Audit of Water Utilities

East Pasadena Water Company

For the Year Ended December 31, 2018

Utility Audits Branch
March 25, 2020

A digital copy of this report can be found at:
http://www.cpuc.ca.gov/utilityaudits/

Thanks to:
Angie Williams, Raymond Yin, Sharmin Wellington, and Khusbindar Kaur

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EXECUTIVE SUMMARY

The California Public Utilities (PU) Code granted CPUC's regulatory authority over Investor-Owned Utilities in California. The Utility Audits Branch (UAB), formerly known as the Utility Audit, Finance and Compliance Branch (UAFCB)[1], is in the Utility Audits, Risk and Compliance Division (UARCD), which reports directly to the Executive Director of the CPUC. Pursuant to PU Code, Sections 314.5, 314.6, 581, 582, and 584, the CPUC has statutory authority to inspect and audit the books and records of the utilities to ensure that ratepayers' money is well spent.

East Pasadena Water Company (EPWC) was incorporated in the state of California on December 26, 1930. EPWC is a Class B water utility subject to the jurisdiction of the CPUC, providing water service in portions of Pasadena, Arcadia, Temple City, and adjacent territory in the County of Los Angeles. EPWC is engaged in the sale and distribution of water to approximately 2,985 residential and commercial customers. EPWC's operations include production, storage, and distribution of domestic water in the Pasadena area of Southern California. EPWC's parent company is California Michigan Land and Water Company. As a regulated water utility, EPWC is required to prepare its financial statements on accrual basis of accounting as set forth in the Uniform System of Accounts (USOA) for Water Utilities that was adopted in Decision (D.) 16-11-006 by the CPUC on November 16, 2016. The USOA is a comprehensive basis of accounting other than the generally accepted accounting principles in the United States of America.

The UAB conducted the audit of EPWC's 2018 Annual Report filed with the CPUC in accordance with applicable PU Code, regulations, and CPUC's directives. The primary objectives of this audit are to ensure the fair presentation of the financial information in EPWC's 2018 Annual Report and to determine whether EPWC complied with the applicable regulations and CPUC's directives. The scope of our audit was limited to the financial information presented in EPWC's 2018 Annual Report filed with the CPUC. In addition, UAB evaluated EPWC's effectiveness of internal control over its accounting and reporting functions as it relates to the audit objectives.

Based on our audit, the following findings were identified:

- Finding 1: EPWC classified and reported vacation and sick leave expenses as regular salaries instead of classifying and reporting them as Employee Pension and Benefits expenses. The misclassification resulted in an understatement of Employee Pension and Benefits expenses by $51,879, and overstatements of Employee Labor, Office Salaries, and Management Salaries by $21,895, $9,215, and $20,769, respectively.

- Finding 2: EPWC collected $41,780 Users Fee from its customers and remitted them to the CPUC. However, EPWC did not follow the USOA guidelines to record and report the gross CPUC Users Fee of $41,780 by using both the Account 480–Other Water Revenue and Account 688–Regulatory Commission Expense in the G/L and the Annual Report.

- Finding 3: EPWC improperly obtained long-term debt of $900,000 from its parent company, California Michigan Land and Water Company, on September 21, 2011, before obtaining the

[1] Effective January 2020, Utility Audit, Finance and Compliance (UAFCB) was renamed to Utility Audits Branch (UAB).

CPUC approval as required by PU Code, Section 818. In addition, EPWC misclassified the debt as Payables to Affiliated Companies instead of Long-term Debt.

- Finding 4: EPWC overly depreciated its assets recorded in Account 334–Meters by $28,527.

- Finding 5: EPWC overstated the total value of its Common Stock recorded in Account 201 by $325,001.

RESTRICTED USE OF THIS AUDIT REPORT

This audit report is intended solely for the information and use by the CPUC and the management of EPWC. It is not intended to be used and should not be used by anyone other than the specified parties. However, this report is a matter of public record and its distribution is not limited.

BACKGROUND

The California Public Utilities Commission (CPUC) was established by Constitutional Amendment as the Railroad Commission in 1911. The Legislature passed the Public Utilities Act in 1912 to expand the CPUC's regulatory authority over natural gas, electric, telephone, and water companies as well as railroads and marine transportation companies. In 1946, the Railroad Commission was renamed the California Public Utilities Commission.[2] The California Public Utilities (PU) Code granted CPUC's regulatory authority over Investor-Owned Utilities (IOU) in California. The Utility Audits Branch (UAB), formerly known as the Utility Audit, Finance and Compliance Branch (UAFCB)[3], is in the Utility Audits, Risk and Compliance Division (UARCD), which reports directly to the Executive Director of the CPUC. The UAB provides auditing, accounting, financial, and advisory services on regulated utilities and monitors compliance with laws and CPUC directives.

PU Code, Section 314.5(a) states, in part, that:

> *The commission shall inspect and audit the books and records for regulatory and tax purposes as follows… (2) At least once every five years in the case of every electrical, gas, heat, telegraph, telephone, and water corporation serving 10,000 or fewer customers.*

In addition, PU Code Section 314.6(a) states that, *"The commission may conduct financial and performance reviews or audits of any entity or program created by any order, decision, motion, settlement, or other action of the commission."* Regulated utilities are required to comply with PU Code Sections 581, 582 and 584 by timely submitting to the CPUC the requested documents in the form and detail prescribed by the CPUC.

On November 10, 2016, CPUC approved Decision (D.) 16-11-006 to update its Uniform System of Accounts (USOA), which is a basis of accounting other than the generally accepted accounting principles in the United States, for the regulated water and sewer IOUs in California. All regulated water utilities are required to comply with the accounting requirements specified in the updated USOA, which became effective on January 1, 2018. Among other requirements, the USOA requires that *"The books of account of all water utilities shall be kept by the double entry method, on an accrual basis. Each utility shall post its accounts monthly and shall close its books at the end of each calendar year."* [4]

For the purpose of applying systems of accounts prescribed by the CPUC, regulated water utilities are divided into four classes based on the number of service connections as follows:

Class A Utilities—having more than 10,000 service connections.
Class B Utilities—having between 2,001 service connections and 10,000 service connections.
Class C Utilities—having between 501 service connections and 2,000 service connections.
Class D Utilities—having 500 service connections or less.

Classes B, C and D water utilities are commonly referred to as "Small Water Utilities."

[2] https://www.cpuc.ca.gov/history/
[3] Effective January 2020, Utility Audit, Finance and Compliance (UAFCB) was renamed to Utility Audits Branch (UAB).
[4] D.16-11-006, Page B13.

East Pasadena Water Company (EPWC) was incorporated in California on December 26, 1930. EPWC is a Class B water utility subject to the jurisdiction of the CPUC, providing water service in portions of Pasadena, Arcadia, Temple City, and adjacent territory in the County of Los Angeles. EPWC is engaged in the sale and distribution of water to approximately 2,985 residential and commercial customers. EPWC's operations include production, storage, and distribution of domestic water in the Pasadena area of Southern California. EPWC's parent company is California Michigan Land and Water Company (Cal-Mich).

OBJECTIVE AND SCOPE

UAB conducted the audit of EPWC's 2018 Annual Report filed with the CPUC in accordance with applicable PU Code, regulations, and CPUC's directives. The primary objectives of this audit are to ensure the fair presentation of the financial information in EPWC's 2018 Annual Report and to determine whether EPWC complied with the applicable regulations and CPUC's directives. The scope of our audit was the financial information presented in EPWC's 2018 Annual Report filed with the CPUC. In addition, UAB evaluated EPWC's effectiveness of internal control over its accounting and reporting functions as it relates to the audit objectives.

METHODOLOGY

To determine EPWC's compliance with the applicable regulations and CPUC's directives in reporting the financial information in its 2018 Annual Report and to assess EPWC's internal controls over its accounting and reporting, the UAB obtained sufficient and appropriate evidence to achieve the audit objectives. The specific procedures performed during this audit included, but were not limited to, the following:

1. Obtained an understanding of the company's business operation and its accounting system.

2. Performed pre-audit analytical procedures on the reported financial data to identify year-to-year trends and significant fluctuations of individual accounts over the past three-year period.

3. Assessed the company's internal controls through observation, inquiry, and documentation. Specific procedures included, but were not limited to, (A) Reviewed the company's policies and procedures, and their implementation pertaining to accounting, recording, reporting, and record retention; (B) Discussed with key company personnel to obtain an understanding of its internal control structure and operating environment; and, (C) Reviewed the company's organization chart to evaluate segregation of duties, authorization and approval processes, performance monitoring and controls, and compliance with regulatory requirements and CPUC's directives.

4. Performed risk assessment and determined materiality level based on the auditor's understanding of the company's operations, the evaluation of its internal control, and UAB's pre-audit financial analysis.

5. Determined the company's compliance with applicable regulation and CPUC's directives regarding the timeliness of filing the Annual Report; compliance with USOA accounting requirements; treatments of public grants, loans, utility plant, facility fees, and user fees; disclosure and accounting treatment of affiliated transactions, etc.

6. Reviewed the list of water plant assets, related invoices, purchase orders, work orders, and depreciation schedule to determine the existence, completeness, rights, and valuation of utility plant.

7. Reconciled Utility Plant in Service and depreciation expense balances shown in the Annual Report to the general ledger and depreciation schedules.

8. Reviewed lease agreements for new leases and determine whether leased assets were properly capitalized, and that related depreciation is determined using an appropriate method and asset's useful life.

9. Determined that amounts recorded as Water Plant Construction Work in Progress are for on-going and uncompleted construction-related projects.

10. Reviewed the loan agreements and bank statements to determine the obligation, completeness, classification, and valuation of reported liabilities related to the utility's operations.

11. Determined the occurrence, completeness, accuracy, classification, and cutoff of the recorded expenditures by reviewing relevant supporting documents, such as purchase requisitions, cancelled checks, bank statements, invoices, contracts or agreements, and insurance policies, etc. Performed sample-testing as appropriate.

12. Determined the completeness, accuracy, and cutoff of the recorded revenues by reviewing the billing records and money received from ratepayers; and performed reasonableness tests of reported revenues based on the CPUC approved tariffs for the audit period.

13. Reconciled the amounts reported on the Annual Report to the underlying accounting records presented on the general ledger and trial balance for the year ended December 31, 2018.

14. Determined that cash exist and is supported by bank statements and bank reconciliations. Determined that cash balance is properly classified (facilities fees, customer's deposits, contributions) in the financial statements and any restrictions on the use of the funds are properly disclosed.

15. Analyzed Common Stock and Other Paid-in Capital accounts by reviewing common stock certificates, par value, shares outstanding, and recalculated average share price.

16. Determined and disclosed if any related/affiliated party transactions per D.06-12-029.

17. Determined that contributions were used for intended construction purposes by reviewing the contribution agreement.

AUDIT FINDINGS AND RECOMMENDATIONS

The results of our audit of EPWC's 2018 Annual Report are described below. The audited financial statements and UAB's Audit Adjustments journal entries are presented in the next section, titled "Audited Financial Statements."

Finding 1: Accrued vacation and sick leave expenses were not properly classified as Employee Pension and Benefits expenses

Condition:
EPWC classified and reported vacation and sick leave expenses as regular salaries instead of classifying and reporting them as Employee Pension and Benefits expenses. The misclassification resulted in an understatement of Employee Pension and Benefits expenses by $51,879, and overstatements of Employee Labor, Office Salaries, and Management Salaries by $21,895, $9,215, and $20,769, respectively.

Criteria:
Regarding Account 674–Employee Pensions and Benefits, the USOA states, in part, that:

> *This account shall include all accruals under employee pension plans to which the utility has irrevocably committed such funds and payments for employee accident, sickness, hospital and death benefits, or insurance therefore. Include also expenses for medical, educational or recreational activities of employees.*

Cause:
EPWC did not properly interpret and follow the USOA guidelines.

Effect:
Inaccurate reporting of Employee Pensions and Benefits, Employee Labor, Office Salaries and Management Salaries account balances distorted EPWC's Income Statement presentation for the year ended December 31, 2018.

Recommendation:
EPWC should classify accrued vacation and sick leave expenses as Employee Pension and Benefits per the USOA guidelines.

Finding 2: Non-compliance with USOA Guidelines for CPUC Users Fee

Condition:
EPWC collected $41,780 Users Fee from its customers and remitted them to the CPUC. However, EPWC did not report the CPUC Users Fee of $41,780 by using both the Account 480–Other Water Revenue and Account 688–Regulatory Commission Expense in the G/L and the Annual Report.

Criteria:
Regarding water utility Users Fee, the USOA states, in part, that *"Water utilities will credit regular operating revenue accounts with amounts billed to customers and charge account 688, Regulatory Compliance Expense, with fees paid to the Commission."*

Cause:
EPWC treated the CPUC Users Fee as a pass-through activity without recording the revenues and expenses associated with the collection and remission of the fees. Thus, EPWC did not follow the USOA guidelines for reporting Regulatory Commission Expense on the 2018 Annual Report.

Effect:
Inaccurate reporting of Other Water Revenue and Regulatory Commission Expense account balances distorted EPWC's Income Statement presentation for the year ended December 31, 2018.

Recommendation:
EPWC should follow the USOA guidelines to record and report CPUC Users Fee in all future filings of its Annual Reports with the CPUC.

Finding 3: Non-compliance and Misclassification of Long-term Debt

Condition:
In D.12-03-009, issued on March 8, 2012, the CPUC authorized EPWC to borrow $1.15 million. However, EPWC improperly obtained the loan from Cal-Mich on September 21, 2011, before obtaining the CPUC approval as required by PU Code, Section 818. In addition, EPWC misclassified the debt as Payables to Affiliated Companies instead of Long-term Debt. The loan amount per the agreement was $900,000 with a maturity date of September 30, 2021. The loan has a variable interest rate with a minimum of 5.25 percent and a maximum of 10 percent. The outstanding loan balance was $313,915 as of December 31, 2018. Since the loan has been outstanding for more than 12 months, it is considered a long-term debt and should have been recorded as such per the USOA guidelines.

Criteria:
The USOA states, in part, the following:

> 224. Long-Term Debt
> *A. This account shall include all notes, conditional sales contracts or other evidences of indebtedness payable more than one year from date of issue.*
> *B. A separate subaccount shall be maintained for each obligation outstanding. Note: Prior authorization must be obtained from this Commission before any long-term indebtedness may be incurred by the utility. (Public Utilities Code, Section 818.)*
>
> 230. Payables to Affiliated Companies
> *A. This account shall include amounts owed to affiliated companies on notes, drafts, acceptances, or other similar evidence of indebtedness, and open accounts payable on demand or not more than one year from date of issue or creation. Note: The records supporting the entries to this account shall be so kept that the utility can furnish complete information concerning each note, draft, acceptance, indebtedness, or other open account.*

Cause:
EPWC did not comply with the USOA guidelines because they considered the loan was from its parent company and not from a third-party; this caused the long-term debt to be understated. In addition, EPWC did not comply with the PU Code, Section 818, which requires that utilities obtain prior CPUC approval before incurring any long-term debts.

Effect:
Misclassification of Long-term Debt distorted EPWC's financial position as of December 31, 2018. Non-compliance with the PUC directives could expose the Utility to undue liability.

Recommendations:
EPWC should adhere to the USOA guideline and reclassify its loan as long-term debt. In addition, EPWC should ensure it complies with the requirements specified under PU Code, Section 818, prior to obtaining any long-term debt in the future.

Finding 4: Over Depreciation of Assets

Condition:
EPWC overly depreciated its assets recorded in Account 334–Meters by $28,527. Gross Meters depreciable basis was $740,623, but Accumulated Depreciation was $769,150 per the depreciation schedule, resulting in an over depreciation of $28,527 ($769,150 - $740,623).

Criteria:
The USOA states in part:

> *General Accounting Instructions paragraph 4. Depreciation*
> *A. Depreciation charges shall be computed using the straight-line remaining life method, and composite depreciation rates. The rates shall be reviewed periodically and adjusted as required, so that the depreciation accrual will bear a reasonable relationship to the remaining life, the estimated net future salvage, costs of plant in service, and to the balance of accumulated depreciation accrued in prior periods.*
>
> *403. Depreciation Expense*
> *This account shall be charged with that portion of the depreciation accrual credited to Account 108, Accumulated Depreciation of Water Plant, applicable to all classes of depreciable water plant except plant represented by contributions in aid of construction. Depreciation shall be accrued on a straight-line remaining life basis.*

Cause:
EPWC did not reconcile its accumulated depreciation to its depreciable base for its utility plant assets to ensure that accumulated depreciation did not exceed the depreciable base. EPWC lacks policy and procedures to ensure assets cannot be overly depreciated beyond its useful life and depreciable base.

Effect:
Depreciating an asset in excess of its depreciable base caused an understatement of EPWC's Rate Base by $28,527 and overstatements of its depreciation expenses for the years beyond the asset's useful life, which could potentially impact water rates for its ratepayers.

Recommendations:
1) EPWC should ensure that it adheres to the USOA guidelines to record its transactions.
2) EPWC should reduce its Accumulated Depreciation in its accounting records to the asset's depreciable base for the Water Meters.
3) EPWC should stop depreciating an asset once it is fully depreciated.
4) EPWC should develop policies and procedures to ensure assets are not overly depreciated beyond its useful life and depreciable base. A copy of the policies and procedures should be submitted to the UAB and the Water Division as part of EPWC's Corrective Action Plan.

Finding 5: Overstatement of Common Stocks

Condition:
EPWC's common stocks of 1,000 shares were originally issued at zero par value. During the change of EPWC's ownership in March 1931, however, the CPUC assigned a par value of $25 per share via D.23475. In addition, the decision limited the number of shares of EPWC's common stocks to 550 for that ownership change. Thus, the CPUC valued the common stocks at a total amount of $13,750 (550 shares x $25/share). In D.66295, which was issued on November 15, 1963, the CPUC approved Cal-Mich's sale and transfer of its water operating rights and properties to EPWC. The issuance of an

additional 450 shares of common stocks at zero par value was approved by D.66295. In its 2018 Annual Report, EPWC reported a total value of $338,751 for the 1,000 shares of common stocks. Therefore, the reported total value for Account 201–Common Stock was overstated by $325,001 ($338,751 - $13,750).

Criteria:
The USOA states in part:

> *201. Common Stock - A. This account shall be credited with the total par value or stated value of common stock outstanding. B. Premiums related to the issue of common stock shall be carried in a separate subaccount of Account 211, Other Paid in Capital.*
>
> *206. Subchapter S Corporation Accumulated Adjustments Account*
> *A. This account shall be used by Subchapter S Corporations for the reporting of changes in its ownership equity.*
> *B. This account shall include all paid-in-capital not derived from earnings.*
> *C. This account shall be credited with:*
> *1. Net income.*
> *2. Accounting adjustments not properly attributable to the current period.*

Cause:
EPWC incorrectly recorded and reported the total value of its common stocks recorded in Account 201 based on its acquisition costs during the change of company ownership.

Effect:
Incorrectly reporting the value of EPWC's Common Stock can be misleading to the CPUC and the public.

Recommendations:
EPWC should value its Common Stock and the number of shares based on CPUC's D.23475. Going forward, EPWC should record and report its Common Stock at a total value of $13,750.

CONCLUSION

In conducting this audit, we obtained an understanding of EPWC's internal controls, including any information systems controls that we considered significant within the context of our audit objectives. We assessed whether those controls were properly designed, implemented, and operating effectively. Any deficiencies in internal control that were identified during this audit and determined to be significant within the context of our audit objectives are included in this report.

EPWC's management is responsible for the preparation and fair presentation of its 2018 Annual Report filed with the CPUC. The CPUC requires that the statements be in accordance with the accounting requirements as set forth in CPUC's USOA. EPWC's management is also responsible for the design, implementation, and maintenance of internal controls relevant to the preparation and fair presentation of its 2018 Annual Report that are free from material misstatements, whether due to fraud or error. In addition, EPWC's management is responsible for the development of its policies and procedures to ensure full compliance with applicable regulations and CPUC directives.

We conducted our audit in accordance with the applicable PU Code, regulations, and CPUC's directives. We planned and performed the audit to obtain sufficient, appropriate evidence to provide a reasonable basis for our findings, audit adjustments and conclusions based on our audit objectives. We believe that the evidence obtained provides a reasonable basis for our findings, audit adjustments, and recommendations presented in this report.

EPWC Management should submit a corrective action plan to Raymond Yin, Program and Project Supervisor of Utility Audits Branch, with a copy to Lucian Filler, Deputy Executive Director of CPUC, no later than May 11, 2020. The corrective action plan should address how EPWC will implement the recommendations and provide the timing of incorporating UAB's audit adjustments to EPWC's books and records. If EPWC is unable to implement UAB's recommendations, the corrective action plan should state the reason(s) for not being able to implement any of the recommendations. EPWC should use the audited amounts in UAB's audit report as the basis to file its 2019 Annual Report with the CPUC.

VIEWS OF RESPONSIBLE OFFICIAL

On January 27, 2020, UAB provided a draft audit report to EPWC for comments. On February 7, 2020, EPWC provided its comments to UAB, which are included in Appendix C of this report. UAB's evaluations of and rebuttals to those comments are in Appendix D of this report. Where appropriate, UAB modified its preliminary audit findings and recommendations. The audit findings and recommendations presented in this report represent our final determination of this audit.

Angie Williams

Angie Williams, Director
Utility Audits, Risk and Compliance Division

cc: Alice Stebbins, Executive Director, CPUC
Lucian Filler, Deputy Executive Director, CPUC
Bruce DeBerry, Program Manager, Water Division
Raymond Yin, Program and Project Supervisor, UAB
Khusbindar Kaur, Senior Management Auditor, UAB
Sharmin Wellington, Public Utilities Regulatory Analyst V, UAB

EAST PASADENA WATER COMPANY
BALANCE SHEET (AS AUDITED)
As of December 31, 2018

ASSETS	
UTILITY PLANT	
Water Plant in Service (Note 2)	$12,021,338
Water Plant in Service - SDWBA (Note 6)	1,500,000
Construction Work in Progress - Water Plant	126,723
Accumulated Depreciation of Water Plant (Note 2)	(5,618,034)
Accumulated Amortization of SDWBA (Note 6)	(1,500,000)
Water Plant Acquisition Adjustments (Note 2)	(242,946)
Net Utility Plant	6,287,081
CURRENT AND ACCRUED ASSETS	
Cash (Note 4)	510,229
Accounts Receivable – Customers	577,935
Receivables from Associated Companies	16,940
Materials and Supplies (Note 3)	22,225
Other Current Assets	117,696
Deferred Charges	10,621
Total Current and Accrued Assets	1,255,646
Total Assets	$7,542,727
LIABILITIES AND OTHER CREDITS	
SHAREHOLDERS' EQUITY	
Common Stock	$13,750
Subchapter S Corp. Accumulated Adj. Acct. (Note 1)	1,350,783
Retained Earnings (Note 1)	4,560,583
Total Shareholders' Equity	5,925,116
LONG-TERM DEBT	
Long-Term Debt (Note 7)	211,891
CURRENT AND ACCRUED LIABILITIES	
Payables to Affiliated Companies	102,024
Accounts Payable	120,750
Short-term Notes Payable	50,000
Customer Deposits	12,750
Accrued Taxes	1,400
Other Current Liabilities	260,230
Total Current and Accrued Liabilities	547,154
CONTRIBUTION IN AID OF CONSTRUCTION	
Contributions in Aid of Construction (Note 5)	1,506,474
Accumulated Amortization of Contributions	(647,908)
Net Contributions in Aid of Construction	858,566
Total Equity and Liabilities	$7,542,727

(The accompanying Notes to Financial Statements are an integral part of these Financial Statements)

EAST PASADENA WATER COMPANY
INCOME STATEMENT (AS AUDITED)
For Year Ended December 31, 2018

OPERATING REVENUES	
Fire Protection Revenue	$31,871
Metered Water Revenue	3,124,639
Other Water Revenue	52,980
Total Operating Revenues	3,209,490
OPERATING EXPENSES	
Plant Operation and Maintenance Expenses	
Purchased Water	453,442
Power	213,142
Other Volume Related Expenses	200,475
Employee Labor	309,272
Materials	37,746
Contract Work	86,816
Transportation Expenses	79,224
Other Plant Maintenance Expenses	35,756
Total Plant Operation and Maintenance Expense	1,415,873
Administrative and General Expenses	
Office Salaries	130,171
Management Salaries	312,327
Employee Pensions and Benefits	189,597
Uncollectible Accounts Expense	839
Office Services and Rentals	97,935
Office Supplies and Expenses	55,718
Professional Services	75,392
Insurance	125,900
Regulatory Commission Expense (Note 9)	69,319
General Expenses	118,712
Total Administrative and General Expenses	1,175,910
Total Operating Expenses	**2,591,783**
Depreciation Expense (Note 2)	300,837
State Corporate Income Tax Expense	113,081
Federal Corporate Income Tax Expense (Benefit)	1,400
Total Operating Revenue Deductions	3,007,101
Total Utility Operating Income	202,389
OTHER INCOME AND DEDUCTIONS	
Non-Utility Income	305
Miscellaneous Non-Utility Expense	(22,291)
Total Other Income and Deductions	(21,986)
Net Income	$180,403

(The accompanying Notes to Financial Statements are an integral part of these Financial Statements)

EAST PASADENA WATER COMPANY
STATEMENT OF CHANGES IN SHAREHOLDERS' EQUITY (AS COMPILED [5])
For Year Ended December 31, 2018

Shareholders' Equity, Beginning of the Year	**$5,405,953**
Common Stock	13,750
CREDITS:	
Net Income	180,403
UAB Adjustment to Other Paid-in Capital	325,005
EPWC's Rounding Adjustment to the 2018 Annual Report	5
Total Credits	505,413
DEBITS:	
Dividend	0
Total Debits	0
Shareholders' Equity, End of the Year	**$5,925,116**

(The accompanying Notes to Financial Statements are an integral part of these Financial Statements)

[5] UAB compiled the Statement of Retained Earnings based on the audited Balance Sheet and Income Statement, and other relevant financial data.

EAST PASADENA WATER COMPANY

NOTES TO FINANCIAL STATEMENTS

Regulated water utilities are required to prepare their financial statements on accrual basis of accounting set forth in the Uniform System of Accounts (USOA) for Water Utilities adopted in Decision (D.) 16-11-006 by the California Public Utilities Commission (CPUC) on November 16, 2016, which is a comprehensive basis of accounting other than the generally accepted accounting principles (GAAP) in the United States of America. The following describe certain differences in accounting treatments between GAAP and USOA, the company's current accounting practices, and its compliance with applicable regulation and CPUC directives.

1. Purpose of Financial Information and Targeted Audience

The objective of preparing financial statements in accordance with GAAP is to provide information that is useful in making decisions about providing resources to the entity. Users of the financial information include existing and potential investors, lenders, and other creditors.

The purpose of using USOA to prepare financial statements is to have the utilities provide financial transparency of their water operations on a consistent basis. The primary user of the financial information is the CPUC for ratemaking and other compliance purposes.

Retained Earnings reflect the accumulated earnings of a corporation since inception less dividends, prior period adjustments and transfers to Other Paid-in Capital account. UAB did not audit the Retained Earnings due to the lack of historical information. Since EPWC converted itself from a C Corporation to an S Corporation effective January 1, 2017, the Retained Earnings of $4,560,583 presented in the Balance Sheet and Statement of Changes in Shareholders' Equity represent the Retained Earnings inherited from the C Corporation form as of December 31, 2016. Other Paid-in Capital of $325,005 recorded in Account 211 was reclassified to Account 206—Subchapter S Corporation Accumulated adjustment based on the accounting requirements from the USOA. The Changes in Shareholders' Equity of $5,911,366 is comprised of Retained Earnings and Subchapter S Accumulated Adjustments.

2. Property, Plant, and Equipment

The USOA distinguishes the plant assets for water operations (i.e., Account 101, Water Plant in Service) from those for non-water operations (i.e., Account 121, Non-Water Utility Property and Other Assets), for ratemaking purposes.

(1) Depreciation Methodology
GAAP allows entities to elect a depreciation methodology of their choices, such as straight-line, double-declining balance, or sum-of-the-years digits depreciation method.

USOA requires utilities to use the "Straight-line remaining life method." "Remaining life" implies that estimates of future life and salvage value will be re-evaluated periodically and that depreciation rates will be adjusted to reflect any changes in estimates. Water utilities are required to comply with the CPUC's Standard Practice (SP) U-4-SM and SP U-4-M when determining depreciation accruals. Specifically, for the water plant with over $100,000, the utility must maintain separate depreciation reserve by different plant accounts in accordance with Appendix B1 of SP U-4-SM; for the water plant under $100,000, if the utility elects not to separate or maintain the depreciation reserve by accounts, it is appropriate to develop a composite value for remaining life for the entire plant in accordance with Appendix B2 or B3 of SP U-4-SM. The USOA suggested that all utilities maintain a separate accumulated depreciation subaccount for each depreciable plant account; and, it is mandatory for water utilities having more than 500 customers.[6] The utility must obtain prior written approval from the CPUC for any practice deviates from the aforementioned SPs.

EPWC utilizes the straight-line remaining life method for each class of asset as prescribed in the Standard Practice U-4 to determine depreciation accruals. EPWC reviews its depreciation rates during the general rate case cycle, which could occur once every three or five years. This could cause assets' depreciation basis not to reflect its useful life. During the audit period assets depreciation did not reflect its useful life; for example, an asset was over depreciated. Refer to Finding 4 of this report for details.

(2) Asset Retirement

USOA requires that water plant be recorded at its original cost. In USOA's depreciation schedule, the difference between the estimated cost of removal and the salvage value is included in the depreciable base to obtain the annual depreciation expense. When retiring an asset, the cost of removal will reduce the balance of Account 108, Accumulated Depreciation of Water Plant, while the cash received from the salvage value or sale price will increase the balance of Account 108, Accumulated Depreciation of Water Plant. The gain or loss from the asset retirement that is recognized under GAAP is recorded in Account 108, Accumulated Depreciation of Water Plant under the USOA.

(3) Water Plant Acquisition Adjustments

Under GAAP, entities recognize gain or loss from disposal of properties and recognize goodwill or gain from a bargain purchase of other entities' segment or properties.

Under USOA, no goodwill or gain is recognized from the sale or acquisition of a water system or unit, unless it's approved by the CPUC's decision. When the utility sells or purchases the water system or unit, the utility shall first record the transaction into a temperate Account 104, Water Plant Purchased or Sold. Within six months from the date of sale or date of acquisition, the utility shall file with the CPUC for approval proposed journal entries to clear this account. The difference between the net original cost of the assets acquired and the cost to the acquiring utility shall be charged or credited to Account 114, Water Plant Acquisition Adjustments.

EPWC reported an acquisition adjustment of ($242,946) for the year ended December 31, 2018. EPWC stated,

> *During years 2001 and 2002, EPW was in the process of drilling and constructing a new well. During the drilling process it was determined that the water produced by the well would not meet the water quality standards set by the United States Environmental Protection Agency or by the California Department of Health Services. During 2003, EPW replaced the well's production capacity through other means, and as a result abandoned the well project. EPW consulted with the CPUC as to the proper treatment of the abandonment. It was determined by EPW and the CPUC that the well costs be reclassified from "Construction work in progress" to "Deferred*

[6] D.16.11-006 dated November 10, 2016, General Accounting Instructions 4 on Page B14.

Charges" as reflected on the December 31, 2003 balance sheet. EPW and the CPUC are in the process of determining the recovery period of these costs from the utility customers. [7]

3. Inventory

GAAP allows entities to use different methodologies, such as average cost, first-in-first-out, and last-in-first-out, for the valuation of inventory, which includes cost components of raw materials, work-in-process, and finished goods, etc.

Under USOA, the inventory includes meters, materials and supplies. If identifiable, the inventory should be recorded at original cost, which includes transportation charges, sales and use taxes and other directly assignable costs. Items of small value whose original cost cannot be readily determined shall be recorded at current prices. Scrap materials shall be carried in inventory at estimated scrap value.

4. Cash and Cash for Restricted Use

Under GAAP, if the restricted funds are considered to offset the current liability, the funds may be included as current asset classification. If the funds are set aside for use in the near future for the liquidation of long-term debts, payments to sinking funds, then the funds should be classified to non-current assets. If unsure of the timing of the use, the restricted cash can be classified as Other Assets.

Under USOA, the restricted funds are recorded to Account 132, Cash–Special Deposits, which should include cash amounts set aside from general corporate funds, deposited in a separate account with fiscal agents or others, and designated for a special use. A separate subaccount shall be maintained for each designated special use. Interest earned from this account shall be credited to Account 421, Non-Utility Income.

5. Contribution in Aid of Construction (CIAC)

CIAC account records non-refundable contributions of cash, land or other property donated to the water utility to assist it in constructing, extending, or relocating its water system. The funds can be from governmental agencies and others. The balances in this account shall be written off over the period of its estimated service life by charging to Account 272, Accumulated Amortization of Contributions instead of a Deprecation Expense account, with contra credits to the appropriate subaccount of Account 108, Accumulated Depreciation of Water Plant.

6. Safe Drinking Water Bond Act (SDWBA) Loans

SDWBA loans are low-interest loans from the California Department of Water Resources (DWR) to assist water utilities to fund materials and services used on DWR-approved construction projects. SDWBA loans are repaid through surcharges on customer water bills. Although the accounting treatment of SDWBA loans is similar to GAAP, the USOA requires water utilities to follow the special accounting procedures below:

Water utilities must obtain the CPUC's written approval prior to obtaining a SDWBA loan and instituting a SDWBA surcharge to its ratepayers. Any SDWBA surcharge collected from ratepayers shall be

[7] EPW is the company's acronym used by East Pasadena Water Company (EPWC) when it responded to UAB's inquiries.

deposited monthly to Account 132, Cash–Special Deposits. The periodical payment of the SDWBA loans and related interest expenses shall be made from this special deposit account.

Plant assets funded by a SDWBA loan are booked in Account 101.1, Water Plant in Service–SDWBA, and are not depreciable. The principal of a SDWBA loan is amortized through the charges to Account 407, SDWBA Loan Amortization Expense, with contra credits to Account 108.1, Accumulated Amortization of SDWBA Loan, over the life of the SDWBA loan. EPWC financial statements reflected water plant in service funded by the Safe Drinking Water Bond Act of $1,500,000. The water plant has been fully amortized.

7. Long-Term Debt

Water utilities are required to obtain prior authorization from the CPUC before incurring any long-term debt. PU Code Section 818, states that,

> *No public utility may issue stocks and stock certificates, or other evidence of interest or ownership, or bonds, notes, or other evidences of indebtedness payable at periods of more than 12 months after the date thereof unless, in addition to the other requirements of law it shall first have secured from the commission an order authorizing the issue, stating the amount thereof and the purposes to which the issue or the proceeds thereof are to be applied, and that, in the opinion of the commission, the money, property, or labor to be procured or paid for by the issue is reasonably required for the purposes specified in the order, and that, except as otherwise permitted in the order in the case of bonds, notes, or other evidences of indebtedness, such purposes are not, in whole or in part, reasonably chargeable to operating expenses or to income.*

In D.12-03-009, which was issued on March 8, 2012, the CPUC authorized EPWC to borrow $1.15 million. However, EPWC improperly obtained the loan from Cal-Mich on September 21, 2011, before obtaining the CPUC approval as required by PU Code, Section 818. In addition, EPWC misclassified the debt as Payables to Affiliated Companies instead of Long-term Debt. The loan amount per the agreement was $900,000 with a maturity date of September 30, 2021. The loan has a variable interest rate with a minimum of 5.25 percent and a maximum of 10 percent. The outstanding balance was $313,915 as of December 31, 2018.

8. Authorized Costs and Revenues

Under GAAP, regulated entities record recoverable costs authorized by the regulator as Regulatory Assets and amortize them over a period of time. Likewise, authorized revenues for future repayment are recorded as Regulatory Liabilities.

USOA requires water utilities to record authorized costs that are to be amortized over future periods as an asset in Account 180, Deferred Charges. Similarly, authorized revenues for future repayment are recorded as liabilities in Account 253, Other Credits.

In addition to regular salaries and benefits of $941,367, EPWC paid a total of $87,000 bonus to eight of its staff for the year ended December 31, 2018. The $87,000 bonus payments were allocated as follows: Management $43,250, Office Staff $10,850, Employees $17,900, and Consultant $15,000.

9. Water Utility Users Fee

PU Code, Sections 401 through 410 authorized the CPUC to set a fee annually to water utilities to cover the costs incurred by the CPUC in regulating them. USOA requires water utilities to credit regular operating revenue accounts with amounts of Users Fee billed to customers and charge Account 688, Regulatory Commission Expense, with fees paid to the CPUC.[8]

EPWC is not in compliance with the USOA guidelines regarding the treatment of CPUC Users Fee. EPWC treated the CPUC Users Fee as a pass-through activity without recording the revenues and expenses associated with the collection and remission of the fees. Therefore, fees collected and remitted to the CPUC of $41,780 was not reported on the 2018 Annual Reports per the USOA guidelines.

10. Affiliate Transactions

Affiliate companies are all entities, including any holding companies, that are under direct or indirect common ownership or control with a water utility regulated by the CPUC. Water utilities are required to comply with the rules specified in D.10-10-019 and SP U-21-W for all the transactions with its affiliates.

Rule 12 of SP U-21-W states, in part, that, "*Water Utility shall file with the Commission each year a report which includes a summary of all transactions between Water Utility and its affiliated companies for the previous calendar year….*"

Cal-Mich has a long-standing real property lease agreement with EPWC with an annual lease agreement of $60,000. Cal-Mich loaned EPWC approximately $900,000 during 2011 with an outstanding balance of $313,915 as of December 31, 2018. There were numerous intercompany transfers between EPWC and Cal-Mich. In addition, EPWC leases water rights from Cal-Mich's President for approximately $453,886 for the year ended December 31, 2018.

In addition, EPWC's 2018 Annual Report reflects Receivables from Affiliated Companies of $16,940. EPWC's Annual Report did not reflect non-tariffed services per D.04-12-023, Ordering Paragraph 3. EPWC's Annual Report reflects the operations of the utility and affiliated transactions except for the findings noted in the audit report.

11. Form of Financial Statements [9]

(1) Balance Sheet

Unlike the financial statements of other industries, the financial statements of regulated water utilities present the water plant as the first major caption on the asset side of the balance sheet, and capitalization is first on the liability side. Current assets and current liabilities are relegated to a comparatively unimportant position in the center of the balance sheet, rather than being placed prominently as in statements for non-regulated industries.

(2) Income Statement

The form of Income Statement reflects the classification of revenues and expenses in ratemaking. Operating revenues and expenses are referred to as "above the line" because they are allowable in ratemaking, and the result of deducting total operating expenses from total operating revenues is

[8] D.16.11-006 dated November 10, 2016, General Accounting Instructions 9 on Pages B18 and B19.
[9] Regulated Utilities Manual—A Service for Regulated Utilities by Deloitte & Touché USA LLP, pages 36-37.

the operating income. Other Income and Deductions are referred to as "below the line" because they are applied after operating income and are not allowable in ratemaking. The "below the line" items include interest revenue, dividend income, other revenues that are from non-water utility operations and/or non-water utility properties, expenses that are unrelated to water utility operations, and interest expense (the interest expense is recovered through the authorized rate of return). The concept of "above the line" revenues and expenses being allowable in ratemaking affects the form of the income statement, the classification of revenues and expenses, and decisions of management in incurring expenses.

12. Exclusion of Statement of Cash Flows

Financial Accounting Standards Board specifies in its Statement of Financial Accounting Standards No. 95 that a Statement of Cash Flows is part of a complete set of financial statements under GAAP. However, Codification of Statements on Auditing Standards AU-C Section 800.A35 states, in part, that, *"Special purpose financial statements may not include a statement of cash flows…."* Since the USOA is an accounting framework other than GAAP for regulatory purposes, the Statement of Cash Flows is not required and therefore excluded from this audit report.

13. Compliance filing of 2018 Annual Report with the CPUC

PU Code, Sections 581, 582, and 584, and the CPUC's directive (i.e., Water Division's annual memorandum to water and sewer utilities) require all regulated water and sewer utilities to file an Annual Report with the CPUC every year. For the year being audited, EPWC has complied with these requirements.

UAB'S AUDIT ADJUSTMENTS

FOR THE YEAR ENDED DECEMBER 31, 2018

Audit Adj. No.	Annual Report			Acct. No.	Description	Debit	Credit
	Sch.	Line	Col.				
1	B-2	20	c	674	Employee Pension and Benefits	$51,879	
	B-2	9	c	630	Employee Labor		$21,895
	B-2	18	c	670	Office Salaries		9,215
	B-2	19	c	671	Management Salaries		20,769
					To classify vacation and sick time to employee pension and benefits per USOA guidelines.		
2	B-2	26	b	688	Regulatory Commission Expense	$41,780	
	B-1	26	b	480	Other Water Revenue		$41,780
					To record CPUC Users Fees per the USOA guidelines.		
3	A	16	b	230	Payables to Affiliated Companies	$211,891	
	A	13	b	224	Long-term Debt		$211,891
					To reclassify loan from an Affiliated Company to Long-term Debt because it is over 12 months outstanding.		
4	A	14	c	108	Accumulated Depreciation of Water Plant	$28,527	
	B	6	b	403	Depreciation Expense		$28,527
					To reduce excess depreciation expense to reflect the plant-Meters depreciable basis.		
5	A	2	b	201	Common Stock	$325,001	
	A	4	b	206	Subchapter S Corporation Accumulated Adjustments		$325,001
					To reclassify Common Stock valued to agree with the Commission's approved value per a share.		

APPENDICES

APPENDIX A—BALANCE SHEETS (AS REPORTED) [10]

ASSETS	As of 12/31/2018	As of 12/31/2017
UTILITY PLANT		
Water Plant in Service	$12,021,338	$11,788,495
Water Plant in Service - Prop 50	1,500,000	1,500,000
Construction Work In Progress - Water Plant	126,723	(1,797)
Accumulated Depreciation of Water Plant	(5,646,561)	(5,275,958)
Accumulated Amortization of Prop 50	(1,500,000)	(1,500,000)
Water Plant Acquisition Adjustment	(242,946)	(242,946)
Net Utility Plant	6,258,554	6,267,794
CURRENT AND ACCRUED ASSETS		
Cash	510,229	603,915
Accounts Receivable - Customers	577,935	542,610
Receivables from Associated Companies	16,940	0
Materials and Supplies	22,225	22,225
Other Current Assets	117,696	116,009
Deferred Charges	10,621	15,548
Total Current and Accrued Assets	1,255,646	1,300,307
Total Assets	$7,514,200	$7,568,101
CAPITALIZATION AND LIABILITIES		
CORPORATE CAPITAL AND SURPLUS		
Common Stock	$338,751	$338,751
Subchapter S Corp. Accumulated Adj. Acct.	997,251	845,370
Other Paid-in Capital	4	4
Retained Earnings	4,560,583	4,560,583
Total Corporate Capital and Surplus	5,896,589	5,744,708
CURRENT AND ACCRUED LIABILITIES		
Payables to Affiliated Companies	313,915	493,245
Accounts Payable	120,750	42,642
Short-term Notes Payable	50,000	100,000
Customer Deposits	12,750	0
Accrued Taxes	1,400	5,159
Other Current Liabilities	260,230	280,309
Total Current and Accrued Liabilities	759,045	921,355
DEFERRED CREDITS		
Advances for Construction	0	2,753
Total Deferred Credits	0	2,753
CONTRIBUTION IN AID OF CONSTRUCTION		
Contributions in Aid of Construction	1,506,474	1,500,880
Accumulated Amortization of Contributions	(647,908)	(601,595)
Net Contributions In Aid of Construction	858,566	899,285
Total Equity and Liabilities	$7,514,200	$7,568,101

[10] The reported amounts were derived directly from EPWC's 2017 and 2018 Annual Reports. They do not represent the audited amounts. They are included here for disclosure purposes only.

APPENDIX B—INCOME STATEMENTS (AS REPORTED) [11]

	For the Year of	
	2018	2017
OPERATING REVENUES		
Fire Protection Revenue	$31,871	$31,102
Metered Water Revenue	3,124,639	3,044,908
Other Water Revenue	11,200	7,986
Total Operating Revenues	3,167,710	3,083,996
OPERATING EXPENSES		
Plant Operation and Maintenance Expenses		
Purchased Water	453,442	213,233
Power	213,142	200,222
Other Volume Related Expenses	200,475	147,652
Employee Labor	331,167	327,100
Materials	37,746	45,893
Contract Work	86,816	79,737
Transportation Expenses	79,224	69,979
Other Plant Maintenance Expenses	35,756	25,644
Total Plant Operation and Maintenance Expenses	1,437,768	1,109,460
Administrative and General Expenses		
Office Salaries	139,386	138,037
Management Salaries	333,096	337,998
Employee Pensions and Benefits	137,718	126,068
Uncollectible Accounts Expense	839	1,933
Office Services and Rentals	97,935	92,221
Office Supplies and Expenses	55,718	50,904
Professional Services	75,392	71,674
Insurance	125,900	127,816
Regulatory Commission Expense	27,539	16,283
General Expenses	118,712	169,359
Total Administrative and General Expenses	1,112,235	1,132,293
Total Operating Expenses	2,550,003	2,241,753
Depreciation Expense	329,364	327,585
State Corporate Income Tax Expense	113,081	109,062
Federal Corporate Income Tax Expense (Benefit)	1,400	5,159
Total Operating Revenue Deductions	2,993,848	2,683,559
Total Utility Operating Income	173,862	400,437
OTHER INCOME AND DEDUCTIONS		
Non-utility Income	305	156
Miscellaneous Non-utility Expense	(22,291)	(24,199)
Total Other Income and Deductions	(21,986)	(24,043)
Net Income	$151,876	$376,394

[11] The reported amounts were derived directly from EPWC's 2017 and 2018 Annual Reports. They do not represent the audited amounts. They are included here for disclosure purposes only.

APPENDIX C—EPWC'S RESPONSES

East Pasadena Water Company
Response To Utility Audit Branch's Audit for Year Ended December 31, 2018

February 7, 2020

Finding No 1
EPWC does not agree with this finding. EPWC believes it has properly reported wages paid to its employees in accounts 630 Employee Labor, 670 Office Salaries and 671 Management Salaries. Further EPWC believes that CPUC audit staff has perhaps mis-interpreted the intent of the instructions for account 674 Employee Pensions and Benefits. EPWC notes that the instructions for account 674 do not mention or include payments for vacation pay, sick pay or holiday pay for that matter. The instructions for account 674 reference payments for types of insurance. In addition, the wording quoted in the CPUC auditor's criteria for this finding no. 1 is not consistent with the wording included in CPUC Standard Practice U-39-W (the USOA for B,C and D Water Utilities.

Finding No 2
EPWC acknowledges that the General Accounting Instructions item no. 9 in the Uniform System of Accounts for B, C and D water utilities provide that CPUC user fees should be credited to regular operating revenue accounts and fees paid to the Commission charged to account 688, Regulatory Commission Expense.

Finding No 3
EPWC does not agree with this finding. EPWC acknowledges that CPUC approval to issue $1.15 million of long-term notes in D.12-03-009 was dated 3/13/2012 and EPWC's Application 11-11-010 was filed 11/07/2011. However, EPWC Application 11-11-010 contained the loan agreement with its parent dated September ___, 2011 (unsigned), See Exhibit C. The same exhibit contains an amortization schedule clearly showing a draw of $350,000 on 11/01/2011 and $550,000 on 12/01/2011. D.12-03-009, p.6, states *"This new financing will allow East Pasadena to fund its capital expenditure plans for the period 2011 through 2013, make loan payments and **refund advances**."* Page 12 of the decision, 12. *"East Pasadena's request is in compliance with §§ 816, 817, 818, 824 and 851.* Page 13, 1. *"...fund its capital expenditure plans for the period 2011 through 2013, make loan payments and **refund advances**."*
In sum, Application 11-11-010 presented a loan agreement contemplating a September 2011 agreement date to cover possible advances. It also included the amortization schedule showing the advances with payments beginning January 2012. D.12-03-009 granted approval to pay back advances and approval of the September 2011 Agreement. For the reasons listed, CPUC Audit Branch did not flag EPWC's loan when it reviewed it again in 2014. Lastly, we believe it is important to note that EPWC was borrowing from its parent and not a third party, giving it the ability to pay down advances prior to a 12-month period and maintaining a short-term borrowing classification.

Finding No 4
EPWC, each time it files a GRC, prepares a depreciation study following Standard Practice U-4. Once the depreciation rates are approved in the GRC, those approved rates are used until the next formal GRC. EPWC 's last GRC was filed for the 2015 test year and those depreciation rates are still in effect. Normally, when EPWC files its next GRC, the depreciation rates will be adjusted and to the extent any category of plant is over depreciated, a negative rate will be used to reduce the over depreciation until the next rate case. EPWC believes it is not appropriate to adjust approved depreciation rates during years between GRC's.

Finding No 5
EPWC has been reporting its Common Stock consistently for many years. At the time of preparing this reply, EPWC has not been able to conclude its research of records back to the 1931 decision that the CPUC auditor refers to and cannot confirm agreement or disagreement with this finding. However, EPWC does not agree with the "Effect" as noted in the CPUC auditors report because EPWC feels it is very misleading to infer that EPWC has overstated its capital when adjustment proposed by the auditor merely moves dollars between capital accounts (specifically common stock and paid-in-capital) resulting in no difference in total capital of EPWC. EPWC feels this matter is not material to the CPUC report and should be removed from further discussion.

Thank you for your time and consideration of the above responses.

Lawrence M. Morales
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East Pasadena Water Company
Relationship, Service, Results

APPENDIX D—UAB'S EVALUATION OF EPWC'S RESPONSES

East Pasadena Water Company (EPWC) submitted its responses to Utility Audits Branch's (UAB) draft report on February 7, 2020. The responses have been reviewed and incorporated into our final audit report. In evaluating EPWC's responses, UAB noted that EPWC did not agree with Findings 1, 3, 4, and 5; however, EPWC agreed with Finding 2. Appendix C contains EPWC's responses in its entirety.

Finding 1: Accrued vacation and sick leave expenses were not properly classified as Employee Pension and Benefits expenses

EPWC did not agree with Finding 1. EPWC believes it has properly reported wages paid to its employees in Account 630 - Employee Labor, Account 670 - Office Salaries and Account 671 - Management Salaries. EPWC believes that UAB is misinterpreting the USOA and that the wording quoted in the criteria for Finding 1 was inconsistent with the USOA.

UAB acknowledged that it made an inadvertent typo in the Criteria section of Finding 1 on page 6 of the draft report[1]. UAB has corrected the typo in the draft report and we appreciated EPWC's feedback.

UAB disagrees with EPWC's position. Account 674 - Employee Pensions and Benefits generally include employer's payments to employees other than actual time worked, or services provided. Employee benefits include compensation for sick days, vacation days, bonuses, health insurance, life insurance, dental insurance, retirement benefits, etc. On Page B47, the USOA allows utilities with more than 1,000 service connections to subdivide Account 674 to correspond with salaries reported in Account 630 - Employee Labor, Account 670 - Office Salaries, and Account 671 - Management Salaries. Therefore, EPWC can separately identify and record its costs of accrued vacation and sick leaves by subdividing Account 674 to record the individual benefits associated with each compensation group.

Although the USOA does not explicitly mention payments pertaining to vacation, sick leaves, or holidays, it provides implicit instruction in Account 674 which states, in part, that the account shall include *"…irrevocably committed funds and payments for employee accident, sickness, hospital and death benefits."* For the reasons stated above, Finding 1 and the related recommendation remain unchanged.

Finding 2: Non-compliance with USOA Guidelines for CPUC Users Fee

EPWC agrees with Finding 2. EPWC should implement UAB's recommendation for this finding.

Finding 3: Non-compliance and Misclassification of Long-term Debt

EPWC did not agree with Finding 3 and stated that the CPUC granted approval for the September 2011 loan agreement in D.12-03-009, dated on March 3, 2012.

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[1] UAB inadvertently typed "also include"; this was corrected to reflect "include also" in the criteria for Account 674–Employee Pensions and Benefits.

UAB disagrees with EPWC's position. Both UAB and EPWC agreed that the CPUC approved the loan agreement between EPWC and its parent company, Cal-Mich, on March 3, 2012, in D.12-03-009; however, EPWC entered into the loan agreement on September 21, 2011, before obtaining the CPUC approval as required by the PU Code, Section 818. UAB reiterates that EPWC had not obtained the CPUC approval for the loan prior to entering into a loan agreement with Cal-Mich as required by PU Code, Section 818. PU Code, Section 818 states, in part:

> *No public utility may issue… evidences of indebtedness payable at periods of more than 12 months after the date thereof unless, in addition to the other requirements of law it shall first have secured from the commission an order authorizing the issue.*

EPWC stated the loan was from its parent; thus, giving them the ability to pay it down prior to a 12-month period and maintain a short-term borrowing classification.

UAB disagrees with EPWC's position. The loan agreement shows that the term of the loan is for a 10-year period commencing on October 1, 2011, and continuing through September 30, 2021. The USOA states in Account 224—Long-term Debt "*shall include all notes, conditional sales contracts or other evidences of indebtedness payable more than one year from date of issue*." Therefore, any portion of the loan that is scheduled to mature beyond one year from the date of the balance sheet should be classified as long-term debt. The ability to repay the non-current portion of long-term debt within 12 months of the balance sheet date does not permit a short-term borrowing classification. Therefore, the non-current portion of the loan is considered long-term debt until the debt is extinguished.

For the reasons stated above, Finding 3 and the related recommendation remain unchanged.

Finding 4: **Over Depreciation of Assets**

EPWC did not agree with Finding 4. EPWC stated that each time they file a General Rate Cases (GRC), they prepared a depreciation study following Standard Practice U-4. Once the depreciation rates were approved in the GRC, those approved rates are used until the next formal GRC. EPWC's last GRC was filed for the Test Year 2015 and those depreciation rates are still in effect. Normally, when EPWC files its next GRC, the depreciation rates will be adjusted and to the extent, any category of plant is over depreciated, a negative rate will be used to reduce the over depreciation until the next rate case. EPWC believes it is not appropriate to adjust approved depreciation rates during years between GRC's.

UAB disagrees with EPWC's position. Although the depreciation method and the composition rates of depreciation were approved by the CPUC via the GRC application processes, EPWC should not have depreciated any of its assets in excess of their depreciable costs. The essence of UAB's finding is that EPWC improperly depreciated its assets in excess of their depreciable costs, not the rates of depreciation. The Standard Practice U-4-SM states:

> *The objectives of allowing depreciation for utilities… is to recover the original cost of utility plant (less estimated net salvage) over the useful life of the property by means of an equitable plan. It is not to provide funds for replacing these facilities.*

Therefore, any assets that have been fully depreciated should be removed from the asset depreciable base. For the reasons stated above, Finding 4 and the related recommendations remain unchanged.

Finding 5: **Overstatement of Common Stocks**

EPWC did not agree or disagree with Finding 5. EPWC stated that they did not have enough time to conclude its research of their records.

Since EPWC could not provide evidence to adequately justify its position, Finding 5 and the related recommendations remain unchanged. However, UAB revised the Effect[2] section to clarify the descriptions.

[2] UAB edited the Effect to read "Incorrectly reporting the value of EPWC's Common Stock can be misleading…" from "Reporting incorrect financial information (i.e., overstatement of Capital) can be misleading…".