from a third party, such as another water utility or the watermaster. The purchase or lease of water rights enables a utility to continue to pump water from its own wells after it has pumped its allowance.

Utilities that significantly exceeded their allowance of water rights had higher water costs. As shown in Figure 3 on page 16, there is a significant difference in the amounts the water utilities spent on water purchases, treatment, and power. Water purchases comprise the majority of those costs for the public utilities. Victorville's and Hesperia's costs related to producing water and purchasing water rights were 25 percent and 29 percent of their total costs, respectively. However, only 12 percent of Apple Valley Ranchos' total costs were for water and water rights, and water costs accounted for only 6 percent of Golden State's Apple Valley service area's total costs. The differences in water costs for the four water utilities we reviewed can be explained by the differences in water rights. As shown in Table 6, the water utilities had widely different water rights allowances and pumped widely different amounts. For example, Apple Valley Ranchos owns a greater allowance per connection than the other utilities, having water rights to pump 0.49 acre-feet per connection—meaning that it can provide more water to each customer before it needs to purchase or lease water or water rights.[5] Apple Valley Ranchos exceeded its water rights by nearly 3,100 acre-feet on average for fiscal years 2010–11 through 2012–13. In contrast, Hesperia exceeded its water rights by just over 6,700 acre-feet on average for fiscal years 2010–11 through 2012–13, more than twice the amount of Apple Valley Ranchos, which contributed to Hesperia's higher water costs.

Table 6
Water Rights and Water Pumped by Water Utility
Average for Water Years 2010–11 Through 2012–13

WATER DISTRICT (AVERAGE NUMBER OF CONNECTIONS)	WATER RIGHTS ALLOWANCE (ACRE-FEET)	WATER PUMPED (ACRE-FEET)	DIFFERENCE BETWEEN WATER RIGHTS ALLOWANCE AND WATER PUMPED* (ACRE-FEET)
Apple Valley Ranchos Water Company (19,092)	9,361	12,456	(3,095)
Per connection	0.49	0.65	(0.16)
Golden State Water Company (Golden State)† (2,882)	531	867	(336)
Per connection	0.18	0.30	(0.12)
Hesperia Water District (26,194)	8,213	14,950	(6,737)
Per connection	0.31	0.57	(0.26)
Victorville Water District (34,145)	16,209	24,038	(7,829)
Per connection	0.47	0.70	(0.23)

Sources: Annual reports of the Mojave Water Agency, the court-appointed watermaster responsible for verifying the amount of water pumped by water parties, monitoring compliance with water rights in the Mojave Groundwater Basin, and preparing the annual report of its findings and activities to the court, among other tasks.

Note: The water year is from October 1 to September 30.

* A positive difference in water rights and water pumped indicates that the utility did not use its full allowance. A negative difference indicates that the utility used more than its allowance, which it can address in various ways. Utilities may have unused allowance carried over from the prior year, or they may purchase water rights from another entity or from the watermaster.

† Because its Apple Valley customers represent only 3 percent of one of Golden State 's regional systems, Golden State does not report financial information for its Apple Valley operations separately. Therefore, we worked with Golden State to estimate amounts applicable to Apple Valley.

5 An acre-foot is 435.6 hundred cubic feet or nearly 326,000 gallons.

The amount each water utility pumps is driven by the water demands of its customers. A water utility cannot directly control demand, but it can reduce demand by encouraging conservation. Victorville and Hesperia's water costs were higher because their customers used more water than the water utilities had rights to pump, which required them to purchase more water rights. As shown in Table 6 on the previous page, Victorville's water rights were 7,800 acre-feet of water less than what it pumped on average for the three years and Hesperia's were 6,700 acre-feet on average less than what it pumped. As discussed earlier, water utilities can purchase water or water rights to make up the difference. However, the utilities also may have carry-over of unused water rights from the previous year that they can use to help address the differences between water rights and the amount pumped.

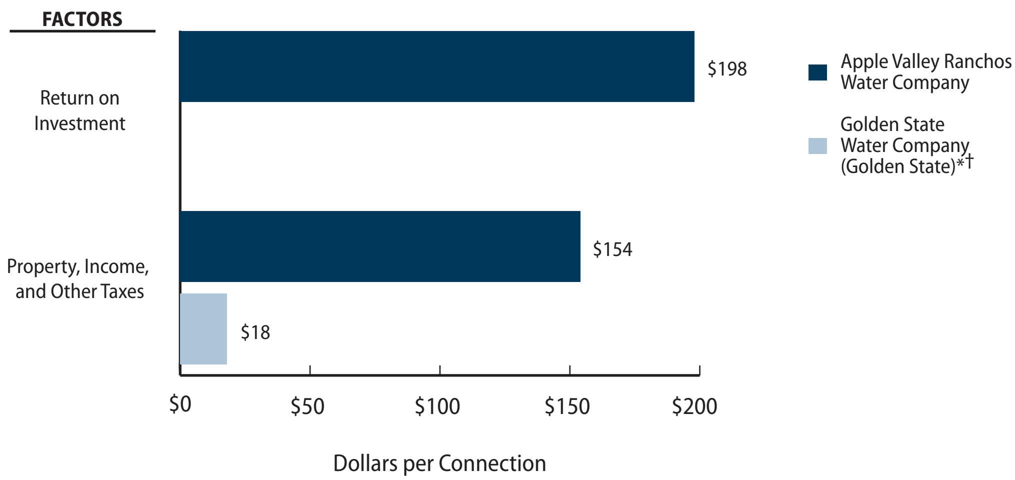
A water utility that has a relatively smaller allowance of water rights per connection is more likely to exceed its allowance and, as a result, more likely to incur additional costs.

A water utility that has a relatively smaller allowance of water rights per connection is more likely to exceed its allowance and as a result more likely to incur additional costs. As shown in Table 6, Hesperia has rights to only 0.31 acre-feet of water per connection, but Apple Valley Ranchos has 0.49 acre-feet per connection. Therefore, even though Hesperia pumped less per connection, Apple Valley Ranchos had a smaller difference between its water rights allowance and the amount it pumped causing it to have to purchase less water or water rights than Hesperia. As we discuss on page 30, the city of Hesperia purchased water rights and leased them to its water district at below-market rates, which helps the district better manage its costs. Nevertheless, water utilities with a relatively low water rights allowance, such as Hesperia, will typically have higher water costs than those that have a relatively high water rights allowance.

Private Utilities' Water Rates Are Higher in Part Because They Have Costs That the Public Utilities Do Not

A key factor that contributes to the dissimilarity in rates among the utilities is the inherent differences between private and public utilities, which result in additional costs to the customers of private utilities, such as certain taxes and return on investment that are incorporated into the rates the utility charges. Although public utilities may receive revenues such as property taxes or connection fees paid by its customers, these amounts are not incorporated directly into customers' rates or shown on their bills. Figure 6 shows the average annual cost per connection for taxes and return on investment that affect the water rates of private utilities. In addition, other factors, such as low-income assistance programs and regulatory fees, add additional charges to the bills of private utility customers.

Figure 6
Annual Average of Other Factors Contributing to Water Rates of Privately Owned Water Utilities for 2011 Through 2013



Sources: California State Auditor's analysis of the utilities' relevant cost information from annual regulatory reports or other financial documents.

* For 2011 through 2013, Golden State operated its Apple Valley service area at a loss and therefore no return on investment is shown above. However, Apple Valley is a small portion of one of Golden State's regional operations, and the region did yield a return on investment.

† Because its Apple Valley customers represent only 3 percent of one of Golden State's regional systems, it does not report financial information at its Apple Valley operations separately. Therefore, we worked with Golden State to estimate amounts applicable to Apple Valley.

To encourage investment in a private water utility, state law allows private water utilities the opportunity to receive a return on investment in their operations. Return on investment is not a cost of operations, by which we mean those costs required for the day-to-day provision of water service. However, the utility includes a return as part of its rate proposal, and if approved by the the California Public Utilities Commission (commission) as reasonable, the return on investment is ultimately passed on as a cost to the ratepayers. During its review every three years, the commission approves the rates that private utilities charge, which include the utility's return on investment. Private utilities propose their return on investment by analyzing the investment they have made in their water systems. As part of the rate-setting process, the commission reviews and sets the rate of return, or return on investment, that a utility can collect based on estimated future costs. A utility's return is not guaranteed. If a utility incurs expenses greater than the estimates included in the rates the commission approved, the additional costs may have to come out of the utility's return on investment. Conversely, if a utility incurs fewer expenses than the estimates included in the rates approved, the cost savings may increase its return on investment. For example, the commission approved a return on investment for Apple Valley Ranchos of 9.07 percent for 2013. According to its 2013 annual report to the commission, Apple Valley Ranchos reported a net income of $3.62 million, or a return of 8.07 percent. As shown in Figure 6, return on investment accounted for $198 per connection.

According to estimates applicable to Apple Valley, Golden State had a net loss for its Apple Valley service area of between $583,000 and $909,000 for 2011 through 2013 and therefore does not show a return on investment in Figure 6. However, its Apple Valley customers represent only 3 percent of one of Golden State's regional systems, and Golden State reported a regional return on investment of 9.15 percent to 10.68 percent for 2011 to 2013.

Unlike public utilities, which are not required to pay property or income taxes, private utilities must pay property and other taxes as well as income tax on their earnings, thus increasing the costs that these utilities include as part of their water rate calculation.

Another cost to the ratepayers of private utilities is tax paid by the utility on income and property. Unlike public utilities, which are not required to pay property or income taxes, private utilities must pay property and other taxes as well as income tax on their earnings, thus increasing the costs that these utilities include as part of their water rate calculation. For 2011 through 2013, Apple Valley Ranchos' average cost for property, income, and other taxes was $154 per connection. Golden State's average cost was $18 per connection during the same time because it had a net loss for its Apple Valley service area. However, as noted, Apple Valley customers represent 3 percent of one of Golden State's regional systems, and the regional system does earn a return on investment and pays tax on that income.

Two other differences between public and private utilities affect what customers pay on their bills. State law authorizes—and the commission encourages—private utilities to offer programs to assist low-income ratepayers. Both private utilities that we reviewed offer low-income rate assistance programs. Apple Valley Ranchos' program provides a monthly discount of about $7 for water customers below certain income levels, such as a family of four whose annual income is at or below $47,100. As of December 2013 Apple Valley Ranchos had more than 5,000 low-income customers, which represented 26 percent of its total customers. For 2013 Apple Valley Ranchos reported that it provided discounts to low-income customers through this program totaling $296,000. Golden State offers a similar program with a discount of $8 per month for its low-income customers in the Apple Valley area. Golden State reported to us that it had more than 1,000 low-income customers in its Apple Valley area, representing 37 percent of its total customers in the service area. It reported providing discounts to low-income customers of more than $95,000 for 2013. To cover the costs of the programs, Apple Valley Ranchos and Golden State include a surcharge on the bills of metered customers who do not benefit from the program. For example, in 2013, Golden State's surcharge was 8 cents per hundred cubic feet of water consumed to pay for its program, which equates to an extra 92 cents on the average customer's monthly bill. Apple Valley Ranchos includes a flat 55-cent surcharge per month to fund its program.

Although state law prohibits public utilities from using revenues from water rates to offer rate assistance programs like those the private utilities offer, public utilities are not prohibited from using other revenues, such as money from a city's general fund, to offer rate assistance programs. The two public utilities we reviewed told us they do not offer any low-income assistance programs and do not have plans to do so. The assistant city manager at Hesperia stated that its water district set up a tiered rate structure with a low tier rate to help keep water bills low for customers who consume less water. However, Hesperia's initial tier applies only to the first 10 hundred cubic feet of water used every two months, and the average residential customer used more than 30 hundred cubic feet of water in this time frame. Further, Hesperia's second tier is higher than Victorville's standard consumption rate, meaning that having a lower initial tier did not lower the average customer's bill compared to Victorville's bill. Victorville's assistant director of water stated that Victorville had not considered a rate assistance program because it believed state law did not allow it.

Finally, private utilities collect a regulatory fee from water customers, which funds the costs of the commission to regulate the private utilities; whereas, public utilities do not have this expense. State law authorizes the commission to collect fees from private utilities that it regulates to fund its operations. The private utilities pass the cost of these regulatory fees directly to ratepayers, in the form of a 1.5 percent fee on customers' bills. They transfer the collected funds to the commission quarterly. This regulatory fee is not part of private utilities' water rates. However, the fee does represent increased costs that a water customer of a private utility pays. The fee for the commission for January 2011 through June 2014 averaged 99 cents each month for an average residential customer of Apple Valley Ranchos and 81 cents each month for Golden State.

Private utilities collect a regulatory fee from water customers, which funds the costs of the commission to regulate private utilities.

Public Utilities Receive Revenues That Private Utilities Do Not

In addition to not incurring certain costs, public utilities receive certain revenues that private utilities do not. These additional revenues allow the public utilities to help keep rates lower for customers. One of these revenues is property tax that customers of the water district pay. State law allows local governments to collect property tax revenue. The public utilities can receive a portion of the revenue from property taxes based on the assessed value of properties in their service areas. In fiscal year 2012–13, Victorville received property tax revenues of $502,000 and Hesperia received $286,000, which they can use to help cover their operations costs. The revenues from property taxes offset roughly 2 percent of their total operating costs.

Public utilities can collect fees for new connections to their utility service; whereas, commission rules prohibit most private utilities from charging such fees.

Public utilities can also collect fees for new connections to their utility service; whereas, commission rules prohibit most private utilities from charging such fees. Both Hesperia and Victorville collect development fees for new connections from residential builders in their service areas. Specifically, Victorville charges a connection fee of $5,142 for a standard residential meter and Hesperia charges $6,175. During fiscal years 2010–11 through 2012–13, Victorville collected an average of $1.4 million per year in connection fees and Hesperia collected an average of $200,000 per year. Connection fee revenues equate to roughly 5 percent of Victorville's total operating costs and 1 percent of Hesperia's. The amount collected is highly variable, depending on the local economy and the amount of building that occurs. For example, in contrast to the $200,000 it collected annually during fiscal years 2010–11 through 2012–13, Hesperia collected nearly $2.1 million in connection fees in 2008. Further, in addition to any fees paid, housing developers in the cities of Hesperia and Victorville are subject to city ordinances requiring them to contribute the water infrastructure they build to the respective water districts. For example, for fiscal years 2010–11 through 2012–13, Victorville received $7.2 million in contributed infrastructure.

The Water Utilities Have Undertaken Cost-Saving Measures but Cannot Always Demonstrate the Amounts Saved

Because higher costs can contribute to higher rates, we expected the water utilities to be able to demonstrate how much they have saved with the efforts they have undertaken. However, although each of the water utilities we reviewed told us that they employed cost-saving measures to reduce the costs to ratepayers, only Victorville and Golden State had determined the cost savings associated with some of their measures. For example, Victorville's assistant director of water provided a summary of cost-saving efforts the water district had implemented. The summary noted that the water district estimated that Victorville saves approximately 50 percent, or $3 million per year, on its electrical pumping costs by pumping during off-peak hours. Golden State provided a summary of several cost-saving efforts noting it saved $185,000 per year companywide by switching from mailing bills itself to using a third-party mailing service.

Conversely, the other two water districts identified cost-saving measures taken but they had not determined the actual benefit of those measures. For example, in a summary of cost-saving measures, Apple Valley Ranchos stated that the installation of automated meter readers in 2013 reduced the time and staff necessary to read meters but it had not quantified how this had benefited ratepayers. The summary also identified that Apple Valley Ranchos saved costs as a result of obtaining centralized administrative services and employee benefits through its parent company, but had not identified the amount of those measures. Additionally, Apple Valley Ranchos and Hesperia each stated that they pump water during off-peak times when electricity costs are lower, but neither had determined the actual savings resulting from that effort. While it is likely that the efforts did cut costs for the utilities, without documenting the savings from their cost-saving measures, the two water utilities cannot demonstrate to ratepayers the positive impacts of their efforts to minimize costs and ensure that rates remain reasonable. The executive vice president of Apple Valley Ranchos agreed that quantifying cost-saving measures could help to demonstrate the effect of its efforts and thought Apple Valley Ranchos could do so. In response to our discussion regarding cost savings, Apple Valley Ranchos determined amounts for some of its cost-saving efforts. Hesperia's assistant city manager also agreed that quantifying cost-saving measures could be helpful.

Without documenting the savings from cost-saving measures, the two water utilities cannot demonstrate to ratepayers the positive impacts of their efforts to minimize costs and ensure that rates remain reasonable.

Water Utilities Are Subject to Public Review Processes Before They Can Increase Their Rates

Water utilities must go through a process before they can raise their rates. Private utilities must receive approval from the commission. That process includes a review of past actual and future estimated costs and revenues and allows for public comment before the commission approves rate increases. The two private utilities we reviewed—Apple Valley Ranchos and Golden State—complied with the commission's process for obtaining approval of increases to their rates for applications that began the process during 2011 through 2013. Public utilities must comply with state law, which limits the authority of local government agencies to impose property-related assessments, fees, and charges. Under state law, a public agency that approves a water rate increase must first give notice to the public. If a majority of ratepayers submit a written protest to the public agency, the rate increase is rejected. Otherwise, the rate increase may be approved. The two public utilities we reviewed—Hesperia and Victorville—did not seek any increases during the three-year period we reviewed.

The Private Utilities Complied With the Commission's Process for Rate Approvals

Apple Valley Ranchos and Golden State followed the commission's process for obtaining rate increases for applications whose process began during 2011 through 2013. State law requires private utilities, including Apple Valley Ranchos and Golden State's regional operation, of which its Apple Valley service area is a part, to receive

The approval process for rate changes for a private utility includes a review of past actual and future estimated costs and revenues and allows for public comment before the commission approves changes to rates.

approval from the commission before making any changes to rates. The approval process, called a *general rate case*, includes a review of past actual and future estimated costs and revenues and allows for public comment before the commission approves changes to rates. The commission generally requires utilities to file a general rate case application once every three years, and the commission reviews it over either 14 or 20 months, depending on the size of the utility. For example, Golden State submitted one rate proposal to increase rates covering 2013 through 2015 in July 2011 and received approval in May 2013. However, the commission later did not allow Golden State to implement the 2.9 percent rate increase for 2015 because it earned more in 2014 than projected. Apple Valley Ranchos submitted its rate increase proposal in January 2014 for rates covering 2015 through 2017 and as of March 2015 was awaiting final approval.

As part of the general rate case process, the Office of Ratepayer Advocates, which is an entity within the commission that represents and advocates on behalf of the interests of ratepayers, negotiates with the utility concerning the rate proposal. Subsequently, the commission and an administrative law judge review the proposed rates by the utility and the Office of Ratepayer Advocates to ensure that the costs the utility has proposed are just and reasonable. During the general rate case, the proposed rates are subject to change and the commission ultimately approves the rate that the utility will charge its customers after hearing testimony from all involved parties. Our review of the most recent rate proposals found that Apple Valley Ranchos and Golden State complied with the commission's process, including the timely submission of required filings and holding public hearings.

In addition to the formal rate review process that occurs every three years, the commission allows private utilities to submit advice letters—a quick and simplified informal process for the commission to review utility requests that are not expected to be controversial or raise important policy questions. Advice letters for water utilities are assigned to one of three tiers, based on the required level of review. Tier 1 advice letters may include instances such as a decrease in rates or a temporary rate increase—a surcharge—to obtain revenue the commission previously approved but the utility did not collect. These advice letters do not require the utility to notify ratepayers in advance and are generally subject to approval or rejection by commission staff. Tier 2 advice letters cover issues such as a new service offering or expanding services into a new area. Tier 2 advice letters are also generally subject to approval or rejection by commission staff. Tier 3 advice letters generally require approval by the commission and include items such as a withdrawal of service. Both tier 2 and tier 3 advice letters require notification to ratepayers.

Advice letters filed by the two private utilities we reviewed typically had the effect of temporarily increasing customers' bills through a surcharge, but such letters occasionally reduce the bills through a surcredit. Apple Valley Ranchos submitted 13 advice letters to the commission that became effective during 2011 through 2013; these advice letters requested a surcharge, a surcredit, or a change to rates. For example, in March 2013, Apple Valley Ranchos requested a surcharge of approximately 26 cents per unit of water used each month for an 18-month period to recover a $2.3 million shortfall in revenues from earlier years. Golden State also submitted 13 advice letters requesting a surcharge, surcredit, or changes to rates to the commission during 2011 through 2013 relating to its Apple Valley service area. Golden State submitted only tier 1 advice letters to implement surcharges, surcredits, or changes to rates, while Apple Valley Ranchos submitted 11 tier 1, one tier 2, and one tier 3 advice letters during 2011 through 2013. After review and any necessary adjustments, commission staff approved each of the tier 1 and tier 2 advice letters. The commission also approved the tier 3 advice letter.

Both private utilities intend to raise their water rates, but the amounts of the increases vary. Apple Valley Ranchos submitted its general rate case proposal to the commission in January 2014, which shows its plan to raise rates by about 14.9 percent in 2015, 8.5 percent in 2016, and 8.2 percent in 2017. In its proposal, Apple Valley Ranchos cited revenue shortfalls due to a decrease in estimates of customer water consumption, additional revenue to produce a fair rate of return on capital invested in property dedicated to providing utility service, increases in unit costs of production, and inflation as the reasons for its request to increase rates. As of March 2015 Apple Valley Ranchos was awaiting approval from the commission. In its current rate case application submitted in July 2014 for the region that includes Apple Valley, Golden State proposes to increase its rates only slightly—by 0.68 percent in 2016, 2.41 percent in 2017, and 2.69 percent in 2018. Its application states that the increases are largely offset by reductions in water production and other related costs.

The Public Utilities We Reviewed Have Not Sought Rate Increases Since 2008

Neither of the public utilities we reviewed—Hesperia and Victorville—have requested approval for rate increases since 2008. Proposition 218, a constitutional provision, requires public utilities to follow a number of procedural requirements before imposing increased water rates. A water district board that intends to increase water rates must give specified notice of the increase to the public and hold a public hearing not less than 45 days after the

A public utility that intends to increase water rates must give specified notice of the increase to the public and hold a public hearing not less than 45 days after the notice is mailed.

notice is mailed. At the public hearing, the agency must consider all written protests against the proposed rate increase. If a majority of parcel owners object, the agency cannot impose the increase. Hesperia's last approved rate increase occurred in 2008 and included a series of five increases over four years from 2008 through 2011. Victorville's last rate proposal was also approved in 2008 and included scheduled rate increases for 2008 through 2010. Victorville implemented the scheduled rate increases in 2008 and 2009 but deferred an approved increase scheduled for 2010 until August 2014, when it implemented part of the increase, or 4.17 percent. The public water districts have not raised rates since these increases.

Hesperia did not raise water rates because the financial assistance from the city of Hesperia allowed it to keep its costs low. According to the assistant city manager, in 2010 the water district had a shortage of cash and borrowed $6 million from the city community redevelopment agency at a quarterly interest rate ranging from 0.22 percent to 0.56 percent. According to the assistant city manager, this loan was the best way to address the needs of the water district without raising rates. The city of Hesperia further helped the water district by purchasing water rights in the fall of 2012 for $30 million and leasing them to the water district at costs lower than it could purchase or lease from others. For example, during fiscal year 2012–13, the city of Hesperia charged the water district $382 per acre-foot, while the local watermaster, Mojave Water Agency, charged $425 per acre-foot.

In addition, for fiscal years 2010–11 through 2013–14, the city of Hesperia charged the water district for only a portion of the costs allocated for services that the city provides to the water district. These costs include the water district's portion of the city's central service departments, such as the city council, city manager, finance, human resources, and information technology. For example, in fiscal year 2013–14, the city allocated to the water district nearly $2.3 million for the costs of these services, but it charged the water district only $1.7 million. The assistant city manager stated that the city of Hesperia charged the amount it felt the water district could pay without needing to raise rates and that the city had sufficient resources in its general fund to cover the additional costs. However, he stated that the city may charge the water district in the future for the unbilled amounts, depending on their impact on water rates.

Citywide salary cuts also may have helped Hesperia control its personnel costs. According to the assistant city manager, in 2008 the city of Hesperia had a severe shortage of funds and instituted a 5 percent pay reduction for all city personnel, which included staff at the water district. He stated that although the district has modestly increased pay in the past five years, the water district has made an effort to control payroll costs primarily by not adding staff and through negotiations with the union.

Like the city of Hesperia, the city of Victorville experienced financial difficulties and the city council approved reductions in employee compensation beginning in fiscal year 2008–09. Specifically, the city council approved reductions of hours and benefits for city employees, including those at the water district. The city shifted full-time employees to a four-day, 36-hour workweek and canceled a future cost-of-living increase of 3.3 percent and those in the next few years, up to a maximum of 10 percent for city employees. Although these reductions were not initiated by water district management, according to the assistant director of water, they have helped in deferring rate increases. The four-day workweek was still in place as of February 2015, and the city council recently approved a cost-of-living increase of 1.2 percent, effective July 2015, to partially make up for lost cost-of-living adjustments in past years.

Victorville has also kept rates low by deferring routine maintenance of its water system. According to a staff report submitted to Victorville's board in June 2014, Victorville deferred $1.3 million annually in routine maintenance and $2.6 million annually in scheduled asset replacements in each of the past four years. The director of public works and water indicated that some of these items included deferring regular inspection of the waterproof coatings on steel storage reservoirs costing $50,000, routine exercising of valves costing $42,000, and planned electronic meter replacements costing nearly $488,000.

The public utilities have different plans regarding their water rates. The assistant city manager of the city of Hesperia stated that the water district does not have plans to raise rates. He stated that in August 2014 the water district made the final payment of $1.2 million on its $6 million loan from the former redevelopment agency, which reduces operating expenses in future years. Also, he stated that electricity costs have been stable for the past five years. However, he stated that after the water district completes its water management plan and related studies of sewer and recycled water usage in the fall of 2015, it will evaluate the need to raise rates. In contrast, Victorville began conducting a water rate study in January 2015 with a scheduled completion by June 2015, and according to the director of public works and water, following the rate study, the water district is likely to increase rates through the Proposition 218 process for the start of the next fiscal year. According to a June 2014 staff proposal presented to the water board at a July 2014 meeting, the director of public works and water cited factors such as increased water pumping costs and

According to the assistant city manager of the city of Hesperia, the water district does not have plans to raise water rates—it recently reduced operating expenses and electricity costs have been stable for the past five years.

deferred routine maintenance and capital replacement needs as reasons why Victorville requested to implement a previously approved, but deferred, water rate increase. The director of public works and water indicated he plans to restore some of the deferred maintenance costing nearly $700,000 and increase capital expenditures by $475,000 to resume deferred maintenance and scheduled asset replacement in 2015.

Victorville's Water District Made a Series of Questionable and Possibly Unlawful Decisions

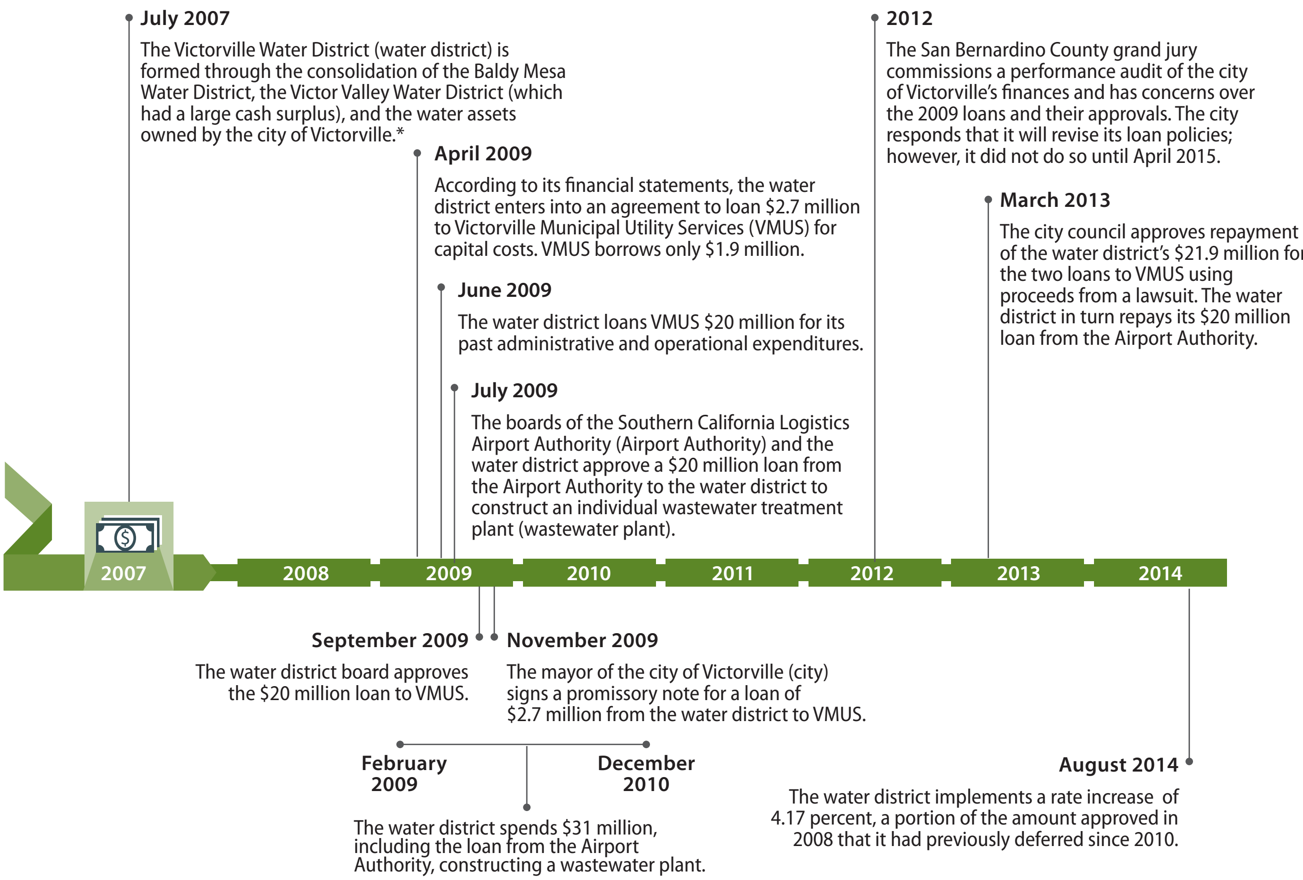
In 2009 the Victorville Water District loaned nearly $21.9 million in ratepayer revenues to the city of Victorville and borrowed $20 million at a significantly higher interest rate, resulting in harm to the ratepayers.

In 2009 the Victorville Water District (water district) loaned nearly $21.9 million in ratepayer revenues in two loans to the city of Victorville (city), during a time the city was experiencing financial difficulties.[6] While the loaned money was ultimately repaid, the loans resulted in harm to the ratepayers. Although it is not unlawful for a water district to loan ratepayer money or otherwise invest it in a prudent manner, it cannot do so if loaning that money impairs its ability to perform the functions for which the ratepayer revenue was collected. While the loans were outstanding, the district deferred maintenance on the water delivery system and borrowed $20 million from another entity—the Southern California Logistics Airport Authority (Airport Authority)—at a significantly higher rate of interest than it received on the money it loaned to the city.

During this same time, the water district spent $31 million to construct an industrial wastewater treatment plant (wastewater plant), which has served primarily to benefit a single customer—a commercial beverage manufacturer. The plant was constructed using the $20 million loan from the Airport Authority and an additional $11 million in water district ratepayer revenue, which includes water delivery fees and connection fees. To the extent that the water district used revenue from water delivery fees to construct the wastewater plant, the construction of the wastewater plant may have violated Proposition 218. Figure 7 provides a timeline of these and other related transactions.

6 Although we use the term *Victorville* to refer to the Victorville Water District earlier in the report, because of the involvement of the city of Victorville here, we refer to the city of Victorville as *the city* and the Victorville Water District as *the water district* in this section.

Figure 7
Timeline of Loan Transactions Involving the City of Victorville and the Victorville Water District



Sources: The city and water district's board resolutions, financial statements, and accounting records, county of San Bernardino Local Agency Formation Commission resolutions, and the San Bernardino County grand jury report dated June 29, 2012.

* Although we use the term "*Victorville*" to refer to the Victorville Water District earlier in the report, because of the involvement of the city of Victorville, we refer to the city of Victorville as *"the city"* and the Victorville Water District as *"the water district"* in this figure.

Past Loans Cost Millions and Resulted in Harm to the Interests of the Ratepayers

Although state law permits a water district to prudently invest surplus funds—those not needed to meet its operations and maintenance needs—the water district's use of ratepayer money to make loans to the city ultimately resulted in harm to its ratepayers. The loans were inconsistent with the general legal principle that a government entity may only loan funds that are designated for a specific purpose if doing so does not impair the entity's ability to perform those purposes and does not otherwise harm the ratepayers. Moreover, the water district's making of these loans was not a prudent investment of surplus funds in that the water district accepted a very low interest rate on those loans in sharp contrast to the interest rate that it agreed to pay on a loan it took out during the same period.

The first questionable transaction involved a $20 million loan in 2009 from the water district to the Victorville Municipal Utility Services (VMUS), a department of the city that provides electricity and gas service to commercial and industrial customers. Under the terms of the loan, VMUS was to pay the water district interest at the Local Agency Investment Fund rate—a quarterly variable interest rate that fluctuated between 0.28 percent and 0.9 percent during the loan period. The agenda item requesting the water district board's approval of the $20 million loan to VMUS stated that the loan was necessary to fund prior years' general administrative and operational expenditures. At the time the loan was made in June 2009, as noted in the city's audited financial statements, there were concerns with the financial stability of the VMUS fund as well as the city's general fund, raising questions about whether the loans would be repaid.

In addition, in November 2009, the mayor of Victorville signed a promissory note for a loan of $2.7 million from the water district to VMUS, also at the Local Agency Investment Fund rate. VMUS ultimately borrowed only $1.9 million of the $2.7 million it was authorized. The water district's financial statements for the fiscal year ending June 30, 2010, however, indicate the loan agreement was entered into in April 2009 and the water district was unable to provide documentation supporting that the water district board approved the loan. This loan was to fund capital costs for VMUS.

The Airport Authority loaned $20 million to the water district for the costs of developing a wastewater plant, charging a higher interest rate than the water district received on the funds it loaned to a city department.

Also during the period it had loaned $21.9 million to the city, the water district board entered into an agreement with the Airport Authority whereby the Airport Authority would loan $20 million to the water district. The loan agreement states that the Airport Authority loaned housing bond proceeds to the water district for the costs of developing a wastewater plant. The loan agreement also states that the water district had to pay 7 percent interest on outstanding loan funds. When we asked about the reason for the difference in interest rates between this loan and the ones the water district had made to the city—the 7 percent that the Airport Authority charged the water district compared with the significantly lower interest rate that the water district charged VMUS—the city manager stated that the city did not intend for the interest rates to be different and had planned to use the lower rate for both. However, he stated that bond counsel advised that any investments of housing bond funds had to be made at 7 percent. We discuss the wastewater plant and the plans for the water district to recoup its costs in building this wastewater plant in the next section.

Ultimately, in March 2013, the city council approved repayment of the two loans the water district made to the city. Specifically, the city received proceeds from a settlement agreement and used a portion of the funds to repay both loans it received from the water district. In turn, the water district paid off the loan it received from the Airport Authority.

Although the loans were repaid, the ratepayers of the water district were harmed as a result of the two loans the water district made to the city. By law, funds that are designated for a specific purpose, such as the ratepayer revenues at issue in these loans, may only be loaned for another purpose if making the loan does not impair the purposes for which the revenues were raised. In other words, the water district may only lawfully loan or otherwise invest these surplus funds if doing so does not impair its ability to perform its water district functions effectively. In this case, the making of the two loans to the city did impair the water district's ability to fulfill its mission effectively and violated the prohibition against loaning such funds under circumstances that harm the ratepayers. During the period the loans were outstanding, the water district deferred replacing assets as well as deferring routine maintenance on the water system. Additionally, it raised rates after the loans were repaid due, in part, to perform the needed maintenance it had previously deferred. Further, the water district ended up paying more than $4.6 million in excess interest on a loan that it might not have needed to take out had it not loaned its own funds to the city.

Because of concerns with the city's finances, in fiscal year 2011–12, the San Bernardino County grand jury commissioned a performance audit of the city's finances. The performance audit's scope of work included, among other things, the review of interfund loans and the use of restricted funds. In particular, the grand jury's auditor reviewed the loans between the water district and VMUS and stated that the city may be at risk of violating state law by providing water district funds collected for the delivery of water services to VMUS, which were used for delivery of electrical and power utility services if the water district was not paid back. The grand jury's auditor was concerned that loaned funds could become a permanent contribution given the financial state of VMUS. According to our legal counsel, loaning these funds may be lawful but as described previously, only if doing so does not impair the ability of the water district to perform those functions it is legally obligated to perform with those funds. In this case, the water district put off performing routine maintenance on the water system, and it paid more than $4.6 million in excess interest on a loan that it took out. After we began asking about these loans and the difference in interest rates, the city manager indicated to us that the city intends to remedy the interest difference to ratepayers. Specifically, the water district on April 7, 2015, approved a 21-year repayment plan covering, in part, the additional interest that it was required to pay as a result of the funds it borrowed from the Airport Authority.

The water district put off performing routine maintenance on the water system, and it paid more than $4.6 million in excess interest on a loan that it took out.

One of the recommendations related to the grand jury's review of the city's interfund loans was that the city revise and improve its interfund loan policy to include specific requirements such as completing a financial analysis of the borrowing fund's ability to repay obligations, a clear and reasonable time frame for the financial analysis to be conducted before approval of the loan, and financial planning and monitoring of the repayment of loans. The grand jury auditor also recommended, among other things, that the city develop and implement a plan to return restricted funds from water fees and charges, which were loaned to VMUS, to the water district. In response to these recommendations, the city stated that it had addressed the concerns over the loans and the appropriateness of using water fees for such a purpose by suspending rate increases and using the proceeds of a lawsuit to repay the loans. The city's response to the audit also asserted that the water district's surplus stemmed from amounts accumulated by the former Victor Valley Water District, and not as a result of water rate increases by the current water district. The current water district was formed in 2007 from the merger of two water districts not managed by the city. Further, the city's response to the audit stated that it would implement the recommendations for changes to its interfund loan policy in fiscal year 2012–13. However, as of January 2015, the city manager confirmed that the city had not updated its interfund loan policy. He stated that one reason that the city had not updated the policy was that the city council did not want to engage in any more interfund borrowing and has not done so, so it was not a high priority. The city manager stated that although the city stated it would update the policy, it was more prudent to not do any more borrowing. After we brought this issue to its attention, on April 7, 2015, the city council approved a revision to its interfund loan policy.

We noted that the city's current interfund loan policy is inadequate to prevent the issues we saw associated with the loan transactions the water district undertook from occurring again.

Further, we noted that the city's current interfund loan policy, also adopted by the water district, is inadequate to prevent the issues we saw associated with the loan transactions the water district undertook from occurring again. Specifically, the relationship between the VMUS and the water district is not an interfund relationship but an interagency relationship. The water district is a separate legal entity from the city, even though the city council serves as the governing board of both. The city's investment policy, also adopted by the water district, and which should govern transactions such as these loans, was not created until after the loans were made. Further, this policy does not recognize that the city and the water district are separate legal entities and that the governing boards have separate fiduciary obligations to each in order to ensure that funds are properly spent on behalf of the government entities they serve. Moreover, any such investment policy should ensure that when and if the water district loans money to another entity, doing so does not impair its ability to effectively perform its core mission—that of efficiently providing its customers with safe, reliable, high-quality water services.

By Using Ratepayer Water Revenues to Construct a Wastewater Treatment Plant, the Water District May Have Violated State Law

During 2009 and 2010, the water district spent $31 million in revenue that consisted of funds borrowed from the Airport Authority and water district revenues, which includes water delivery fees and connection fees, to construct a wastewater plant. In 2007 the city began working with a beverage company to encourage the building of the beverage company's West Coast manufacturing and distribution facility. As a result of that effort, in June 2008, the city council and the former redevelopment agency's board of directors approved agreements that detailed the transaction and the responsibilities of the parties involved. Under the agreements, the beverage company agreed to build the manufacturing and distribution facility, which was expected to employ 210 people. The agreements also obligated the former redevelopment agency to construct an industrial treatment facility capable of accepting, treating, and discharging the beverage company's wastewater. The city's initial finance plan indicated that it planned to fund the wastewater plant with the short-term use of the city's sanitation funds and the issuance of tax-exempt bonds. According to the city manager, the city originally planned to fund, own, and operate the wastewater plant and to finance the plant by setting up a separate enterprise fund and issuing bonds. However, he added that because of two delayed audit reports in 2009, the city was not able to complete the bond issuance. He further explained that the city chose the water district to construct the plant because it was the only entity that had sufficient cash available at the start of construction. He stated that the city intended for the use of water district funds to be a short-term loan but was unable to obtain longer term financing.

A portion of the funds used by the water district to construct the plant included a combination of water delivery fees and water connection fees. As noted earlier, Proposition 218 prohibits the use of revenue from property-related fees, including fees for the delivery of water, to be used for any purpose other than that for which the fees were collected. California courts, in considering the lawful use of property-related fees, have stated that the chief requirement of Proposition 218 is that the revenues derived from a fee or charge must be spent to provide the service paid for and may be used only for that service. Although water districts are additionally authorized to construct works such as wastewater treatment plants, sewage treatment is a distinct service from the delivery of water to residential or commercial customers, and the

Proposition 218 prohibits the use of revenue from property-related fees, including fees for the delivery of water, to be used for any purpose other than that for which the fees were collected.

Because the water district has not yet sold reclaimed water and because it used revenue from water delivery fees to construct the wastewater plant, it may be in violation of Proposition 218.

wastewater plant was built, at least in part, with water delivery fee revenues. According to the city manager, the wastewater plant is eventually intended to provide reclaimed water for district uses resulting in a benefit to the water ratepayers. It is our view, however, that the primary purpose for constructing the wastewater plant was to meet the wastewater needs of the beverage company and not to produce reclaimed water, a side benefit that has not yet been realized. Therefore, because the water district has not yet sold reclaimed water and because it used revenue from water delivery fees to construct the wastewater plant, the water district may be in violation of Proposition 218.

Furthermore, although the water district spent $31 million to build the wastewater plant, it has not been guaranteed any reimbursement. An agreement between the city and the beverage manufacturer requires an annual minimum payment of $1.95 million from the beverage manufacturer for use of the plant, but none of that amount is contractually obligated to go to the water district for its costs to build the plant. However, according to the director of public works and water, the city internally allocates some of the funds it receives from the beverage manufacturer and connection fees from other users of the plant to repay the water district. As of June 2014 the city had allocated $4.5 million to the water district, including $2.2 million from the beverage manufacturer. The director of public works and water stated that the city internally has allocated 49 percent of the cost of constructing the plant to payments from the beverage manufacturer and intends to reimburse the water district that percentage of the cost to build the plant out of the payments received. The water district also has an agreement that it entered into in 2010 to sell reclaimed water generated by the wastewater plant to a power plant but it has yet to sell any water. However, because the water district expects to receive only half of its investment from the beverage manufacturer and has not sold any reclaimed water yet, we question whether the water district fulfilled its duty to prudently invest ratepayer funds. The water district is considered a trustee of the funds it collects from ratepayers and is required by state law and financial principles to exercise due care, skill, prudence, and diligence in investing those funds. The city manager and the director of public works and water indicated that the city plans for revenues from the wastewater plant to increase over time as a result of new water connection fees from additional customers. After we discussed this issue with the water district, its board approved an item at its April 7, 2015, meeting that established a 21-year repayment plan covering most of the cost the water district spent on the wastewater plant. The water district hopes to find additional sources of financing for the repayment plan in the next three years.

The water district could have used the $31 million it spent on the wastewater plant and the more than $4.6 million in excess interest it paid on the loan to the Airport Authority for its own operations. In three of the four fiscal years 2009–10 through 2012–13, the water district incurred net losses ranging from $1.6 million to $5 million. In addition, the water district deferred routine maintenance and repairs. According to an agenda package to the water district board in July 2014, the director of public works and water submitted a staff report and recommendation for approval of a rate increase that had been deferred since 2010. The staff report states that over the past four years, rates have not been adjusted, and with inflation and the rising costs of purchasing water rights and other expenses, the district has had to defer roughly $1.3 million in routine maintenance and repairs each year, as well as deferring $2.6 million intended for scheduled asset replacement each year. In April 2014 the California Department of Public Health (Public Health) reported the results of an inspection of the water district system. The inspection letter notes that overall the water system inspected is adequately maintained and operated, but it indicates areas that the water district needs to address such as its reservoir inspection and valve exercising maintenance practices. In a staff report, water district staff also cited these results of Public Health's inspection letter along with concerns that the district is no longer in a position to continue deferring vital infrastructure maintenance and replacement activities. The city manager stated that the water district deferred maintenance for a variety of reasons but did not consider the loans when making the decision and does not believe the loans affected rates in any way. Further, he stated that the long-term plans for the water treatment facility will allow the water district to defer rate increases in the future, which makes it a prudent investment. However, despite the city manager's assertion, the loans and the wastewater plant construction diverted millions of dollars from the water district during a time it was suffering losses and deferring necessary maintenance.

Recommendations

To assist low-income water customers, Hesperia and Victorville should work with their respective governing bodies to consider the feasibility of using revenues from sources other than water rates to implement rate assistance programs.

To demonstrate to water customers how they are working to keep rates reasonable, the four water utilities should document their cost-saving efforts and quantify, to the extent possible, any specific cost savings achieved from their respective efforts.

To ensure that it does not use revenues from ratepayers for inappropriate purposes, by October 2015, Victorville should revise its policies to prohibit transfers or loans of water fee revenue for nonwater district purposes. Victorville should also revise its investment policy that specifies the circumstances under which it can invest water revenues—setting prudent limits on its investment in assets that the Victorville city council manages.

To address the excess interest expense resulting from loans to the city of Victorville and the building of the wastewater plant, Victorville should seek reimbursement from the city for its unrecovered costs. Victorville should work with the city to prepare and submit to the water district board and the Victorville city council by October 2015 a formal repayment plan including specific dates and payments to be made to ensure that the water district and its ratepayers are made whole. When the water district board approves such a plan, it should take steps to ensure compliance with the repayment plan.

We conducted this audit under the authority vested in the California State Auditor by Section 8543 et seq. of the California Government Code and according to generally accepted government auditing standards. Those standards require that we plan and perform the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings and conclusions based on our audit objectives specified in the scope section of the report. We believe that the evidence obtained provides a reasonable basis for our findings and conclusions based on our audit objectives.

Respectfully submitted,

Elaine M. Howle

ELAINE M. HOWLE, CPA
State Auditor

Date: April 30, 2015

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For questions regarding the contents of this report, please contact Margarita Fernández, Chief of Public Affairs, at 916.445.0255.

Appendix

COSTS AND OTHER FACTORS CONTRIBUTING TO WATER RATES OF THE FOUR WATER UTILITIES REVIEWED

Table A beginning on the following page shows the main factors that affected water rates for each of the four water utilities for the three years we reviewed. As discussed in the Audit Results, a variety of cost factors contribute to water rates of the four water utilities in the Apple Valley area. For the purposes of Table A, these costs are grouped into the major categories that drive water rates: personnel, which includes salaries and benefits; operations; water purchases; power; water treatment; depreciation; interest expense on long-term debt; costs allocated from the utility's main office; return on investment; and taxes. Although return on investment is not a cost of day-to-day operations, the utility includes such a return as part of its rate proposal, and if approved by the California Public Utilities Commission as reasonable, the return on investment is ultimately a cost to the ratepayers.

Table A also shows the percentage increases for each category between fiscal years 2010–11 and 2012–13, or calendar years 2011 through 2013, depending on the water utility. In figures 2 and 3 on pages 15 and 16 and Figure 6 on page 23, this information is presented as an average per connection of the three years we reviewed.

Table A
Costs and Other Factors Contributing to Water Rates for the Four Water Utilities Reviewed (Dollars in Thousands)

TYPE OF COST	CALENDAR YEAR 2011	2012	2013	PERCENTAGE CHANGE 2011 TO 2013*
Apple Valley Ranchos Water Company (Apple Valley Ranchos)				
Personnel†	$4,592	$4,871	$5,078	10.6%
Operations	2,578	2,534	2,550	(1.1)
Water purchases	989	1,018	1,050	6.2
Power	1,076	1,018	1,115	3.7
Water treatment	65	71	87	33.2
Depreciation	2,509	2,716	2,866	14.2
Interest expense	37	12	(5)	(113.5)
Allocated from main office	2,236	2,138	2,086	(6.7)
Return on investment‡	3,134	4,604	3,624	15.6
Property and income taxes	2,460	3,126	3,264	32.7
Totals*	**$19,677**	**$22,108**	**$21,715**	**10.4%**
Number of connections (thousands)	19	19.1	19.2	1.4
Total annual cost per connection (dollars)*	$1,038	$1,159	$1,129	8.8

TYPE OF COST	CALENDAR YEAR 2011	2012	2013	PERCENTAGE CHANGE 2011 TO 2013*
Golden State Water Company (Golden State)—Apple Valley area only§				
Personnel†	$779	$778	$706	(9.4)%
Operations	972	889	802	(17.4)
Water purchases	<1	26	53	100.0
Power	128	134	114	(11.0)
Water treatment	11	8	9	(21.3)
Depreciation	423	472	426	0.8
Interest expense	261	255	252	(3.4)
Allocated from main office	420	436	433	3.0
Return on investment‡	–	–	–	–
Property and income taxes	42	53	62	47.3
Totals*	**$3,035**	**$3,051**	**$2,856**	**(5.9)%**
Number of connections (thousands)	2.9	2.9	2.9	1.3
Total annual cost per connection (dollars)*	$1,060	$1,059	$985	(7.1)

TYPE OF COST	FISCAL YEAR 2010–11	2011–12	2012–13	PERCENTAGE CHANGE 2010–11 TO 2012–13*
Hesperia Water District (Hesperia)				
Personnel†	$5,117	$5,262	$5,191	1.5%
Operations	2,762	1,693	1,566	(43.3)
Water purchases	3,553	2,912	2,593	(27.0)
Power	2,074	1,882	2,028	(2.2)
Water treatment	29	20	29	(0.8)
Depreciation	3,571	3,549	3,548	(0.6)
Interest expense	828	807	1,020	23.2
Allocated from main office	1,700	1,700	1,700	0.0
Return on investment‡	-	-	-	-
Property and income taxes	-	-	-	-
Totals*	**$19,634**	**$17,824**	**$17,675**	**(10.0)%**
Number of connections (thousands)	26.2	26.2	26.2	0.1
Total annual cost per connection (dollars)*	$750	$681	$674	(10.1)

TYPE OF COST	FISCAL YEAR 2010–11	2011–12	2012–13	PERCENTAGE CHANGE 2010–11 TO 2012–13*
Victorville Water District (Victorville)				
Personnel†	$6,078	$6,310	$6,561	7.9%
Operations	2,865	5,388	3,831	33.7
Water purchases	3,632	4,320	3,974	9.4
Power	2,384	2,110	2,205	(7.5)
Water treatment	406	432	480	18.3
Interest expense	2,094	2,066	634	(69.7)
Depreciation	7,113	7,876	10,212	43.6
Allocated from main office	1,384	1,280	1,312	(5.2)
Return on investment‡	-	-	-	-
Property and income taxes	-	-	-	-
Totals*	**$25,956**	**$29,781**	**$29,210**	**12.5%**
Number of connections (thousands)	33.5	33.9	35.1	4.6
Total annual cost per connection (dollars)*	$774	$880	$833	7.6

Source: California State Auditor's analysis of each utility's relevant cost factors as reported in audited financial statements, annual regulatory reports, or other financial records.

Note: Apple Valley Ranchos and Golden State operate on a calendar year. Victorville and Hesperia operate on a fiscal year, July 1 through June 30.

* The amounts and percentages are based on numbers before rounding.

† Personnel costs include salaries and benefits, including postemployment benefits and payroll taxes.

‡ Although return on investment is not a cost of day-to-day operations, the utility includes a return as part of its rate proposal, and if approved by the California Public Utilities Commission as reasonable, the return on investment is ultimately a cost to the ratepayers.

§ For 2011 through 2013, Golden State operated its Apple Valley service area at a loss. However, Apple Valley is a small portion of one of Golden State's regional operations, which did yield a return on investment. Because its Apple Valley customers represent only 3 percent of one of Golden State's regional systems, it does not report financial information at its Apple Valley operations separately. Therefore, we worked with Golden State to estimate amounts applicable to Apple Valley.

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APPLE VALLEY RANCHOS **WATER COMPANY**™

April 14, 2015

Ms. Elaine M. Howle, CPA*
State Auditor, California
621 Capitol Mall, Suite 1200
Sacramento, California 95814

Dear Ms. Howle:

Apple Valley Ranchos Water Company (Ranchos) sincerely appreciates the opportunity to participate and work with you and your staff to provide information for your audit of costs and the processes used to establish the water rates in the high desert area around Apple Valley (Audit 2014-132). Ranchos hopes that the results of this audit will provide a better understanding of water rates and water costs in the Apple Valley area.

Ranchos also appreciates the opportunity to review a redacted draft of the report and provide comments. In general Ranchos agrees with the redacted draft of the report, however there are a few points which Ranchos believes would benefit from clarification. Therefore Ranchos provides the following comments:

Recommendations

The recommendation contained in the draft provided to Ranchos is that Ranchos document going forward cost-saving efforts and quantify, to the extent possible, any specific cost savings achieved. Because Ranchos' rates are set on a future- test year basis, Ranchos has typically estimated the impact of future cost saving measures in rate-setting proceedings and has not routinely documented quantification of cost saving resulting from prior measures which are already incorporated in current expenses. However, Ranchos agrees that it would be beneficial to inform customers of efforts to reduce costs and the results of those cost saving efforts and that providing such information to customers would be good practice for all utilities. Ranchos agrees with this recommendation.

Other Comments

1) The Title of the Report Should be Revised to Avoid Confusion 1
Ranchos is concerned that titling the report "APPLE VALLEY WATER RATES" may

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* California State Auditor's comments begin on page 51.

cause confusion. Technically there is not a valley designated as "Apple Valley"; all the
1 communities covered by this audit, City of Victorville, City of Hesperia, and the Town of Apple Valley are situated in the Victor Valley. Therefore the term "Apple Valley" would likely betaken to mean the Town of Apple Valley. Only two of the four utilities included in the audit actually serve in the Town of Apple Valley. The Audit Scope and Objectives for this audit on the State Auditor website states "The audit by the California State Auditor (state auditor) will provide independently developed and verified information related to rates charged by four water suppliers serving customers <u>in and around Apple Valley</u>." (emphasis added). In addition, Ranchos, Apple Valley Ranchos Water Company, is the only one of the four utilities which has "Apple Valley" as a part of its name, which has caused some confusion in the past. Especially given the subtitle of the report, Ranchos is concerned that people will read the title, "Apple Valley Water Rates", as indicating that the entirety of the audit, and the subtitle, applies to Ranchos. Ranchos notes that in recent prior audits of water utilities in the Antelope Valley and in Southeast Los Angeles County, geographical names used in the title were broad enough to include area served by all the utilities reviewed in the audit. Ranchos suggests that the title be revised to "WATER RATES IN AND AROUND APPLE VALLEY", "APPLE VALLEY AREA WATER RATES", or "WATER RATES IN APPLE VALLEY, VICTORVILLE, AND HESPERIA".

2) Return on Investment Is a Cost of Providing Water Service

2 On page 3 of the Draft Audit Report, it states "In addition, state law allows private utilities the opportunity to receive a reasonable return on their investment in the water utility, if approved by the California Public Utilities Commission (commission). This return on investment
2 is a component of the costs included in the water rates that customers pay." On page 22, it states "To encourage investors to invest in a private water utility. State law allows private water utilities the opportunity to receive a return on investment in their operations. Although return on investment is not a cost of operations, the utility includes a return as part of its rate proposal, and if approved by the commission as reasonable, the return on investment is ultimately passed on as a cost to the ratepayers."

While the return on investment is not an Operations Expense in accounting terminology, it is a necessary cost of providing water service. Private water utilities raise a portion of the funds necessary for replacement of aging or outdated infrastructure as equity from shareholders. The CPUC allows private utilities the opportunity to earn a reasonable rate of return because it recognizes that "In seeking equity, utilities compete with other sellers of common stock." and that "In general, it is good policy to authorize a return on equity for a water utility that is the lowest rate sufficient to permit the company to raise enough capital to provide reliable service at reasonable rates." (CPUC Decision No. 13-05-027 in A.12-05-001, AVR's most recent Cost of Capital proceeding before the CPUC, page 14).

The cost of raising funds necessary for the construction of infrastructure improvements i a cost of service for water utilities, public or private. Private companies cannot efficiently raise all necessary funds through debt, because debt becomes increasingly more expensive and more difficult to obtain the more debt you have (public water providers, which cannot utilize shareholder equity as a funding source, must maintain substantial liquidity reserves to hedge against default as a condition of the loans). The only real difference between bondholders and shareholders is that bondholders require fixed interest payments and shareholders accept the greater risk of receiving what is left. Whether raised through equity or debt, funding for infrastructure improvements is necessary to provide water service and the costs of raising the funds, either interest on debt or return sufficient to attract shareholder equity, is a cost of providing water service.

Ranchos asks that the audit report clarify the language on pages 3, 22, and footnote 2 to ②
Table A to state that, although return on investment is not an Operations Expense, it is a cost of
providing water service, a cost of raising funds for infrastructure replacement and that is the
reason the CPUC sets rates to allow private utilities the opportunity to earn a reasonable return ③
on investment.

3) Inclusion of the Return on Investment in Figure 6 is Misleading as to Costs that Private Utilities have and Public Utilities Do Not ④

The draft audit report (page 21) states "A key factor that contributes to the dissimilarity ②
in rates among the utilities is the inherent differences between private and public utilities, which
result in additional costs to the customers of private utilities, such as certain taxes and return on
investment, that are incorporated into the rates a utility charges." While income and property
taxes are legitimately described as additional costs which private water utilities have and public
utilities do not, the same is not the case for return on investment. As explained above, return on
investment is a cost of raising capital for infrastructure improvements. Public utilities also incur
the costs of raising funds for infrastructure improvements. They simply use different
mechanisms for doing so. Public utilities do not have shareholders and cannot issue equity; they
raise funds through debt, property tax assessments and connection fees. Private utilities raise
funds through debt and equity. Either way, raising funds is a necessary activity and a water
utility, public or private, will have costs to raise funds. Therefore, the costs of raising funds
through shareholder equity, the return on investment, is not an additional cost that private
utilities have and public utilities don't; it is simply a different cost for the same activity.
Describing and showing the return on equity as an additional cost that public utilities do not
have, ignores that fact that public utilities still have to raise funds and will have a cost of raising ④
those funds through debt (or, as the draft report notes, ratepayers will have a cost even if
connection fees are used), even if they do not raise the funds through equity.

Granted, the costs of raising the same amount of funds through other methods may be different. The return on investment necessary to attract equity capital is typically higher than interest rates on debt because shareholders accept more risk than do bondholders (although the necessity for public utilities to fund liquidity reserves would result in a significantly higher cost of the funds raised which are actually usable; effectively a cost of negative arbitrage on the liquidity reserved portion that must be added to the effective cost of the debt). This does not mean that all the return on investment is "additional" cost for private utilities.

5 For Ranchos, showing all the return on investment is especially misleading. As the draft
2 audit report notes (page 16) Ranchos' parent company issues all the long-term debt for itself and its subsidiaries (the CPUC is aware of this arrangement and takes it into account in setting Ranchos' rates[1]). Because its parent holds the debt, neither that debt nor the resulting interest
5 expense is reflected on Ranchos' books. Since there is no interest expense due to the long-term debt on Ranchos' books, all the costs of raising funds show as return on investment. Therefore, including the return on investment exclusively in the category of additional costs that public
6 utilities do not have is effectively the same as saying that public utilities do not have any cost of raising funds.

4 Ranchos asks that the State Auditor consider modifying the format of the tables to include the return on investment in Figure 3, along with interest on debt which is also a cost of raising funds to replace infrastructure. Alternatively, Ranchos asks that an explanation be provided, and a footnote added to Figure 6, that the return on investment is just the cost of raising funds, a cost that public utilities also have, but the cost of raising funds using a different method than that used by public utilities.

7 4) The Description of Payment for New Infrastructure in New Development is not Accurate

2 The draft audit report (bottom of page 9) includes a description of the mechanisms used by private and public utilities for payment for the cost of new infrastructure for new development. The description is not entirely accurate in the respects explained below.

Both public and private utilities require the developer to pay the costs for construction of new infrastructure directly required to provide service to a new development. The commission does allow private utilities to accept that payment from developers as an advance and reimburse developers for the cost of the new infrastructure over 40 years. Treatment of the costs as an advance results in an allowance for depreciation expense on that infrastructure in rates, however the commission only allows the advance procedure in situations where the revenue generated by the new development, through charging the utility's normal rates, will cover all the incremental costs and rate impacts of providing service to the development and existing customers are not

[1] For rate-setting purposes the CPUC assumes that AVR has the capital structure of the Park and Subsidiaries-Consolidated entity, currently estimated at 57% equity and 43% debt, resulting in a current blended weighted cost of capital (return on rate base) of 9.07%, based on a return on investment (return on equity) of 9.79% (CPUC, D. 13-05-027, page 2 & Ordering Paragraph No. 1).

negatively affected. Otherwise the private utility is required to take payment for the infrastructure from the developer as a contribution just as public utilities typically do (AVR CPUC-approved Tariff Rule No. 15, Section C.1.d).

Public utilities typically charge connection fees (charged per individual new connection or meter) in addition to requiring the developer to contribute the cost of the specific new infrastructure needed to serve the development. These connection fees are typically substantially higher than the actual cost of the individual connection or meter and the monies from connection fees may be used to fund other system improvements. Therefore, both the cost of the new infrastructure to serve the development, and additional costs of other system improvements are paid for by the customers of public utilities through the cost of their homes. 8

Ranchos asks that the description on page 9 be clarified consistent with the explanation provided above. 2 7

5) PUC Fees

The draft audit report (page 24-25) states that private utilities collect, and remit to the CPUC, a regulatory fee to fund the operations of the CPUC. The draft audit report notes that, while this fee is not part of the private utilities' rates, it represents increased costs that a customer of a private water utility pays. While it is true that customers of private water utilities pay an additional amount for this fee, they also receive services which customers of public water utilities typically do not. This user fee is designed to cover the costs of the services provided to utility customers by the CPUC, including: 2

- The consumer-advocate function, the Office of Ratepayer Advocates, which participates on behalf of ratepayers in rate increase proceedings, as well as CPUC Investigative and Rulemaking proceedings, and also routinely reviews all applications and advice letter filings of water companies to determine if it will protest and intervene;
- The Division of Water & Audits which processes advice letters and oversees compliance with CPUC decisions, general orders, and other rules;
- The ombudsman function of the Consumer Affairs Branch which responds to informal customer complaints;
- The Public Advisors Office which reviews notices to customers, runs public participation hearings, and provides help to customers who may wish to participate in proceedings.

The CPUC also:

- reviews and audits utilities' operations every three years in general rate case proceedings;
- reviews water utilities' compliance with water quality standards as part of ongoing jurisdiction;
- implements and ensures compliance with Public Utility Code sections on safety;

- maintains and enforces service standards (water pressure, customer response, etc.) through General Order 103-A
- exercises financial oversight of stock and debt issuances to ensure utilities maintain the financial capability to provide service;
- and maintains and enforces procedures for interactions between the utility and customers through the service rules in the utility's tariffs.

Customers of public utilities typically do not have the benefit of any consumer advocate function or any third-party oversight of the rates and procedures of their water provider and do not have a third-party ombudsman function available to them if they disagree with, or are unsatisfied by, responses they receive from the public utility. Ranchos notes that your letter to the Governor and legislative leaders prefacing the audit of water rates in Southeast Los Angeles County (Audit 2012-104) states:

> "Despite the water rate increases, we found that mechanisms exist for the public to provide input into rate increase, including the transparency of proposed actions and the ability to use the electoral process if not satisfied with specific outcomes, but such mechanisms could be more effective. Our review noted that the City of Los Angeles recently began using an independent ratepayer advocate to consider water rate increase proposed by the Los Angeles Department of Water and Power before higher rates are approved by the city council. Depending on the effectiveness of this advocacy, the Legislature may want to consider requiring all publicly operated water suppliers to use a similar ratepayer advocate."

Ranchos also notes that the State Audit Report on Antelope Valley Water Rates (Audit 2013-126) states (page 20) that "The procedural requirements imposed on public utilities by Proposition 218 gives property owners the right to contest such fees or charges through written protest." , but concludes " – it seems unlikely that there would ever be sufficient protests to reject a rate increase in most circumstances."

The customers of private utilities receive considerable value from regulation by the CPUC in return for the additional cost of paying the fees to fund the CPUC, which customers of
9 public utilities do not receive. Ranchos asks that this be mentioned in the audit report.

Ranchos appreciates the efforts of you and your staff in the preparation of this audit report to provide a better understanding of the differences between public and private water utilities. Ranchos submits these comments to provide clarifications that will promote that end and asks that they be given due consideration.

Respectfully,

Leigh K. Jordan
Executive Vice President
562.299.5107

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE APPLE VALLEY RANCHOS WATER COMPANY

To provide clarity and perspective, we are commenting on the Apple Valley Ranchos Water Company's (Apple Valley Ranchos) response to our audit. The numbers below correspond to the numbers we have placed in the margin of Apple Valley Ranchos' response.

1 To avoid confusion, we have modified the report title to state "Apple Valley Area Water Rates."

2 While preparing our draft audit report for publication, page numbers shifted. Therefore, the page numbers that Apple Valley Ranchos refers to in its response do not correspond to the page numbers in our report.

3 We do not believe our audit report needs clarification. As it pertains to an audit of water rates, the key point regarding a private utility's return on investment is that it is ultimately passed on as a cost to the ratepayers as we explicitly state on page 23 and on page 43 in a footnote to Table A. Similarly, in our summary comments on page 2, we state that return on investment is a component of the costs included in the water rates that customers pay.

4 We disagree with Apple Valley Ranchos' contention that the manner in which we have shown return on investment is misleading. State law allows a private utility a return on investment but not a public utility, and therefore we discuss it on page 23 as part of the section relating to costs private utilities have that public utilities do not. Further, our analysis does show the cost of interest expense incurred by the four utilities, which are their costs to raise funds through debt. Figure 3 on page 16 displays the interest expense for each of the four utilities. Therefore, it is reasonable to describe return on investment as a cost only incurred by private utilities.

5 Our report is not misleading. We discuss the arrangement Apple Valley Ranchos has with its parent company, Park Water Company, on page 17. Further, the return on investment and interest expense we present is based on financial reporting by Apple Valley Ranchos to the California Public Utilities Commission (commission), and therefore we believe it is appropriate to report.

6 Apple Valley Ranchos' statement is incorrect. In Figure 3 on page 16 we show the interest expense for each of the four utilities we reviewed. As Apple Valley Ranchos notes in its response, interest expense is the cost of raising debt, and therefore we do show the cost public utilities have in raising funds.

7 Apple Valley Ranchos' heading is misleading. Although Apple Valley Ranchos indicates that our description on page 9 of costs related to new development is not accurate, its response does not contradict our text, it only provides additional details or nuances that occur in some situations. However, the purpose of the section of the report that Apple Valley Ranchos is referring to is intended to convey the fundamental differences between private and public utilities and how those differences can affect water rates.

8 We are unclear as to why Apple Valley Ranchos has included these comments about connection fees when, in fact, the comments are consistent with our discussion of connection fees on pages 9 and 26.

9 As our report does not question the benefit that the commission provides to private utilities, we believe that our existing discussion of regulatory fees on page 25 is sufficient and does not need to be modified.

Golden State
Water Company
A Subsidiary of American States Water Company

April 15, 2015

Ms. Elaine M. Howle *
California State Auditor
California State Auditor's Office
621 Capital Mall
Suite 1200
Sacramento, CA 95814

RE: Draft Report "Apple Valley Water Rates"

Dear Ms. Howle;

Golden State Water appreciates the opportunity to provide these comments on the Draft Audit Report titled "Apple Valley Water Rates: Differences in Costs Affect Water Utilities Rates and One Utility May Have Spent Millions of Ratepayer Funds Inappropriately" (Draft Report). Golden State's comments will address three specific areas of the Draft Report.

1. Reliability of Golden State's financial information

On page 14, the Draft Report states "...because its Apple Valley customers represent only 3 percent of one of Golden State's regional systems, it does not report financial information for its Apple Valley operations separately and therefore we were unable to verify the computer-processed information provided to us. As a result, we assessed the data from Golden State to be of undetermined reliability for the purpose of calculating the average residential monthly water bill and the average annual cost per connection by category, district, and time period. ...." 1

Golden State takes exception to the auditors' comment that data provided to them regarding our Apple Valley service area was not reliable or verifiable. Golden State is a registrant with the Securities and Exchange Commission, and is therefore required to file quarterly and annual financial statements with the SEC. The annual financial statements are audited by the independent accounting firm of PricewaterhouseCoopers, and are included in the Company's Form 10-K filed with the SEC. The information provided on Apple Valley came from Golden State's books and records, which roll-up to Golden State's Region III, which then rolls-up to the consolidated Golden State financial statements filed with the SEC. 2

* California State Auditor's comments appear on page 55.

While it is true that Golden State is not required to issue a complete set of standalone financial statements for its Apple Valley service area, the information provided came from the books and records which are used
② in the consolidation of all of Golden State's operations. Therefore, the data and information provided is reliable and can be verified against the sub-consolidations records.

2. Return on Investment is a Cost

①③ Golden State strongly disagrees with the discussion on page 22 of the Draft Report pertaining to Return on Investment, in particular, the characterization that return on investment is not a cost of operation. (See
① page 22 of Draft Report) As part of the ratemaking process, the Commission authorizes utilities to earn a rate of return on the investments made in utility infrastructure. This is our Return on Investment. The
③ Return on Investment is comprised of two components: Interest payments to debt holders, and return to equity investors. Both of these are real costs of our operations. Bondholders expect to receive interest payments. Similarly, equity investors expect to receive dividends on their investments. There is no dispute in the Commission's ratemaking process that the return on investment is a legitimate cost of the operation. The Commission's role is to establish a reasonable level.

3. The Draft Report discounts the Commission Ratemaking Process

④ The recommendation in the Draft Report that Golden State should document and quantify future cost saving efforts to show customers that the Company is attempting to keep rates reasonable doesn't acknowledge the Commission's extensive and thorough ratemaking process. The Commission conducts a very detailed review of all of Golden State's costs and operations once every three years. The process takes 20 months. Every aspect of the Company's operations is subject to review by the Commission's staff. The objective is to establish rates that are "just and reasonable". Customers should already be assured that the Commission's oversight is aimed at keeping rates reasonable.

This concludes our comments. Once again, thank you for the opportunity to review the Draft Report and provide our comments.

Sincerely,

Keith Switzer
Vice President, Regulatory Affairs

Ltr49615

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE GOLDEN STATE WATER COMPANY

To provide clarity and perspective, we are commenting on the Golden State Water Company's (Golden State) response to our audit. The numbers below correspond to the numbers we have placed in the margin of Golden State's response.

1 While preparing our draft audit report for publication, page numbers shifted. Therefore, the page numbers that Golden State refers to in its response do not correspond to the page numbers in our report.

2 We do not conclude that Golden State's data is unreliable. Audit standards require that we assess the sufficiency and appropriateness of computer-processed information that we use to support our findings, conclusions, or recommendations. As we state on page 13, we did not perform accuracy and completeness testing on Golden State's data because this audit is a one-time review, and testing the number and variety of data systems used in this audit would be cost-prohibitive. Similarly, although we could have reviewed the process which Golden State used to extract Apple Valley-specific data from its consolidated financial information and verified the consolidated information to its financial statements, we did not do so because the audit is a one-time review. As such, we assessed Golden State's data to be of undetermined reliability for the purposes of our audit. We have modified the text on page 13 to clarify this conclusion.

3 To increase clarity, we have revised our text on page 23 to indicate that a private utility's return on investment is not a cost of operations, by which we mean the costs required for the day-to-day provision of water service, but is ultimately passed on as a cost to the ratepayers. Further, we exclude return on investment from other costs shown in Figure 3 on page 16, such as personnel and interest expense, because it is a cost only to private utilities. Finally, our report discusses the California Public Utilities Commission's (commission) role in the process. We state on pages 8 and 23 that as part of the rate-setting process the commission reviews and sets a reasonable return on investment for the utility.

4 On pages 27 through 29, we acknowledge the role the commission plays in reviewing private utilities' costs.

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City of Hesperia

Gateway to the High Desert

April 14, 2015

California State Auditor *
Elaine M. Howle, CPA
621 Capitol Mall, Suite 1200
Sacramento, CA 95814

Dear Ms. Howle:

In response to the draft report, titled "Apple Valley Water Rates: Differences in Costs Affect Water Utilities' Rates and One Utility May Have Spent Millions of Ratepayer Funds Inappropriately", the Hesperia Water District provides the following response:

The audit identifies that private utilities have the ability to offer low-income assistance programs and recommends that Hesperia Water District consider a similar program utilizing funding from other sources, such as the City's General Fund. The purpose of a low-income assistance program is to help customers with the cost of their service. Another way to provide assistance is to maintain low water rates for our customers. 1

The Apple Valley Ranchos Water Company (AVRWC), which is also included in this audit, does offer a low-income assistance program. The program offers a reduction of their water bill of $13.38 (bi-monthly) for qualified customers. The following is a comparison of Hesperia Water District and AVRWC rates, both with and without the AVRWC low-income assistance reduction at four different bi-monthly usages (HCF refers to one hundred cubit feet):

Agency	10 HCF	24 HCF	50 HCF	86 HCF
Hesperia WD	$48.27	$69.97	$113.57	$183.41
AVRWC w/o reduction	$79.06	$123.27	$212.92	$348.62
AVRWC w/ reduction	$65.68	$109.89	$199.54	$335.24

As shown in the table above, Hesperia Water District rates are substantially lower than AVRWC even when the low-income assistance program is factored in. We believe it is more important that water rates are maintained at a level where they are affordable, than to establish rate assistance programs needed to offset the higher cost of water, such as those used by for-profit entities including AVRWC. 1

A second recommendation of the audit references Hesperia's documentation of cost saving efforts. We believe this recommendation is in response to the fact that Hesperia Water District implemented cost savings measures during the audit review period that allowed it to continue operations without the need to raise rates, but that the quantified dollar amount of the savings could not readily be provided. We are somewhat perplexed by this comment since the audit

Eric Schmidt, Mayor
Bill Holland, Mayor Pro Tem
Russell Blewett, Council Member
Mike Leonard, Council Member
Paul Russ, Council Member

Mike Podegracz, City Manager

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* California State Auditor's comments appear on page 59.

City of Hesperia

2 does mention the Hesperia Water District's reduction in personnel costs due to salary and benefit reductions, the practice of the City leasing water to the District at below market rates, and that electrical costs have not increased for several years by pumping during off-peak periods. These are all demonstrated actions taken by the Hesperia Water District to maintain our low water rates. Additional Hesperia Water District staff resources could have been assigned the task of projecting a quantified dollar savings for each of these measures undertaken but the real result is in keeping water rates low for Hesperia Water District customers by focusing the District's limited resources on efficiently providing water to our customers.

Although not quantified, these cost savings measures enabled the Hesperia Water District to continue operations at the District's existing low rate structure, without the need to raise rates during the audit review period.

Sincerely,

Mike Podegracz
City Manager

Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE CITY OF HESPERIA

To provide clarity and perspective, we are commenting on the city of Hesperia's response to our audit. The city manager is also the general manager of the Hesperia Water District (Hesperia) and is speaking on behalf of it. The numbers below correspond to the numbers we have placed in the margin of Hesperia's response.

Hesperia is correct in its assessment that low-income assistance programs help customers with the cost of service, which is why it should consider creating such a program. Regardless of the rates of other utilities in the area or its current rates, we believe Hesperia should consider helping those most in need by providing a low-income assistance program. 1

As we state on page 27, without documenting the savings from its cost-saving measures, the water utilities cannot demonstrate to ratepayers the positive impacts of their efforts to minimize costs and ensure that rates remain reasonable. While Hesperia has not had to raise its rates recently, it may need to do so in the future and quantifying its cost savings could be helpful in demonstrating to ratepayers its efforts. Further, as we note on page 27, during the audit Hesperia's assistant city manager agreed that quantifying cost-saving measures could be helpful. 2

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April 10, 2015

Elaine M. Howle, CPA *
California State Auditor
621 Capitol Mall, Ste. 1200
Sacramento, CA 95814

Ms. Howle:

I was shocked to receive the final, redacted draft report on Apple Valley Water Rates in which the City of Victorville ("City") was asked to voluntarily participate and in which, by necessity the Victorville Water District ("VWD") did participate. The title of the report alone is so salacious it belongs on a supermarket tabloid rather than on a professional audit by a state agency. It is irresponsible and unprofessional to use a report, the original purpose of which was to compare water rates, to sensationalize past issues of the City. Despite the City's and the VWD's open and willing participation in the audit, it is clear just from the title alone that the State Auditor's intent is to, for reasons unknown, damage the VWD and City. (1)

It is my understanding from discussions with your staff during our exit conference that the VWD is afforded an opportunity to respond, in writing, and that this response will be attached to the end of your report. I was also asked by your staff to notify them of any factual errors "offline", (2) not in this letter, so that they can correct the report. In light of the VWD's and the City's several (3) prior attempts to set the record straight and correct the ill assumptions of the auditors, the VWD and City are hereby declining the opportunity to correct your staff, yet again, as such attempts will only result in the misuse of facts. In a purported effort to be fair and accurate, your staff has repeatedly sent or hand-delivered sections of the draft report, requesting that the VWD and City respond. I, alone, count at least nine emails asking for such review and correction from me and I (3) suspect other VWD and City staff were asked to do the same, as well as several phone calls to discuss errors and corrections. Our final review came during our exit conference wherein we reiterated our concerns over statements in the report we believe to be inaccurate and misleading. Further, to add insult to injury, I was astonished that the State Auditors had its general counsel (4) present without prior knowledge or notification of City and VWD staff; meanwhile, the VWD general counsel was not invited to participate in the exit conference.

During this entire process, staff and I were led to believe if we found factual errors in the draft report, that it could be modified to correct such errors/omissions. To our dismay, this was not the truth. Instead, the sum of all of these reviews by VWD and City staff and legal counsel (5) resulted in nothing more than minor, qualifying modifications such as the words "may have"

* California State Auditor's comments begin on page 65.

rather than outright claiming the VWD violated Proposition 218, as prior drafts claimed. Other
(5) corrections or clarifications have been ignored by your staff over the course of this audit,
especially if they undermined some of the more scurrilous claims. Had it not been for the
(3)(5) genuine effort of the VWD and City staff correcting and re-correcting ill-founded assertions
made by your staff, the report would have stated that the VWD raised rates due to the internal
borrowing that occurred and that the VWD violated Proposition 218 as a result. As your report
(6) clearly shows, the VWD did not raise rates, and as the VWD clearly demonstrated to your legal
counsel, the VWD did not violate Proposition 218. Instead of removing this content, in a
(7) desperate attempt to find damage caused by the borrowing, your staff qualified the report by
claiming deferred maintenance harmed our customers. Specifically, on page 40 of the draft audit,
your staff cites a report from the California Department of Public Health whose inspection noted
the system was "adequately maintained and operated". The auditors ignored the fact that the rate
deferral was a function of politicians hesitant to increase rates, and cause harm to customers,
during a catastrophic economic recession.

(8) VWD and City staff have repeatedly explained that the loans were not considered by the City Council as part of the Proposition 218 process, which was undertaken in 2008. The loans were put in place in subsequent years and therefore could not have been part of the rate increase that was approved by the voters in 2008. Your staff conveniently chose to omit the Proposition 218 majority protest process off the timeline in Figure 7 of the report. If they had included it perhaps they would have noticed that, as VWD and City staff pointed out to them on several occasions, the loans that were made occurred after the Proposition 218 process and therefore could not have had a bearing on the current water rates. The rate study currently underway, which will also be subject to the Proposition 218 process, also does not include the loans as a factor in determining the rates. While it may be marginally defensible to say Proposition 218 "may have" been violated, it is more accurate to say it has not.

(9) In the course of the audit, your staff did not care to examine the options available to the City Council at the time the loans were made. Many times, City Councils are faced with the immediate need to make an important decision and, though all of the options and arguments may be viable, they must choose one over the other. Similarly, there are many times all of the options are not optimal but the City Council must still pick the best possible option for their constituents or ratepayers. The borrowing that occurred in 2009 and 2010 clearly were not the preferred options for the City or VWD. Admittedly, many of the issues that occurred were self-inflicted by previous management's poor administration of finances. Unfortunately, due to poor prior management, the City Council was faced with only unappealing options. The borrowing that was undertaken was done so out of necessity after all other options had been exhausted. The only alternative was to either default on a sizeable contract or enter into a private placement financing deal at an interest rate of 10%-12%. Therefore, the City Council made the most prudent choice under the circumstances.

Perhaps the most unfortunate result of this audit is notoriety from producing a scathing audit and
the inability of your staff to let go of baseless notions that will distract the public from the
(10) original and primary purpose for the audit as prescribed by the Joint Legislative Audit
Committee. The request and scope of the audit, as denoted on page 15, was an audit of water
rates — which Victorville has managed to keep flat during some of the most difficult and trying

times for our ratepayers. I cannot know how VWD's rates compare to the other agencies in the report until the final report is made public; however, I believe the VWD rates are highly competitive with the other agencies, whether compared to the full rate or any assistive low-income rate. Instead, the public's likely focus will be on the misguided and unnecessary forensic audit of Victorville's unfortunate past temporary financing needs. These issues have been well- ⑩
documented by a total of three County Grand Juries, a forensic auditor, and a performance auditor, not to mention a variety of other oversight bodies. Rather than letting those findings rest, the California State Auditor chose to dredge up the findings, restate them with perhaps a slightly ⑪
different nuance, and publish them in a report whose purpose will be overshadowed by these restated issues.

Lastly, in reading some of the other audits performed by the California State Auditor, I noticed ⑫
some alarming mishandling of the comments submitted by past auditees. We have been told that our response letter would be attached to the back of the audit for the public to see as a sort of rebuttal or response. In reading some of the audits, I was appalled to find comments that were summarized, rather than printed in their entirety. Please do not edit this letter prior to publication or summarize it. The public has a right to know everything we've done to try to correct the misstatements in this audit. I also found additional editorial comment from the California State Auditor presented following the rebuttal letter in what feels like a feeble attempt to have the final word in a petty argument.

For all the reasons stated above, the VWD and City will not repeat corrections or provide additional correction to the draft report "offline". The VWD and City will instead provide further ②
comment on the report via an Open Letter to the California State Auditor upon the final release of the audit on Apple Valley Water Rates. After having our past corrections used only to refine the audit findings in ways to strengthen the auditor's ability to defend against our rebuttal, I see no reason to continue to assist in this manner.

Regards,

Douglas B. Robertson
City Manager

cc: City Council/VWD Board
California State Auditor staff

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Comments

CALIFORNIA STATE AUDITOR'S COMMENTS ON THE RESPONSE FROM THE CITY OF VICTORVILLE

To provide clarity and perspective, we are commenting on the city of Victorville's (city) response to our audit. The city manager is also the general manager of the Victorville Water District (water district) and is speaking on behalf of the water district.[7] The numbers below correspond to the numbers we placed in the margin of the response.

We strongly disagree that the report is irresponsible, unprofessional, or sensationalizes past issues. The audit was conducted according to Government Auditing Standards and the California State Auditor's thorough quality control process. In following audit standards, we review past audit reports to identify issues relevant to our scope. In this instance, we noted a past audit report citing concerns related to two loans that the water district made to the city. In following up on the resolution of those loan transactions, as we state on page 36, we determined that the city had not implemented a recommendation for changes to its interfund loan policy even though it indicated it would. Further, as we state on pages 34 and 35, during the same time the water district loaned $21.9 million to the city, it borrowed $20 million from the Southern California Logistics Airport Authority (Airport Authority) at a much higher interest rate. As a result of these loans, the water district paid more than $4.6 million in excess interest for a loan that it may not have needed had it not loaned money to the city. Although the city manager considers this a past issue, the water district has not yet recovered the $4.6 million in excess interest it paid from the city to make the ratepayers whole. As we state on page 35, after we discussed these issues with the water district, it approved items at its April 7, 2015, meeting establishing a 21-year repayment plan addressing the excess interest. At the same meeting, the city council adopted a revised interfund loan policy. 1

By "offline," the city manager refers to our standard process of asking auditees to inform us of any statements in the draft report that they believe are inaccurate, and to the extent we agree based on a review of the pertinent evidence the auditee provides to us, we modify the report accordingly. Further, we reviewed and considered all of the documentation provided by the city and the water district and consider the report an accurate reflection of that information. 2

7 Although we use the term *Victorville* to refer to the Victorville Water District earlier in the report, because of the involvement of the city of Victorville here, we refer to the city of Victorville as *the city* and the Victorville Water District as *the water district* in these comments.

3 The response mischaracterizes our interactions during the audit regarding requests for confirmation of discussions. Consistent with our process on every audit, we confirm the accuracy of the information we have received from oral interviews and clarifications needed on documentation we review. We encourage auditees to correct and clarify the information if they believe it does not accurately depict what they told us or shared with us. This is part of our standard process to ensure that we present accurate information. The city manager's statement that he counted nine emails asking for such review and correction, if applicable, is consistent with this process.

4 In scheduling exit conferences, it is our practice to inform the auditee that management may invite those individuals it believes are appropriate and that would certainly include an auditee's legal counsel. We informed the city manager's assistant who arranged the exit conference more than a week in advance of the meeting that our legal counsel would be in attendance to address any legal questions. Further, we discussed our anticipated findings with the city manager in advance of the exit conference, and given the legal nature of some of the findings, it is unclear why he was "astonished" that our legal counsel was present. Because the city's legal counsel did not attend, our legal counsel reached out by telephone shortly thereafter to discuss our findings. These discussions occurred nearly four weeks prior to the publication of our final audit report.

5 The city manager is incorrect in stating that we ignored corrections or clarifications. We reviewed all documentation provided; however, we believe all our conclusions are fully supported and factually correct.

6 The response incorrectly states that the water district clearly demonstrated to our legal counsel that it did not violate Proposition 218. As we state on page 38, it is our view that the primary purpose for constructing the wastewater treatment plant (wastewater plant) was to meet the wastewater needs of the beverage company and not to produce reclaimed water, a side benefit that has not yet been realized. Because the water district has not yet sold reclaimed water and because it used revenue from water delivery fees to construct the wastewater treatment plant, the water district may be in violation of Proposition 218.

7 The claim that we made a "desperate attempt to find damage caused by the borrowing" ignores the very real harm caused by loans involving the water district. As we describe on pages 34 and 35, the ratepayers of the water district were harmed by $4.6 million in excess interest the water district paid on a $20 million loan it obtained from the Airport Authority at a 7 percent interest rate compared to the $21.9 million it loaned to the city at the same time

at a variable interest rate that fluctuated between 0.28 percent and 0.9 percent. Additionally, as we state on page 35, during the period the loans were outstanding, the water district deferred replacing assets as well as deferred routine maintenance on the water system. Moreover, as we state on page 39, in a 2014 report to the water district board, staff cited the deferred maintenance and asset replacement over the past four years as one of the reasons to implement a deferred rate increase. It also cited the negative results of the letter report from the California Department of Public Health as one of the reasons it was no longer in a position to continue deferring maintenance and replacement activities.

We are well aware that the loans occurred after the last Proposition 218 process in 2008, and our report does not indicate the loans affected the process at that time. However, Proposition 218 does not only specify the process local governments use to raise rates, it also governs how they spend ratepayer funds. As we state on page 38, because the water district has not yet sold reclaimed water and because it used revenue from water delivery fees to construct the wastewater plant, the water district may have violated Proposition 218. As such, the city manager's discussion of the 2008 rate increase process is not on point. 8

The statement that we did not care to examine the options available to the city council at the time the loans were made is not true. Although the city council believes it made the most prudent choice when faced with tough decisions in deciding what to do about the sizeable contract it was about to default on, its choice was not the most prudent choice for the water district. As we state on page 36, the city council and the water district are separate legal entities, and their governing boards must make the best decision for each. The entity that was responsible for the contract was the city, not the water district. However, the water district was the entity that had to bear the burden when the city's options became exhausted. What may have been prudent for the city was not prudent for the water district, which the response fails to acknowledge. 9

Although the city manager attempts to portray the issue as in the past, the city has yet to reimburse the water district the $4.6 million in excess loan interest that harmed the ratepayers and has only reimbursed the water district $4.5 million of the $31 million spent to build the wastewater plant. As we indicate on page 38, after we discussed our concerns with the water district, the water district approved a repayment plan in April 2015 covering most of the water district's costs related to the wastewater plant. However, the repayment plan shows that the reimbursement will occur over 21 years. 10

11 The city manager's response is misleading when it states that we are dredging up old findings and restating them with a slightly different nuance. As noted in comment number one on page 65, audit standards require that we review past audit reports to identify issues relevant to our scope. In this instance, we noted a past audit report citing concerns related to two loans that the water district made to the city. As a result of these loans, the water district paid more than $4.6 million in excess interest for a loan that it may not have needed if it had not loaned money to the city. Although the city manager considers this a past issue, the water district has not yet recovered the funds from the city to make the ratepayers whole. Additionally, our audit is the first to address issues surrounding the $31 million the water district spent on a wastewater treatment plant for the primary purpose of aiding a beverage manufacturer. Further, as we note on page 38, the water district has only recovered $4.5 million of the $31 million it cost to build the plant and has yet to realize a reclaimed water benefit for its water ratepayers.

12 It is unclear what the city manager is referring to when he indicates some audit report responses he reviewed were summarized. It is possible he was reviewing responses to our investigative reports, which are appropriately summarized because the original responses contain confidential information. However, our standard practice with respect to performance audits we conduct is to include responses to audits in their entirety, as we have done here.