



## *California Public Utilities Commission*

It Could Improve the Transparency of Water Rate  
Increases by Disclosing Its Review Process and  
Ensuring That Utilities Notify Customers as Required

*December 2018*

**REPORT 2018-118**





**CALIFORNIA STATE AUDITOR**

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December 18, 2018  
*2018-118*

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 the California Public Utilities Commission's (CPUC) water ratesetting process for investor-owned companies that serve water customers. The CPUC regulates investor-owned water companies (water utilities) and authorizes the rates water utilities may charge customers. To facilitate this authorization process, the CPUC requires large water utilities that serve more than 10,000 connections each, or Class A water utilities, to submit a formal request to change the rates they charge to customers. It requires water utilities to submit these requests, known as general rate case applications, to the CPUC every three years. The CPUC allows small water utilities that serve fewer than 10,000 connections each—Class B, C, and D water utilities—to submit informal requests known as advice letters to change their rates. This report concludes that although the CPUC's general rate case process appears reasonable and it appropriately followed and documented key steps in its processes, it has not provided customers with clear information about water rate increases or its processes for approving those rate changes.

We concluded that the CPUC does not provide sufficient information to customers about why and by how much its general rate case decisions will change their rates over time. Further, the CPUC does not provide customers with readily accessible information related to its regulation of water rates, including the general rate case and advice letter processes. Without this information, customers may not understand how the CPUC reviews and approves water rates proposed by water utilities, or how they can participate in the process. In addition, the CPUC has not ensured that water utilities notify customers about proposed rate increases and public participation hearings—which are conferences that give customers an opportunity to share their perspective on the requested rate change—as required. Because the CPUC does not verify that water utilities are complying with regulations related to publishing notification of public participation hearings in local newspapers, it lacks assurance that customers have the necessary information at the appropriate time to participate in public hearings. In fact, we found that several of the utilities we reviewed did not provide timely notification to customers, which may have limited their participation.

Finally, the CPUC relies on reviews that its independent Public Advocates Office conducts of general rate cases to fulfill its statutory requirement to conduct audits of Class A water utilities. However, because these reviews are not audits, the CPUC risks that it is not fulfilling the intent of the law. Further, the CPUC does not conduct audits of Class B, C, and D water utilities as frequently as required. These audits can provide the CPUC with a better understanding of how water utilities operate, which can influence whether the CPUC approves a utility's request to raise its rates.

Respectfully submitted,

A handwritten signature in black ink that reads "Elaine M. Howle". The signature is written in a cursive, flowing style.

ELAINE M. HOWLE, CPA  
California State Auditor

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## CONTENTS

Summary	1
Introduction	3
The CPUC Has Not Provided Customers With Clear Information About Water Rate Increases and Its Process for Approving Rates	9
The CPUC Has Not Ensured That Water Utilities Notify Customers About Public Hearings and Proposed Rate Increases as Required	15
The CPUC Has Not Conducted Audits of Water Utilities as Required	21
Other Areas We Reviewed	25
Scope and Methodology	29
<b>Response to the Audit</b>	
California Public Utilities Commission	33

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## SUMMARY

The California Public Utilities Commission (CPUC) regulates privately owned electric, natural gas, telecommunications, water, railroad, rail transit, and passenger transportation companies, and other utilities in the State. As a part of its oversight of water companies, the CPUC regulates 98 privately owned water companies (water utilities), which serve about 14 percent of Californians throughout the State. State law requires the CPUC to verify that a water utility's proposed rates are just and reasonable before it permits the utility to change its rates. The CPUC performs this verification through a process referred to as a *general rate case proceeding*, and water utilities submit advice letters to implement changes to their rates and operations. For this audit, we reviewed whether the CPUC's ratesetting processes are reasonable, appropriate, and transparent to the public.

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### **The CPUC Has Not Provided Customers With Clear Information About Water Rate Increases and Its Process for Approving Rates**

Page 9

The CPUC could do more to provide customers with understandable information about the reasons their water rates are changing, its general rate case process, and the advice letters that authorize changes to water rates. At present, it does not clearly disclose to customers the full impact that its decisions may have on water rates and it has not made information about its ratesetting processes readily available.

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### **The CPUC Has Not Ensured That Water Utilities Notify Customers About Public Hearings and Proposed Rate Increases as Required**

Page 15

The CPUC does not verify whether water utilities comply with regulations related to certain types of notifications to the public. The CPUC requires water utilities to provide these notifications and to do so within a specified time frame. However, several of the utilities we reviewed did not always provide timely notifications to customers, thereby possibly limiting the ability of those customers to offer comments and participate effectively in the ratesetting process.

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### **The CPUC Has Not Conducted Audits of Water Utilities as Required**

Page 21

The CPUC does not conduct audits of large water utilities; instead, it relies on its independent Public Advocates Office's (Public Advocates) review of these utilities during general rate case proceedings.

However, the CPUC's chief compliance officer expressed concern that the Public Advocates' reviews do not meet the intent of a law requiring periodic audits of these utilities. In addition, the CPUC has not conducted audits of all the smaller water utilities as frequently as required by law. Without timely and effective audits, the CPUC lacks assurance that these water utilities are complying with applicable requirements, which could affect the rates and service that customers receive.

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### **Other Areas We Reviewed**

We reviewed the reasonableness of the three-year term for the general rate case, as well as the CPUC's processes for reviewing water utility infrastructure projects and for ensuring that the costs of capital factored into the ratesetting process are representative of actual and necessary costs. We did not identify a need for the CPUC to modify its three-year general rate case term or find any issues with its processes concerning costs of capital or reviewing infrastructure projects.

### **Summary of Recommendations**

By May 2019, the CPUC should begin to publish after each general rate case a summary of why, and by how much, water rates will change as a result of the proceeding.

By July 2019, the CPUC should make information about the general rate case process and advice letters more understandable to the public.

The CPUC should implement a process by May 2019 to verify that water utilities are providing their customers with timely notifications of rate increases and public hearings.

The CPUC should begin to audit Class A water utilities, or develop policies and procedures by May 2019, to ensure that the Public Advocates' reviews of Class A water utilities provide appropriate assurance as intended by the law. The CPUC should ensure it completes audits of all small water utilities as required.

### **Agency Comment**

The CPUC agreed with our recommendations and indicated that it plans to implement them.

# INTRODUCTION

## Background

The California Public Utilities Commission’s (CPUC) mission is to regulate services and utilities, protect consumers, safeguard the environment, and assure that Californians have access to safe and reliable utility infrastructure and services. The CPUC, which was established by a constitutional amendment in 1911, includes five members (commissioners) serving six-year terms who are appointed by the Governor and approved by the Senate. It regulates privately owned—also known as *investor-owned*—electric, natural gas, telecommunications, water, railroad, rail transit, and passenger transportation companies along with other utilities in the State, and it authorizes the rates these utilities may charge. The CPUC obtains its funding by imposing fees on the public utilities it regulates. This audit focuses on CPUC’s regulation of privately owned water companies (water utilities) through its ratesetting processes.

## State Regulation of Private Water Utilities

Many Californians receive their water through water utilities. Specifically, as of October 2018, there were 98 water utilities serving an estimated 5.6 million Californians, or 14 percent of the State’s population, in both rural and urban areas of California, including parts of Sacramento County, the San Francisco Bay Area, and Los Angeles. The CPUC categorizes these 98 water utilities into four classes based on their number of service connections, which represent buildings that receive water from a utility, as shown in Table 1. Almost all customers that receive water from private water utilities receive their services from the nine large water utilities that comprise Class A. The Class B, C, and D water utilities (small water utilities) serve fewer than 10,000 connections each and collectively serve 57,000 customers. About half of the Class A water utilities have multiple districts or areas to which they provide services. For example, in 2018 the largest Class A water utility, California Water Service Company, was serving 21 districts throughout California ranging from Chico to the Antelope Valley, while the San Jose Water Company was providing services to customers in only one district in the San Jose area.

**Table 1**  
**Class A Utilities Serve the Most Connections**

CLASS	NUMBER OF SERVICE CONNECTIONS	NUMBER OF WATER UTILITIES	TOTAL SERVICE CONNECTIONS
A	More than 10,000	9	1,456,600
B	Between 2,000 and 10,000	5	27,700
C	Between 500 and 2,000	22	21,400
D	Fewer than 500	62	8,000
<b>Totals</b>		<b>98</b>	<b>1,513,700</b>

Source: Amounts reported by the CPUC as of August 2018.

### The Roles and Responsibilities of Key Players in the CPUC's Water Ratesetting Processes

- **The commissioners:** Governor appointees who issue decisions and adopt resolutions for the CPUC, such as approving a general rate case.
- **Administrative Law Judges (ALJs):** Preside over cases, such as a general rate case, and draft proposed decisions for action by the commissioners.
- **The Water Division:** Performs research, analysis, and assessments of regulated water utilities, including reviewing advice letters, and communicates the results to the commissioners.
- **The Public Advocates Office (Public Advocates):** An independent entity within the CPUC that represents and advocates on behalf of the interests of water customers to obtain the lowest possible rate for service consistent with reliable and safe service levels, such as providing recommendations to the commissioners for a utility's proposed rate change.

Source: The CPUC's website and documents related to general rate case and advice letter processes.

In total, the CPUC regulates more than 1.5 million water utility service connections. As a part of its responsibilities, state law requires the CPUC to determine whether a water utility's proposed rates are just and reasonable before the utility can change the rates it charges its customers. To facilitate this determination, the CPUC has a process referred to as a *general rate case proceeding* to evaluate those proposed rate changes. Once the commissioners have issued a decision for a general rate case, the CPUC requires water utilities to submit informal requests known as *advice letters* to change their water rates. We describe the key players in these processes in the text box.

### General Rate Case Proceedings

State law requires the CPUC to establish a schedule that requires Class A utilities to file a general rate case application every three years. To facilitate the three-year review period, the CPUC has set a timeline for the various stages of the review process, which starts with the submission of a proposed application as shown in Figure 1. The CPUC's estimated length for a proceeding is about 340 days for a single-district

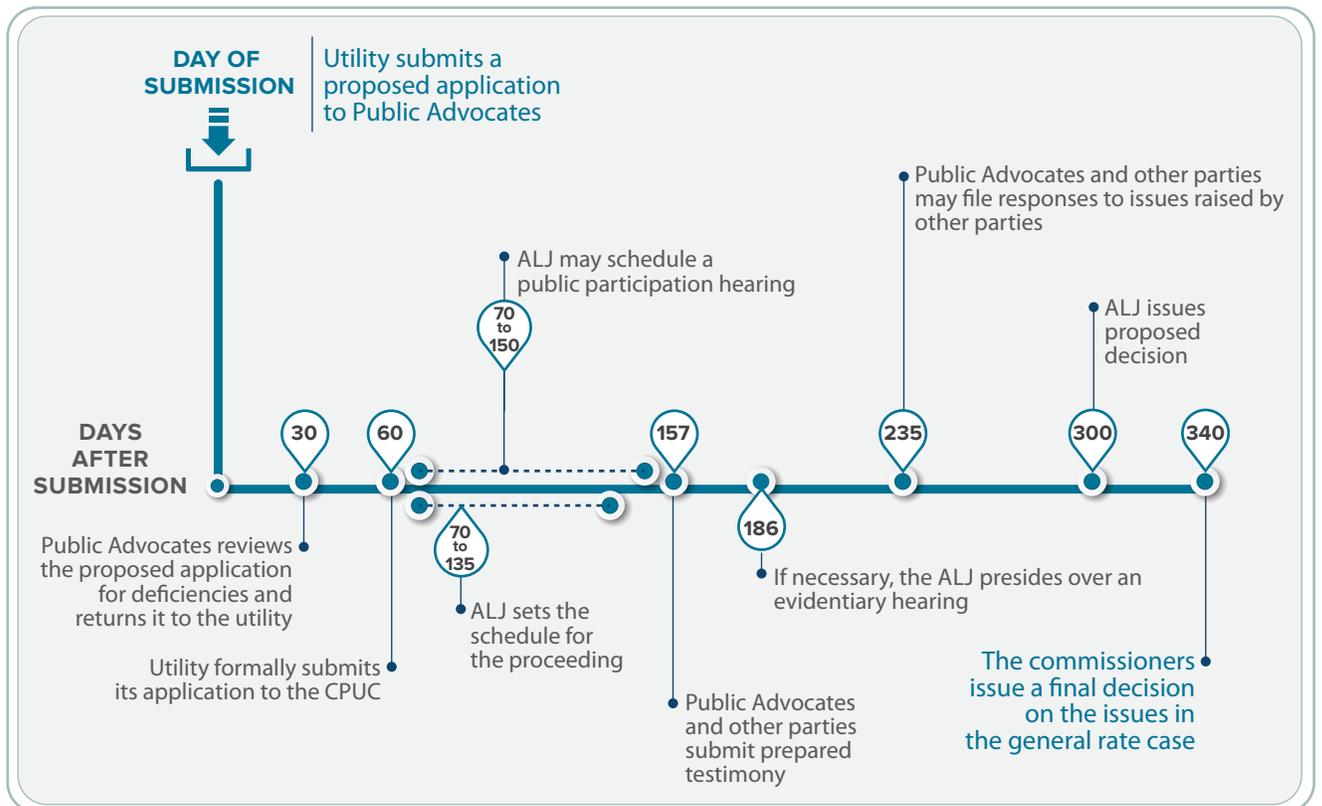
Class A water utility and about 560 days for a multidistrict utility before the commissioners issue a formal decision. The proceedings may take longer if commissioners issue any extensions during the process.

In addition to the timeline of the process, the CPUC outlines the various steps and parties involved in general rate case proceedings as well as a list of requirements a water utility must satisfy in its general rate case application. Before the utility submits its formal application, the Public Advocates Office reviews the proposed application for any deficiencies. Once Public Advocates determines that the water utility's application meets the requirements set out in the rate case plan, the utility can submit its formal application to the CPUC. After receiving the formal application, the CPUC generally holds several hearings. For example, to begin the proceeding, an ALJ holds a conference to set the schedule for the proceeding.<sup>1</sup> The ALJ may also schedule a public participation hearing to allow customers to raise concerns about the general rate case proposal or the water utility's operations. If a general rate case application does not include material changes from the prior general rate case, an ALJ may determine that a public participation hearing is unnecessary. Once Public Advocates and other

<sup>1</sup> Regulations allow a commissioner to preside over a general rate case with, or instead of, an ALJ. For all nine general rate cases we reviewed, an ALJ presided over the proceedings. Therefore, for the purposes of this report, we refer to the ALJ as the presiding officer over general rate cases.

parties to the proceeding submit their prepared written testimony, the ALJ may elect to hold an evidentiary hearing, which is a series of oral presentations by the parties to the proceeding that include testimony on the evidence they have presented. After all hearings during a proceeding have concluded, the ALJ prepares a proposed decision outlining his or her recommendation for the commissioners that includes a discussion of relevant issues raised in the proceeding. The commissioners issue a final decision (CPUC decision) on the proceeding based on a majority vote.

**Figure 1**  
CPUC’s General Rate Case Proceeding for Class A Single-District Water Utilities Is Estimated to Take Nearly a Year to Complete



Source: The CPUC’s decision #07-05-062 outlining the general rate case process for Class A water utilities, and documents related to the nine general rate cases we reviewed.

Note: This timeline represents the CPUC’s estimated schedule of a general rate case proceeding for a single-district utility; however, the CPUC allows the ALJ to modify this schedule if necessary. According to the CPUC, the time frame for a proceeding involving a utility with multiple districts is approximately six months longer due to its additional complexity.

### Categorization of Advice Letters

Water utilities also file advice letters to request approval from the CPUC to change their rate structure, including rate increases or decreases, or to change their service terms or conditions. One of the primary uses of an advice letter is for a water utility to change rates as previously authorized by a statute or a decision by the commissioners, such as a decision that the CPUC issues at the end of a general rate case. The CPUC also allows small water utilities to use the advice letter process as an alternative to the more formal general rate case process because these utilities are less complex than Class A water utilities. A water utility may also submit an advice letter for other reasons that do not impact rates, such as a transfer of ownership or the offering of a new service.

The CPUC classifies advice letters into three categories, referred to as tiers, based on how the CPUC processes and approves them. Tier 1 advice letters—the most common—take effect upon filing and water utilities often submit them to comply with a CPUC decision, such as increasing rates to reflect changes in the Consumer Price Index. In contrast, Tier 2 and Tier 3 advice letters require CPUC staff review and disposition before they can take effect. The Division of Water and Audits (Water Division) has the authority to approve Tier 2 advice letters because the requests generally do not impact rates, such as when a water utility updates its service area map. As a result, these types of advice letters have high approval rates.

Tier 3 advice letters, which are more complex than advice letters for other tiers, require the passage of a formal resolution by commissioners for approval. For example, a small water utility may submit a Tier 3 advice letter for an informal general rate case to increase rates, or a Class A utility may submit one to petition to change a CPUC resolution. According to Public Advocates, it is not involved in the advice letter review process but it can receive notification of proposed rate changes as a result of advice letters and occasionally files a protest to an advice letter. We present the number of advice letters submitted by water utilities by tier from fiscal years 2015–16 through 2017–18, and the percentage the CPUC had approved as of November 2018, in Table 2.

**Table 2**  
**Most Advice Letters Are Approved**

CLASS	FISCAL YEAR					
	2015-16		2016-17		2017-18	
	SUBMITTED	APPROVED	SUBMITTED	APPROVED	SUBMITTED	APPROVED
1	241	98%	215	98%	226	97%
2	85	94%	104	94%	62	95%
3	55	87%	30	83%	36	47%*
<b>Totals</b>	<b>381</b>		<b>349</b>		<b>324</b>	

Source: Analysis of the CPUC's advice letter data.

Note: Although the CPUC may modify an advice letter before approving it, the CPUC does not track whether it modified the terms of an advice letter before approval. Therefore, we do not present this information in the table above.

\* According to the Water Division, as of November 2018, 12 advice letters were still pending a formal resolution by the commissioners, which explains the lower approval rate for fiscal year 2017-18.

### Infrastructure Investment Reviews

To better provide services to their customers, water utilities may undertake infrastructure improvement, repair, or installation projects (infrastructure projects), such as a new water metering system, reservoir replacement, or pipeline replacement. State law requires the CPUC to determine whether such infrastructure projects, once completed, are being used and are useful for the utility's operations. Once the CPUC makes this determination, the utility may increase its rates to reflect the cost of such a project. The CPUC may make this determination during a general rate case proceeding if the utility requests in its application to include the cost of an infrastructure project as a part of its proposed rate change. However, a utility may also submit an advice letter to obtain a rate increase to reflect the costs of an infrastructure project.

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## The CPUC Has Not Provided Customers With Clear Information About Water Rate Increases and Its Process for Approving Rates

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### Key Points:

- The CPUC's general rate case process appears reasonable and the CPUC appropriately followed and documented key steps in its process for the general rate cases we reviewed. However, the CPUC does not provide water utility customers with clear and concise information about the complete impact its general rate case decisions will have on their rates over time.
- The CPUC also does not provide the public with readily accessible information related to its regulation of water rates, including the general rate case and advice letter processes. Without this information, customers may not fully understand how the CPUC reviews and approves water rates proposed by water utilities or how they can participate in these processes.
- The CPUC has not published the advice letters that water utilities submit and which often implement rate changes. Without this information, customers may not fully understand why and by how much their rates are changing.

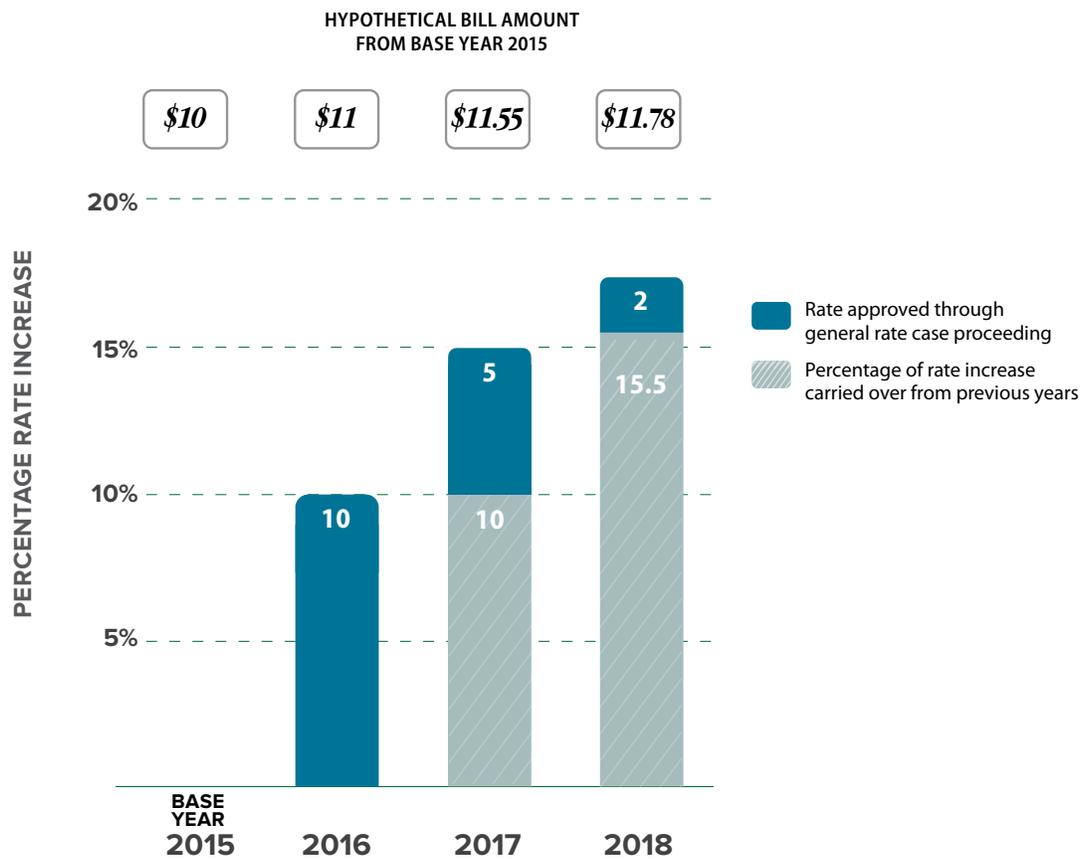
### The CPUC Does Not Provide Clear Information on Rate Changes

Although the CPUC has a reasonable process for reviewing water utility requests to change rates, it does not always make clear the ultimate outcome of that process, such as the extent that rates will change. Based on our review of the CPUC's most recent general rate case decisions for the nine Class A water utilities, as of June 30, 2018, we found that CPUC and Public Advocates rigorously and consistently followed key steps and that their actions during the process were well documented. Our review included whether Public Advocates, the ALJs, and the commissioners completed their key required responsibilities in our selection of cases. We did not identify any concerns with the reasonableness or appropriateness of the steps in the process.

However, the CPUC's proceedings and decisions do not provide the public with an understandable and transparent explanation of why, and by how much, rates will cumulatively change over a three-year general rate case period for Class A water utilities. For instance, Figure 2 on the following page shows a hypothetical example of how the CPUC might have approved a general rate case in 2015 that included a 10 percent increase in rates in 2016, a 5 percent increase in 2017, and a 2 percent increase in 2018. To implement these approved rate changes, the CPUC's practice is to require the water utility to submit advice letters in each of those three years to reflect the approved rate increases. In other words, in 2016, the water utility would submit an advice letter to reflect the 10 percent increase, which would increase a hypothetical \$10 bill by \$1, leading to an \$11 bill. The water utility would submit another advice

letter in 2017 to increase its rates by 5 percent, which is on top of the 10 percent, for a new bill amount of \$11.55. This hypothetical example shows that rate increases build upon one another and produce a greater impact on customers' rates than they do individually. In the example shown in Figure 2, the utility's cumulative rate increase would be \$1.78 higher in 2018 than the original rate of \$10 customers paid before the CPUC issued that general rate case decision in 2015.

**Figure 2**  
Hypothetical Example of How Rates Can Continue Increasing After CPUC Approves a General Rate Case



Source: Analysis of general rate case decisions.

The CPUC could provide customers with more precise information on how its general rate case decisions may fully impact rates over the three-year period. Although the CPUC publishes its general rate case decisions online, these decisions and supporting documentation are very lengthy, sometimes exceeding hundreds of pages; they also use technical terminology that can be difficult to understand. Further, these decisions are difficult to locate on the CPUC website. Therefore, to provide customers with a more easily accessible, straightforward method to understand the full impact that a general rate case decision will have on their water rates, the CPUC could provide a concise description or summary on its website of how a general rate case decision will likely impact rates. The CPUC agreed that it could provide this information to the public to disclose how it expects customer rates to change over time.

In addition to impacts on rates related to general rate case proceedings, the CPUC also permits water utilities to increase their rates for other reasons. The CPUC may issue a resolution that gives permission to all water utilities to amend their rates through advice letters to reflect any number of changes. For example, in 2016 the CPUC increased the fees water utilities pay for the costs the CPUC incurs to regulate them. To offset that increase in costs, the CPUC permitted water utilities to increase their rates to reflect these updated fees. The combination of general rate increases and the other increases that the CPUC allows water utilities to implement can significantly increase a water utility's rates over the course of three years.

***Insufficient Information May Limit Public Engagement***

Although the CPUC has published some information on its website, it could improve the information that it provides to the public about the process for regulating water rates by making it more understandable and more prominently displayed. In 2007 the CPUC published a decision online that describes its process for regulating Class A water utilities' rates through general rate cases. In addition, the CPUC publishes resolutions, general orders, and Standard Practices online, and they describe the process of regulating water rates, including the rates of small water utilities, along with other significant CPUC processes. The text box describes these policies and procedures. Because the ratesetting process is complicated, we expected the CPUC to have developed a simplified and understandable

**The CPUC's Policies and Procedures**

- **Decisions:** An opinion or judgment of the commissioners that decides the resolution of a proceeding, such as approving whether a water utility can change its rates in a general rate case.
- **Resolutions:** An official ruling of the commissioners on matters handled through informal processes, such as approving whether a small water utility can change its rates through an advice letter.
- **General Orders:** Standards, procedures, or guidelines applicable to a class of utilities as distinguished from a decision affecting only a single utility, such as the general process for submitting and reviewing advice letters for all utilities.
- **Standard Practices:** Direction or guidance specific to the Water Division. These practices can also provide direction to utilities on how to perform an action, such as on how to file an advice letter, and describe the specific steps staff must follow related to this action, such as how to process advice letters.

Source: The CPUC's decisions, resolutions, Standard Practices, and glossary.

description of both the general rate case and advice letter processes, including instructions as to how customers can participate in either process, and to have made this information readily available to the public. However, we found that it has not adequately done so.

Although the CPUC has decisions, resolutions, general orders, and Standard Practices available on its website, it does not display this information prominently and does not provide direction to customers on how to easily access these documents. We found that its decisions, which are critical because they explain why the CPUC approved a change in water rates, are accessible only if the visitor already knows specific information, such as the decision number or the date of the CPUC's meeting during which it made the decision. Public Advocates has pages on its website for specific general rate cases that includes general information on these particular cases, including, in some cases, a link to the respective CPUC decisions. However, it is difficult to find this information because Public Advocates does not prominently display this information on its website. In addition, we found that the general orders and Standard Practices available online contain very detailed descriptions of the processes related to regulating water rates, which customers may find confusing as they may not have the expertise necessary to understand the technical terminology used in these descriptions.

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**The CPUC acknowledges that it needs to summarize its processes and make this information available to the public to increase transparency.**

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For example, one of the CPUC's general orders describes in detail the information and documents that a water utility must submit when filing an advice letter and how to present and format a tariff sheet, a document that sets forth the terms and conditions of the utility's services to its customers. Although it is important for water utilities to have the opportunity to access these detailed policies and procedures on the CPUC website, we expected it to have developed a separate webpage specifically for water customers that would contain a high-level description of the general rate case and advice letter processes. This description could include items such as key steps that the CPUC follows to ensure that a water rate change is reasonable and how customers can get involved in the process. The CPUC acknowledges that it needs to summarize its processes and make this information available to the public to increase transparency.

Even though the CPUC has developed brochures that summarize certain information about the general rate case process, including how customers can participate in the process, this information is not specific to water utilities, it is not prominently posted on its website, and it does not describe the advice letter process or how rates can significantly increase over time. For example, a key step where the public may participate in the ratesetting process is a public hearing. Although the CPUC has a brochure that explains how customers can participate in public hearings, it could do more to ensure that the public can easily access this information. The CPUC explained that staff have passed out the brochure to the public at community meetings and events; however, the Water Division does not have the brochure or similar information on its webpage for members of the public to access who do not attend these events. Rather, the CPUC makes the brochure available on the webpage of another division of the CPUC, which requires several steps for an individual to locate.

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**Although the CPUC has a brochure that explains how customers can participate in public hearings, it could do more to ensure that the public can easily access this information.**

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In addition, the CPUC does not summarize any information regarding the advice letter process in these brochures, including how it requires water utilities to notify customers of rate increases through bill inserts or direct mailing. The CPUC also does not describe in these brochures the relationship between general rate cases and advice letters, including how rates can change through these processes. By not displaying this information prominently, the CPUC may be limiting customers' participation or understanding of how rates can change. The Water Division director stated that the CPUC could provide more information to the public to disclose how it expects customer water rates to change over time, such as a summary of how a general rate case decision will impact rates.

#### ***The CPUC Should Fully Publicize Advice Letters***

The CPUC is working to make water utilities' advice letters available on its website, but it has experienced significant delays and predicts that it will take several years to publish all advice letters and related

documents on its website. The CPUC currently maintains a listing of advice letters on its website, but it does not publish the full content of the letters themselves. Without access to these documents, customers may question why their rates are changing and whether these changes are appropriate, particularly because the notice that water utilities provide to customers notifying them of rate changes do not always include this information. Advice letters provide a detailed explanation about proposed rate changes.

The CPUC is developing a new system which, among other things, will include a component to allow all utilities that the CPUC regulates to electronically submit documents, such as advice letters. However, technical issues with the development of the system have impeded its completion by several years. As of October 2018, the CPUC explained that it is seeking additional information on potential options for completing the project. However, until it devises a means for the public to access advice letters from the CPUC, it is missing an opportunity to provide customers with complete information about how and why their rates are changing.

### **Recommendations**

To ensure that water utility customers can access understandable information regarding why and by how much their water rates are changing as a result of general rate case proceedings, by May 2019 the CPUC should create a webpage specifically for water customers that includes the following information:

- A summary of water rate changes for each general rate case for Class A water utilities.
- A summary of any resolutions and decisions that give all water utilities the authority to change their rates for reasons external to the general rate case process, such as increases in the fees the CPUC charges utilities for regulating them.

To ensure transparency and promote public understanding of its processes, by July 2019 the CPUC should create and publish information for customers regarding its general rate case and advice letter processes, including how and when water utilities are required to notify customers of increased rates and how customers can participate in both processes.

To ensure that the public can access advice letters on the CPUC's website and because it is unknown when the system it is developing will be complete, the CPUC should immediately begin developing another process to make advice letters easily available by July 2019, such as by scanning them and posting copies on the Water Division's webpage.

## The CPUC Has Not Ensured That Water Utilities Notify Customers About Public Hearings and Proposed Rate Increases as Required

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### Key Points:

- The CPUC does not verify that water utilities are complying with regulations for publishing notifications of public hearings in local newspapers. In fact, several of the utilities we reviewed did not provide timely notifications to customers, which may limit customer participation in hearings.
- The CPUC does not verify whether the notices that water utilities send to customers for advice letters implementing rate increases are timely. Customers have a right to know in a timely fashion about rate increases and their right to participate in public hearings.

### The CPUC Does Not Verify Required Notifications

The CPUC allows the assigned ALJ to schedule public hearings if necessary due to public interest, and may hold those public hearings in the areas where water utilities are requesting rate increases. Water utilities are required to notify their customers of the time, date, and location of these hearings. During these hearings, the CPUC can inform customers about the general rate case process and the requested rate increase, the water utility and Public Advocates can share their perspectives on the rate change and the reasons it may or may not be necessary, and customers can provide input. In each of the nine general rate cases we reviewed, the ALJ decided to hold a public participation hearing to inform customers of requested increases in rates.

If an ALJ chooses to set a public hearing, regulations require the utility to publish a notice in a newspaper available to their customers between a minimum of five and a maximum of 30 days before the date of the hearing. Regulations also allow ALJs to impose additional notification requirements on utilities. For example, in one general rate case we reviewed, the ALJ required the utility to mail customers a notification regarding the time, date, and place of the public hearings. Although the CPUC was able to provide documentation demonstrating that three of the nine class A water utilities met the notification requirements, the CPUC did not have documentation demonstrating that the remaining six water utilities met the required time frames.

Of the six water utilities, we discovered that three did not properly notify customers of public hearings within the required time frame. The CPUC did not know of the untimely notifications because it did not verify whether water utilities had met the requirements for informing customers. Specifically, two of the water utilities notified customers four days before the public hearing rather than five days, and the third published its newspaper notification 42 days before the hearing, or 12 days before regulations allow. When water utilities send notices to customers for public hearings earlier or later than

required, it may limit customer participation because customers may not remember the date of a hearing so far into the future or have enough time to prepare due to short notice.

For the three other water utilities, we found that the CPUC could not initially demonstrate whether the utilities had published notifications in local newspapers of upcoming public hearings for general rate cases. To ensure that these utilities published the notifications as required, we requested and received documentation or information from them. In one case, we contacted the utility and found that for one of its districts, it had published a newspaper notification two days before the date of the public hearing rather than the minimum five days as required. The remaining two water utilities provided documentation showing that they had complied with the notification requirements. However, because not all water utilities are notifying their customers within the required time frame and the CPUC does not ensure that water utilities meet these requirements, it cannot assure that customers have the information necessary at the appropriate time to participate in public hearings.

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**When water utilities send notices to customers for public hearings earlier or later than required, it may limit customer participation.**

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Some of the ALJs we interviewed stated that they perform a cursory, high-level review of the notifications the water utilities provide to their customers, whereas others indicated they generally do not review the notifications. Some of the ALJs explained that they do not ensure that the water utility has met the notification requirements because a water utility failing to properly notify customers would violate CPUC's rules and be considered a serious offense. For example, the last time the CPUC fined a water utility for failing to notify its customers of a hearing during a general rate case proceeding was more than 10 years ago when it imposed a \$1,000 fine. Our findings show that the CPUC could have considered whether to fine other utilities with more recent failures to fully comply with the notification requirements. Further, because the CPUC lacks a formal process for verifying whether water utilities notify customers of increased rates, it would likely only know of a problem if a customer filed a complaint. As a result, some customers are receiving notices that are not timely and thus may limit their participation in the hearings and opportunities to provide

feedback to the CPUC. We believe the ALJs' approach to ensuring that water utilities comply with the notification requirements is insufficient because it is not proactive in ensuring that utilities do so.

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**The CPUC has not ensured that all Class A water utilities meet notification requirements associated with general rate cases.**

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The CPUC has also not ensured that all Class A water utilities have complied with notification requirements associated with formal submission of their general rate case. State regulations require water utilities to publish a notice about proposed rate increases in a local newspaper of general circulation within 20 days of filing a general rate case application as well as a notice by mail or electronic bill to each customer within 45 days of filing.<sup>2</sup> These notifications inform customers of a potential change to their water rates and provide them with information on how to inquire about opportunities to participate in the ratesetting process, such as by contacting the CPUC for additional information or signing up for an email service to follow a proceeding. Although the nine Class A water utilities we reviewed generally complied with this requirement, one of the nine—a multidistrict water utility—did not publish the newspaper notification within the required time frame for four of the five districts that we reviewed, and another—a single-district water utility—mailed its notification to customers nine days late. The multidistrict water utility published three of its districts' newspaper notifications one week late and one of its district's notifications one day late. Without timely notifications, customers may not know of the proposed rate change or may miss an opportunity to participate in the general rate case proceeding that directly impacts their rates.

***The Water Division Does Not Ensure That Water Utilities Notify Customers About the Rate Increases in Advice Letters***

Although the CPUC has directed the Water Division to review advice letters regarding rate changes that water utilities file to determine whether the rate changes are appropriate, it has not required the division to verify whether utilities are providing

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<sup>2</sup> For water utilities on a 60-day or longer billing cycle, state regulations require that they provide notifications to customers within 75 days.

customers with the required notices. The CPUC requires all water utilities to provide notice of rate increases, or of more restrictive terms or conditions, to customers at least 30 days before the effective date of a Tier 2 or Tier 3 advice letter.<sup>3</sup> As we discuss in the Introduction, Tier 2 and Tier 3 advice letters require staff review and disposition before the CPUC approves them, and they can relate to an acquisition of a municipal water company or a general rate case for smaller water utilities. Water utilities may provide this notice in a newspaper publication, bill insert, direct mailing, or email if a customer uses electronic billing. Because a Tier 1 advice letter generally takes effect immediately upon filing, the CPUC requires water utilities to provide a notice of the resulting increase in rates in the first customer bills that include the increased rate. However, the Water Division does not verify whether water utilities are properly notifying customers about rate increases implemented through advice letters. As a result, it cannot ensure that customers are receiving information from utilities about the new rates or if the notice arrives in a timely manner.

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**The Water Division cannot ensure that customers are receiving information from utilities about the new rates in a timely manner.**

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For 11 of the 13 advice letters we reviewed, the Water Division could not provide us with documentation demonstrating that the water utilities notified customers as required. The Water Division explained that it relies on an attestation from water utilities that they will comply with the notification requirements and a draft version of the customer notice, which utilities include in their application to change rates. However, the water utilities make these attestations before they provide customer notifications. Therefore, these attestations do not provide the same assurance as the documentation that Class A water utilities submit to the CPUC after they provide customer notifications in general rate cases. The Water Division also indicated that it is unlikely that water utilities would not comply with the requirements, given its belief that such activity would be a serious violation of the CPUC's rules and they could face a penalty. If the Water Division were to cite a Class B, C, or D utility because it did not provide the notification as required, it must allow the utility at least 30 days to cure the violation or

<sup>3</sup> A utility is required to provide a notice of a Tier 2 advice letter requesting a rate increase only when the change results in an increase in revenue for the utility of 10 percent or more than the revenue the utility was previously earning.

contest the citation. After 30 days, if the utility does not cure the deficiency, the Water Division can issue a penalty of up to \$1,000 for small water utilities and up to \$10,000 for Class A water utilities per violation. We question the adequacy of the fine as a deterrent for noncompliance with the notification requirements, particularly because the CPUC has issued only one fine in just over 10 years to a water utility that had not provided the required notification.

The Water Division indicated that its approach to ensuring water utilities' compliance with the notification requirements relies on customers coming forward and showing that their bill did not include information pertaining to a rate increase. However, we expected the Water Division to take a more proactive approach by requesting documentation from the water utilities to demonstrate they had complied with the notification requirements and by reviewing this documentation to ensure that water utilities properly informed customers.

Because the Water Division could not demonstrate that water utilities notified customers of rate increases in 11 of the 13 advice letters we reviewed, we independently contacted these utilities to determine whether they had complied with the notification requirements. We found that all six of the Class A and B water utilities we reviewed were able to provide documentation that supported their notifications, such as bill inserts the utilities mailed to customers or proof that a newspaper had published the notification. However, of the five Class C and D water utilities we reviewed, two were not able to demonstrate they had complied with the notification requirements and two did not respond to our requests. Water Division staff explained that Class C and D water utilities have far fewer resources and staff than the larger Class A and B water utilities and, in some cases, the Water Division has had to contact these utilities and help them create documentation to file advice letters. Together, these four water utilities provide service to roughly 2,000 connections and the potential exists that they are not notifying their customers of rate increases as required.

### **Recommendations**

To ensure that it informs customers that they have an opportunity to provide their input regarding general rate cases, by May 2019 the CPUC should implement a process to verify and maintain records that demonstrate that water utilities are submitting notifications to their customers of the following:

- Public participation hearings in accordance with the time frames set out in regulations and any additional notification requirements the ALJs may impose.

- General rate case application filings in accordance with the time frames set out in regulations.

To the extent that it identifies noncompliance with notification requirements, the CPUC should evaluate whether to impose a fine on the water utility.

To ensure that all customers receive timely notification from water utilities of potential and actual rate increases, the CPUC should implement a process by May 2019 that requires water utilities to submit proof of customer notification to its Water Division, which should then review these notifications to ensure that the utilities are meeting the requirements. If the water utilities do not comply with the requirements, the CPUC should consider whether to impose a fine on the water utility.

## The CPUC Has Not Conducted Audits of Water Utilities as Required

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### Key Points:

- The CPUC relies on the reviews Public Advocates conducts of general rate cases to fulfill the CPUC's statutory requirement to conduct timely audits of Class A water utilities. However, the Public Advocates' reviews are not designed nor intended to comply with this requirement and, therefore, the CPUC risks it is not fulfilling the intent of the law.
- Although the CPUC conducts some audits of small water utilities, it did not complete audits of the majority of those utilities from fiscal years 2013–14 through 2017–18.

### The CPUC Lacks Assurance That It Is Conducting Audits of Class A Water Utilities in Accordance With State Law

Since 1975 state law has required the CPUC to audit the books and records of utilities serving over 1,000 customers at least once every three years for regulatory and tax purposes.<sup>4</sup> Although the CPUC has a Utility Audit, Finance, and Compliance Branch (audit branch) tasked with auditing small water utilities—and as we note in the next section, it has completed some audits of small water utilities—it has no dedicated staff to conduct audits of the Class A water utilities, which serve most of the State's private water utility customers through about 1.5 million service connections. Instead, the CPUC relies on the Public Advocates to review and report on the Class A water utilities and has done so for several years. In our March 2014 report, we found that the CPUC relied on the review that the Public Advocates conducts in connection with general rate cases to fulfill the CPUC's audit requirement.<sup>5</sup> In our previous report, we found that this reliance on Public Advocates was misplaced because Public Advocates did not review nearly half of utilities' balancing accounts. Further, we recommended that the CPUC audit all utilities it regulates as state law requires. In our current audit, we found that the CPUC has continued to rely on the Public Advocates' review of general rate cases to comply with state law that requires the CPUC to conduct audits of Class A water utilities.

Public Advocates stated, however, that its review of general rate cases is not designed nor intended to comply with the requirement that the CPUC audit Class A water utilities. As a result, the CPUC risks that it is not fulfilling the intent of the law. Public Advocates explained that its reviews are focused on specific information contained within the general rate cases and are not audits of the utilities. Public Advocates

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<sup>4</sup> In September 2018, the Governor approved a bill amending the law to require the CPUC to audit all utilities serving more than 10,000 connections every three years.

<sup>5</sup> Our March 2014 report is titled *California Public Utilities Commission: Improved Monitoring of Balancing Accounts Would Better Ensure That Utility Rates Are Fair and Reasonable*, Report 2013-109.

stated that its reviews serve as a means of determining whether financial information presented by the utility is appropriate for regulatory purposes.

The state law requiring the audits does not define the term “audit,” nor does it set forth expectations for what such an audit should entail. For example, although state law specifies that the CPUC is to audit water utilities for regulatory and tax purposes, neither the law nor its available legislative history describes what such audits should entail. As the agency charged with administering the statute, the CPUC has the authority to interpret the law’s requirements for conducting audits for regulatory and tax purposes.

As the individual responsible for overseeing the audit branch, the CPUC’s chief compliance officer expressed concern that Public Advocates’ reviews do not meet the intent of the statute. She believes they do not satisfy the intent of the law because the reviews generally do not involve an assessment of risk or an examination of utilities’ policies and procedures for financial reporting, nor do they adhere to a set of accepted auditing standards, which are key elements of a high-quality audit. By not taking this structured and in-depth approach to conducting its audits, she explained that the CPUC leaves customers vulnerable to higher rates or less effective service. To guide the audit branch’s activities, the CPUC has a Standard Practice that provides procedures on how the audit branch should conduct its audits that includes these key elements. However, as we described previously in this section, the audit branch does not conduct audits of Class A utilities.

### ***The CPUC’s Audits of Small Water Utilities Are Not Timely***

Although the CPUC is required to complete audits of small water utilities, it has not completed most of the audits within the time frames established in state law. Public Advocates generally does not review Class B, C, and D water utility general rate cases. These audits can provide the CPUC with a better understanding of how water utilities operate and can influence whether the CPUC approves a utility’s request to raise its rates. State law requires the CPUC to audit each of the five Class B water utilities and nine of the 22 Class C water utilities—those serving more than 1,000 customers—every three years.<sup>6</sup> However, of the 14 audits required under the law, the CPUC completed only five between fiscal years 2015–16 through 2017–18. Further, state law requires the CPUC to audit water utilities serving 1,000 customers or fewer

<sup>6</sup> In September 2018, the Governor approved a bill amending the law to require the CPUC to audit all small water utilities at least every five years.

at least once every five years for regulatory and tax purposes. However, we found that the CPUC completed only 20 of the approximately 75 required audits of small water utilities for the five-year period of fiscal years 2013–14 through 2017–18, despite receiving funding in 2015 for two additional audit staff positions to complete these audits.

**We found that the CPUC completed only 20 of the approximately 75 required audits of small water utilities for the five-year period of fiscal years 2013–14 through 2017–18.**

The CPUC again attributed the delays in completing the audits to staffing shortages, even though it has known for several years that it is not completing audits as required. Specifically, in our March 2014 report, the CPUC also pointed to insufficient staffing as its reason for not conducting audits of all water utilities within the time frame required in state law. Subsequent to our audit, the CPUC requested—and received—two additional staff positions to conduct these audits. Although the CPUC has been able to complete more audits of small water utilities in fiscal years 2016–17 and 2017–18, it has fallen short of meeting its statutory audit requirement. Without timely audits, the CPUC lacks assurance that water utilities are complying with applicable regulatory and tax requirements and is hindered in its ability to make a fully informed decision on whether a utility should be able to increase its rates.

The audits the CPUC currently conducts include a review of the water utilities' annual reports, including the related statements of income, retained earnings, and cash flows. However, the CPUC stated that some small water utilities fail to file these annual reports, which further limits the CPUC's assurance that water utilities are operating in compliance with requirements. Because these audits are a key monitoring mechanism, untimely audits can allow fiscal problems at an unaudited water utility to continue undetected and do not provide the CPUC with adequate assurance that the utility's request for an increase to its rates reflects accurate information. In an audit the CPUC issued in 2016, for example, it found that a water utility was out of compliance with state law because it had not requested or received the CPUC's authorization for long-term debt it reported in its financial statements. In a different report it issued in 2018, the CPUC stated that because another water utility

did not provide it with certain requested information and lacked sufficient supporting documentation, it was unable to determine whether that utility's financial statements were presented fairly. In both cases, these audit findings provided the CPUC with a better understanding of how the water utility was operating or failing to comply with requirements, which could influence whether the CPUC approves the utility's request to raise its rates in the future.

### **Recommendations**

To ensure that the CPUC fulfills its statutory requirement for auditing all water utilities, it should do the following:

- Immediately begin to follow its Standard Practice when auditing Class A water utilities, or develop policies and procedures by May 2019 to ensure that the reviews Public Advocates conducts of general rate cases demonstrate compliance with the legal requirement for audits of these utilities.
- Immediately develop a plan to complete audits of Class A water utilities and small water utilities in a timely manner.

## OTHER AREAS WE REVIEWED

To address the audit objectives approved by the Joint Legislative Audit Committee (Audit Committee), we reviewed several other issues. Specifically, we assessed the appropriateness and effectiveness of the three-year term of the general rate case, including whether a legally established formula for setting rates would be more beneficial. We also reviewed the CPUC's process for tracking and verifying data regarding water utility infrastructure and its process for ensuring that the costs of capital factored into the ratesetting process are representative of actual and necessary costs. Below are the results of our reviews.

### The Three-Year General Rate Case Term Appears Reasonable

Based on our review of the general rate case process in California and in several other states, as well as a review of alternate ratemaking methods, we found that the three-year rate case term is appropriate and effective. In 1979 the CPUC adopted the three-year rate case term for water utilities to reduce delays stemming both from the utilities, which often delayed providing key information to the CPUC, and from the CPUC in processing rate case filings. In 2002 the Legislature enacted the three-year term as part of legislative efforts to ensure CPUC's timely processing of general rate cases, as it had often failed to meet established deadlines for completing those cases either because of actions of the CPUC or the utilities. As part of our audit, we asked the CPUC and Public Advocates for their perspective on the reasonableness of the three-year general rate case term. According to the CPUC, it considers the three-year term a short enough time to allow for the accurate forecasting of changes within the utility and the water industry and to ensure that rates are updated regularly—rather than infrequently, which could result in dramatic rate changes. The Public Advocates also stated that the term provides a long enough amount of time between general rate cases so that the utilities and the Public Advocates are not constantly undergoing these reviews.

The CPUC considered moving to a longer general rate case term for certain types of utilities in 2015. Public Advocates and two major energy utilities filed a petition with the CPUC to extend the general rate case term for the large energy utilities to four years in the interests of minimizing the potential for delays and to make more efficient use of CPUC and utility company resources. The following year, the CPUC rejected the petition but it began to reevaluate its three-year general rate case term for energy utilities, including whether to extend it in the interest of processing general rate case proceedings in a more efficient and timely manner. The CPUC discussed the proposal with—and reviewed presentations

from—the four major energy utilities and Public Advocates. In its evaluation, the CPUC assessed the considerable resources required of the CPUC, Public Advocates, and the utilities in general rate case proceedings as well as the challenges to timely processing of these proceedings. Ultimately, the CPUC decided not to lengthen the rate case term for reasons that included increased uncertainty in forecasting for the fourth year of the term and a determination that it would not lead to a significant improvement in the heavy workload caused by multiple general rate case proceedings occurring at the same time.

To identify whether other methods for setting rates would be beneficial, we reviewed the general rate case terms of four other large states—Illinois, New York, Pennsylvania, and Texas—and found that none require their private water utilities to file general rate cases with a specified frequency. Instead, they only require water utilities to file when necessary. Because of the significantly different sizes of California’s water utilities and because the topics in proceedings cover a wide array of issues that can change with each general rate case, we did not identify a different method of setting rates or a different length rate case term that would be more advantageous.

### **The CPUC Does Not Need Additional Tracking of Water Utility Infrastructure**

Although the CPUC does not have a database or tracking system that maintains information related to the age, condition, industry standard life expectancy, and repair and replacement history of a water utility’s infrastructure, its process for reviewing and verifying these characteristics in general rate cases is thorough. We did not identify any provisions in the Public Utilities Code or regulations that require the CPUC to have such a tracking system, and the CPUC agreed that there were no such legal requirements. As part of Public Advocates’ reviews of general rate cases, its staff evaluates water utility infrastructure reimbursement proposals. For example, we found that the CPUC did review age, size, life expectancy, replacement rate, and leak history when it analyzed a pipeline replacement project as part of one water utility’s general rate case application. Based on our review of general rate cases submitted by three water utilities, we found that Public Advocates’ reviews of infrastructure reimbursement proposals are appropriate and extensive, and that they include on-site visits to verify the condition or replacement of the infrastructure. In addition, Public Advocates reviews water utility infrastructure reimbursement proposals to determine whether projects had a necessary and appropriate cost. We also reviewed the Water Division’s analysis of a selection

of advice letters for small water utilities' general rate cases and determined that Water Division staff performed similarly extensive reviews as the Public Advocates conducted for large water utilities.

A database of water utility infrastructure could allow the CPUC to prevent some water quality problems, but it has other assurance that water utilities are adequately maintaining their infrastructure. When infrastructure malfunctions or fails due to age or a lack of maintenance, customers may receive water that violates water quality standards, such as if a water treatment plant malfunctions or fails. However, Public Advocates and the Water Division conduct extensive reviews of infrastructure information from water utilities as discussed previously. In addition, the Water Division reviews water quality reports from the State Water Resources Control Board to determine whether the water utility is in compliance with safe drinking water standards and regulations and to ensure that the water utility has corrected any identified deficiencies before it approves any advice letter rate change. Similarly, the CPUC requires all ALJs in a general rate case proceeding to appoint a water quality expert who will provide an informal report to the ALJ, which identifies specific findings related to the utility's water quality compliance. All of the general rate cases we reviewed had an informal water quality report that discussed any water quality issues or noncompliance with water quality standards by the utility. Therefore, we find it reasonable that the CPUC does not have a database or tracking system that maintains information on the age, condition, industry standard life expectancy, and repair and replacement history of a water utility's infrastructure.

### **Cost-of-Capital Proceedings Are Reasonable**

The Audit Committee asked us to identify and evaluate the CPUC's processes for ensuring that the costs of capital for water utilities—the overall rate of return, or return on investment, that can be anticipated by entities that provide capital to water utilities—are representative of actual and necessary costs. The CPUC uses a cost-of-capital proceeding that is separate from the general rate case to set a water utility's return on equity, the costs of debt, and the debt-to-equity ratio (the percent of debt the water utility carries versus its equity) to determine the overall rate of return. In its most recent cost-of-capital proceeding in March 2018, for example, the CPUC authorized four Class A utilities to earn a rate of return ranging from 7.48 percent to 7.91 percent. These authorized rates are also included in the rates that the CPUC approves through general rate case proceedings. According to the CPUC, the objective of the proceeding is to set the return on equity at the lowest level that meets a test of reasonableness. At the same time, the CPUC states that the adopted equity return

should be sufficient to provide a margin of safety to pay interest and reasonable common dividends, and to allow the water utility to keep some money as retained earnings. Based on our review, we conclude that the CPUC's rates of return are appropriate in relation to state, national, and legally required levels of return on investment for utilities. We also reviewed the processes the CPUC uses to determine rates of return for Class B, C, and D water utilities and found they were reasonable.

To ensure that the costs of physical capital, or infrastructure, that the CPUC factors into general rate cases are representative of actual and necessary costs, we evaluated the CPUC's process for reviewing water utility infrastructure reimbursement proposals. As part of its role in reviewing general rate case applications, Public Advocates conducts reviews of infrastructure reimbursement proposals that the water utilities make. Specifically, when Public Advocates reviews an infrastructure project, its practice is to make a recommendation to the CPUC as to whether it believes the infrastructure change was necessary. It also reviews the cost of the infrastructure project, such as ensuring that the costs only include appropriate factors and amounts, including inflation rates. We found that Public Advocates' reviews adequately determine whether projects were necessary and had an appropriate cost.

## SCOPE AND METHODOLOGY

The Audit Committee requested that the California State Auditor audit the CPUC to determine whether it was appropriately and transparently regulating water utility rates through its ratesetting processes, including general rate cases and advice letters. Table 3 lists the objectives that the Audit Committee approved and the methods we used to address them.

**Table 3**  
**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, rules, regulations, CPUC decisions, and resolutions.
<p>2 Identify and evaluate the CPUC's processes for ensuring the following:</p> <p>a. The principles that commissioners and ALJs follow are applied uniformly when determining appropriate rates for water services.</p> <p>b. Applicable policies are being followed in all cases during the ratesetting process.</p> <p>c. The costs of capital factored into the ratesetting process are representative of actual and necessary costs.</p>	<ul style="list-style-type: none"> <li>• Identified that the principles the ALJs and commissioners follow are contained in statutes, regulations and CPUC policies, among other sources.</li> <li>• Reviewed the statutes, regulations, and CPUC policies and identified the key responsibilities of the Water Division, Public Advocates, ALJs, and commissioners during the general rate case process.</li> <li>• Reviewed one general rate case for each of the nine Class A water utilities to determine whether the parties identified above completed their respective responsibilities consistently.</li> <li>• Reviewed the 2007 CPUC decision that describes cost of capital proceedings and identified key requirements for water utilities in their applications, such as a description of the utility's proposed capital structure and rate of return, and an explanation of any significant changes from the previously adopted capital structure and cost of capital.</li> <li>• Reviewed four cost-of-capital applications to determine whether water utilities satisfied the key requirements.</li> <li>• As part of Objective 5, reviewed the process Public Advocates used to review three infrastructure projects.</li> </ul>
<p>3 Evaluate the advice letter rate increase process to determine the following:</p> <p>a. For fiscal years 2015–16 through 2017–18, the number of advice letter rate increases that have been submitted and approved.</p> <p>b. Whether the process is transparent and accessible to the public.</p> <p>c. Whether the process appears to be used to avoid the more in-depth review of a general rate case.</p>	<p>Because the CPUC does not track the number of advice letters requesting increases, we randomly selected a sample of 29 advice letters to evaluate the impact the letters had on rates. Of the 29 advice letters we reviewed, 52 percent of the letters resulted in a rate increase.</p> <ul style="list-style-type: none"> <li>• Reviewed the CPUC website and information brochures it distributes to the public regarding the advice letter process.</li> <li>• Judgmentally selected 15 advice letters based on the number and type of advice letters filed by water utilities from each class between fiscal years 2015–16 and 2017–18. Determined which of these 15 advice letters required the water utility to notify customers about a rate increase.</li> <li>• For the 13 advice letters requiring customer notification, we determined whether the CPUC verified that water utilities notified customers in the required time frame.</li> <li>• If CPUC did not verify the timeliness of the notifications, contacted the water utilities to determine the timeliness or existence of customer notices.</li> <li>• From the sample of 29 advice letters in 3a, we selected the 15 advice letters that resulted in rate increases. We selected an additional five advice letters from Class A water utilities that requested rate increases and reviewed these 20 advice letters to determine whether the advice letters were appropriate for the rate change request.</li> <li>• The advice letters we reviewed generally implemented a decision by the commissioners, a condition of a general rate case, or were otherwise appropriate for the rate change request.</li> </ul>

*continued on next page ...*

AUDIT OBJECTIVE	METHOD
<b>4</b> Assess the rationale for the three-year term of the general rate case to determine whether it is appropriate and effective. Also determine whether other methods would be beneficial and have been considered, such as a legally established formula for setting rates.	<ul style="list-style-type: none"> <li>• Interviewed officials in the Water Division and Public Advocates regarding the reasonableness of the three-year term and other approaches to ratemaking.</li> <li>• Interviewed staff from the CPUC's Consumer Protection and Enforcement Division and its Transportation Branch regarding transportation industry ratemaking.</li> <li>• Interviewed officials representing the New York Department of Public Service, Pennsylvania Public Service Commission, Texas Public Utilities Commission, and Illinois Commerce Commission about water ratemaking in those states.</li> <li>• Reviewed commissioner decisions and state laws that implemented and modified the three-year term.</li> </ul>
<b>5</b> Evaluate the CPUC's process for tracking and verifying data on the age, condition, industry standard life expectancy, and the repair and replacement history of investor-owned utilities' system components.	<ul style="list-style-type: none"> <li>• Because Public Advocates does not have policies and procedures that guide staff on how to review a utility's infrastructure components, we interviewed a Public Advocates supervisor to determine the process it follows.</li> <li>• Judgmentally selected three of the nine general rate cases we reviewed for Objective 2, and evaluated whether Public Advocates conducted its reviews in accordance with the described process.</li> <li>• Selected three advice letters that involved an infrastructure project and reviewed supporting documentation to ensure that the Water Division conducted its reviews in accordance with its policies and procedures.</li> </ul>
<b>6</b> Determine whether the return-on-investment (ROI) amounts are appropriate by considering state, national, and legally required levels of return on investment.	<ul style="list-style-type: none"> <li>• Reviewed relevant state laws and federal Supreme Court decisions.</li> <li>• Interviewed a key Public Advocates supervisor to determine the process for setting rate-of-return, which is another way of describing ROI.</li> <li>• Interviewed officials representing Pennsylvania Public Service Commission, Texas Public Utilities Commission, and Illinois Commerce Commission to determine their methods for determining rates of return.</li> </ul>
<b>7</b> Assess the appropriateness and transparency of the CPUC's communications with consumers and constituents, including the following:  <b>a.</b> The frequency and legitimacy of closed-session meetings.  <b>b.</b> The availability of archived rate case and advice letters to the public.  <b>c.</b> The sufficiency and adherence to CPUC's notification policies and procedures.	<ul style="list-style-type: none"> <li>• As permitted by the Bagley-Keene Open Meeting Act, the commissioners may meet in closed session to discuss ratesetting matters, which the CPUC calls deliberative meetings. The commissioners do not take votes in these meetings, and although the CPUC provides public notification of the meetings, it does not prepare meeting transcripts.</li> <li>• Reviewed the agendas from all ratesetting deliberative meetings held in fiscal years 2015–16 through 2017–18. The commissioners held only one such closed-session meeting related to a water utility between July 1, 2015, and June 30, 2018, and in our review of the meeting, we did not identify any areas of concern regarding this meeting or the outcome of the related general rate case.</li> <li>• Reviewed the CPUC website for archived general rate cases and advice letters.</li> <li>• Interviewed Water Division officials about information relating to general rate cases and advice letters, and about the CPUC's efforts to improve availability and transparency regarding advice letters.</li> <li>• Refer to Objectives 2b and 3b.</li> </ul>
<b>8</b> Review and assess any other issues that are significant to the audit.	<ul style="list-style-type: none"> <li>• Interviewed key CPUC staff about its process for performing audits of water utilities.</li> <li>• Reviewed CPUC audits of small water utilities to determine whether the CPUC conducted audits at the required frequency.</li> </ul>

Source: Analysis of the Audit Committee's audit request number 2018-118, as well as information and documentation identified in the column titled *Method*.

We conducted this audit under the authority vested in the California State Auditor by Government Code 8543 et seq. 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 and Methodology 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,

A handwritten signature in black ink that reads "Elaine M. Howle". The signature is written in a cursive, flowing style.

ELAINE M. HOWLE, CPA  
California State Auditor

Date: December 18, 2018

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STATE OF CALIFORNIA

EDMUND G. BROWN JR., Governor

**PUBLIC UTILITIES COMMISSION**

505 VAN NESS AVENUE  
SAN FRANCISCO, CA 94102-3298



November 20, 2018

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

**CALIFORNIA PUBLIC UTILITIES COMMISSION RESPONSE TO CSA AUDIT 2018-118 –  
CPUC RATE SETTING PROCESS**

Dear Ms. Howle,

The California Public Utilities Commission (CPUC) hereby provides responses to the draft findings of the California State Auditor's (CSA) report entitled, *California Public Utilities Commission: It Could Improve the Transparency of Water Rate Increases by Disclosing Its Review Process and Ensuring That Utilities Notify Customers as Required*. The CSA has conducted this audit and issued three findings and six recommendations.

CPUC agrees with the findings and the recommendations. Accordingly, the CPUC has either established corrective action plans and timelines towards implementing them or already taken steps to do so. CPUC is committed to continuous improvement of its operations.

CPUC appreciates the work performed by the CSA and the opportunity to respond to the findings. If you have further questions, please contact me at (916)703-3808.

Sincerely,

A handwritten signature in black ink that reads "Alice Stebbins".

Alice Stebbins  
Executive Director

Enclosure

Cc: Michael Picker, President  
California Public Utilities Commission

Ginny Veneracion-Alunan, Chief Internal Auditor  
California Public Utilities Commission

Barbara Owens, Director External Audits  
California Public Utilities Commission

Rami Kahlon, Director Water Division  
California Public Utilities Commission

## California Public Utilities Commission Response to CSA Audit 2018-118 CPUC – Rate Setting Process

### *It Could Improve the Transparency of Water Rate Increases by Disclosing Its Review Process and Ensuring That Utilities Notify Customers as Required*

**Finding #1: The CPUC has not provided customers with clear information about water rate increases and its process for approving rates.**

The CPUC could do more to provide customers with understandable information about the reasons their water rates are changing, its general rate case process, and the advice letters that authorize changes to water rates. At present, it does not clearly disclose to customers the full impact that its decisions may have on water rates, and it has not made information about its ratesetting processes readily available.

**Recommendation 1: By May 2019, the CPUC should begin to publish a summary of why and by how much water rates will change as a result of each general rate case proceeding, and by July 2019, make information about the general rate case process and advice letters more understandable to the public.**

- To ensure that water utility customers can access understandable information regarding why and how their water rates are changing as a result of general rate case proceedings, by May 2019, the CPUC should create a webpage for water customers that includes the following information:
  - A summary of water rate changes for each general rate case for Class A water utilities.
  - A summary of any additional resolutions and decisions, that give water utilities the authority to change their rates for reasons external to the general rate case process, such as an increase in the fees the CPUC charges utilities for regulating them.
- To ensure transparency and promote public understanding of its processes, by July 2019, the CPUC should create and publish information for customers regarding its general rate case and advice letter processes, including how and when water utilities are required to notify customers of increased rates and how customers can participate in both processes.
- To ensure that the public can access advice letters on the CPUC's website and because it is unknown when the system it is developing will be complete, the CPUC should immediately begin developing another process to make advice letters easily available by July 2019, such as scanning them and placing copies on the Water Division's webpage.

**Response: CPUC:**  Agrees  Disagrees with the recommendation.

*The CPUC will post on its public website summaries of water rate changes for all its Class A water utility general rate proceedings, as well as a listing of any additional resolutions and decisions and their respective impacts on water rates. Planned completion date: May 31, 2019.*

*The CPUC will develop additional customer information that will describe the general rate case and advice letter processes. This information will also explain further how and when water utilities are required to notify customers of increased rates, and how utility ratepayers can participate in these processes. Additionally, the CPUC will post on its public website all water utility advice letters, and require utilities to do the same on their website. Planned completion date: July 31, 2019.*

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**Finding #2: The CPUC has not ensured that water utilities notify customers about public hearings and proposed rate increases as required.**

The CPUC does not verify whether water utilities comply with the regulations related to certain types of notifications to the public. The CPUC requires water utilities to provide these forms of notice within a specified time frame, but several of the utilities we reviewed did not always provide timely notifications to customers, thereby possibly limiting customer participation in and feedback to the ratesetting process.

**Recommendation 2: The CPUC should verify that water utilities are providing their customers with timely notifications of rate increases and public hearings and implement this verification process by May 2019.**

- To ensure that it informs its customers that they have an opportunity to provide their input regarding their general rate cases, by May 2019, the CPUC should implement a process to verify and maintain records that demonstrate that water utilities are submitting notifications to their customers of the following:
  - Public participation hearings in accordance with the time frames set out in regulations and any additional notification requirements the ALJs may impose.
  - General rate case application filings in accordance with the time frames set out in regulations.To the extent that it identifies noncompliance with notification requirements, the CPUC should evaluate whether to impose a fine on the water utility.
- To ensure that all customers receive timely notification from water utilities of potential and actual rate increases, the CPUC should implement a process by May 2019 that requires water utilities to submit proof of customer notification to its Water Division, which should then review these notifications to ensure that the utilities are meeting the requirements. If the water utilities do not comply with the requirements, the CPUC should consider whether to impose a fine on the water utility.

**Response: CPUC:**  **Agrees**  **Disagrees with the recommendation.**

*The CPUC will develop a process to ensure that customer notifications for Public Participation Hearings and other notifications of potential rate changes, including notices for general rate*

*case proceedings, are recorded and verified. The CPUC will develop and implement procedures to verify customer notifications, review such notifications, and enforce its procedures. Planned completion date: May 31, 2019.*

**Finding #3: The CPUC has not conducted audits of water utilities as required.**

The CPUC lacks policies and procedures detailing how it will conduct legally required audits of the largest water utilities and it has not conducted the majority of audits of the smaller water utilities as required by law. Without timely and effective audits, the CPUC lacks assurance that these water utilities are complying with applicable requirements, which could affect the rates and service that customers receive.

**Recommendation 3: The CPUC should develop and implement policies and procedures setting forth detailed requirements for the audits of Class A water utilities May 2019 and ensure it completes audits of small water utilities as required.**

To ensure that the CPUC fulfills its statutory requirement for auditing all water utilities, it should:

- Immediately begin to follow its Standard Practice when auditing Class A water utilities, or develop policies and procedures by May 2019 to ensure that the audits conducted of Class A utilities provide appropriate assurance regarding a utility's services and rates.
- Develop a plan to complete audits of all Class A water utilities and small water utilities in a timely manner.

**Response: CPUC:  Agrees  Disagrees with the recommendation.**

*The Utility Audit Branch (UAB) is currently developing policies and procedures and revamping its audit program to ensure it addresses both compliance and financial accountability issues with the water utilities. These efforts will be completed by May 31, 2019. UAB is also updating the audit manual to comply with generally accepted government auditing standards. In addition, the Water Audit Unit is performing a risk assessment of the entire population of water utilities based on established criteria to ensure our limited audit resources will be diverted to those with the highest risk. UAB's audit plan for water utilities will also incorporate the new auditing requirements and criteria outlined in SB 1410 enacted in September 2018.*

*Further, to address the number of water utility audits and their complexity, we will request additional auditors utilizing the BCP process to ensure Utility Audits has adequate staff to perform the required work. Currently, there are two authorized auditor positions focused on auditing small water utilities. Approval of more auditor positions will assist in addressing the audits of both the Class A and the small water utilities in a more timely and efficient manner.*