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ORIGINAL

Decision No. 63490

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SUBURBAN WATER SYSTEMS, a California corporation for authority to enter into a main extension agreement with Penobscot Investors Company No. 2, Inc. and Lou Dillon Enterprises for the development of property in the Whittier area.	Application No. 40977 (Amended)

Arthur D. Guy, Jr., for applicant.

Hugh N. Orr, for the Commission staff.

O P I N I O N

Nature of the Proceeding

Applicant requests authority to deviate from certain provisions of its water main extension rule by refunding tract developers' advances for construction with 3% preferred stock in lieu of cash and by including in such advances the estimated cost of certain pressure and storage facilities not required exclusively for specific tracts (Rule 15, pars. C.1.; C.2.a.).

The application, filed March 30, 1959 and amended June 15, 1961, was submitted at the conclusion of public hearings held July 7 and 17, 1961 at Los Angeles before Examiner John M. Gregory.

The Issues

The issues may be stated as follows: (1) Was the 405-acre Penobscot project area, early in 1959 when the utility and the developer negotiated and executed a prototype contract for construction of certain initial tract water facilities (Exhibit A,

this application), "contiguous" to the utility's then certificated service area so as to permit extensions under Public Utilities Code, Section 1001, without further certification? (2) If contiguous, did the utility, by installing facilities in the initial and later tracts violate: (a) a restriction against extensions outside its certificated area without express Commission authorization (Decision No. 58716, July 7, 1959, Application No. 40628 - 1st Suppl.; rehearing denied August 18, 1959); (b) statutes, general orders or its own main extension rule (Public Utilities Code, Section 532; General Order No. 96, Section X; Rule 15, cited above)? (3) Does the record, in any event, justify granting the requested authority?

Background of the Case

Admittedly, hearings and a decision on this application have been delayed. It is one of a number of proceedings before the Commission involving various aspects of the current water main extension rule and proposals for its revision. (See Rule, Decision No. 50580, September 28, 1954, Case No. 5501, 53 Cal. P.U.C. 490). The refund method for which authority is requested here is similar to that proposed in an application filed by the same utility on November 3, 1958 (Application No. 40579) to revise its extension rule for subdivisions so as to permit securing funds for construction of extensions by the optional issuance of securities in lieu of requiring a refundable cash advance. That application, because of its bearing on the issues presented by a reopening, on October 28, 1958, of the Commission's general investigation of the water main extension rule (Case No. 5501), was consolidated for hearing and decision with the latter case and was submitted with it

for decision on October 23, 1961, following extensive hearings (May 29, 1959 - July 22, 1960); an Examiner's Report (filed March 31, 1961; exceptions and replies to exceptions to the report (filed by July 31, 1961), and oral argument before the Commission en banc. A decision in that consolidated proceeding is now in preparation.

Meanwhile, Suburban has been faced with a variety of demands for extension of its water service to tracts, subdivisions, industrial developments and other classes of users and, from time to time, has applied for and has received (or has been denied) various authorizations to deviate from its extension rule with respect to specific developments. In addition, the utility has obtained authority, from time to time, to issue securities for general corporate purposes, including general system improvements. The latter authorizations, in some instances, have been conditioned against use of the proceeds to construct facilities in tracts, for which the present main extension rule provides the only method of obtaining construction funds in the absence of prior authority to deviate from its provisions (Public Utilities Code, Section 532; General Order No. 96, Section X; California Water & Telephone Co. v Public Utilities Commission (1959) 51 Cal. 2d 478).

It was in one of these financial applications (a supplemental application to engage in certain short-term financing during 1959), that the Commission imposed a restriction prohibiting the utility from extending outside its then certificated areas without express authorization (Decision No. 58716, supra).

It is the company's position that the restriction was not operative until the effective date of the Commission's order, issued on July 7, 1959, or until the petition for rehearing was denied the

following month. Consequently, the utility argues, negotiations and arrangements for extending into the Penobscot development, concluded during the preceding March, were not subject to the restriction. Whether restricted or not, arrangements for construction of extensions either in or out of then certificated territory, if at variance with the utility's filed and effective rules, were clearly subject to the prohibitions and procedures of the above-cited provisions of the Public Utilities Code and General Order No. 96. In addition, the restriction in Decision No. 58716 is not qualified in any way so as to except extensions for which negotiations had commenced. To so interpret that decision could effectively circumvent regulation. Had the Commission wished to exempt any extensions from the restriction, the order would have so provided.

In any event, while extensions outside certificated areas were proscribed at least after the effective date of the restriction, the utility, by August 1959, was engaged both in construction of the initial tract facilities of the Penobscot project and in hearings in Case No. 5501 and Application No. 40579, in which it was seeking approval of an arrangement similar to that under which the Penobscot and, perhaps, other developments were proposed to be supplied with water. Construction of facilities for the Penobscot project was still proceeding at the time of the hearings herein in July 1961.

The Evidence

1. The Prototype Agreement

The evidence reveals that on March 20, 1959, after negotiations commenced in January of that year between Clifford L.

Holmes, president of Penobscot Investors Co. No. 2 (one of eight or more corporations under which Holmes and his associates are developing the Penobscot project) and Camille A. Garnier, president of Suburban Water Systems, the developer and the utility executed a contract, designed as a model for later developments, which recites that - "Developer has this day deposited with Company the sum of $14,000.00 which is to be used by Company for the purpose of installing and constructing such distribution mains, services, booster plant, and fire hydrants as are required specifically to furnish water service to the tracts hereinafter described." The tract is described as "Tract 24476, Lots 1 through 23 inclusive, located at Mar Vista east of Catalina, Whittier, County of Los Angeles, State of California."

The contract provides for determination, after completion of construction work, of the actual cost of the installations and for refund of the total adjusted deposit in the following manner:

> "1. For each service connection directly connected to Company's extension within the above described tracts, exclusive of that of any customer formerly served at the same location, Company will commence and proceed to refund to Developers within 90 days after the date of first service to a bona fide customer an amount equal to the total of the adjusted deposit, divided by the number of lots in such tract. The refunds provided for herein shall be paid by the issuance to Developers of Suburban's presently authorized Class B, 3% Cumulative Preferred Stock having a par value of $50, on a dollar for dollar basis. Said refunds shall be made quarterly, and the first of said refunds shall be made at the end of the first quarter following the service of water to a bona fide customer within such tract. Such refunds shall be made in multiples of $50 and any amount of less than $50 which is not refunded in any one quarter shall go to augment the refund for the following quarter."

The agreement is assignable, by mutual consent of the parties, after final adjustment of the deposit and contains the usual provision for such modifications as may be directed by the

Commission. There is no provision for termination of the obligation to make refunds.

2. Deviations from Main Extension Rule in Agreement

The agreement contains terms which vary from the utility's filed main extension rule (Rule 15) as follows:

a. In requesting authority to pay refunds on a dollar for dollar proportionate cost basis with 3% preferred stock, the utility is proposing what appears to be a variation, but with approximately the same end result, of a plan conditionally approved by former decisions (which authorized conversion of certain 35%-of-revenue contracts under the pre-1954 extension rule to Class B, 3% cumulative preferred stock of $50 par value), the most recent of which contains the following language:

> "....authorization is granted with the understanding that applicant will request no conversion of refund contracts under present Rule 15 through the issuance of 3 percent cumulative preferred stock for the duration of the applicability of said Rule 15." (Decision No. 55135, June 18, 1957, Application No. 38298.)

b. An allocated cost of storage and pressure facilities is included in the advance. Normal operation of Rule 15 would require the company independently to finance "backup" plant, unless storage or pressure facilities were required exclusively for the service requested. The record here indicates that, on the contrary, the booster plant for Tracts 24476 and 24477 (the initial tracts of the project) will serve to reinforce peak demand and fire flow for Suburban's existing customers.

c. Under the proportionate cost refund method provided by Rule 15, no refunds are to be made after ten years from the date of the extension. No provision for

termination of the stock refund obligation appears in the prototype agreement.

d. Under Rule 15, the amount of refund is limited to that portion of the total amount of the advance which is determined from the ratio of 65 feet of main to the total footage of mains in the extension for which the cost was advanced. The prototype agreement does not include a "saturation" clause limiting the extension distance per customer on which the company will base its refund; moreover, in completing the prototype agreement the record shows that the company will have extended approximately 86 feet of main per lot.

It is clear that the provisions of the prototype agreement, as well as similar arrangements proposed for construction or installation of facilities for later tracts in the project, constitute a departure from the provisions of Rule 15 and are thus ineffective unless specifically authorized by the Commission. (Public Utilities Code, supra; General Order No. 96, supra; California Water & Telephone Co. v Public Utilities Commission, supra.)

3. The Penobscot Project

This project, like a number of land development activities in California in recent times, involves the gradual preparation of a 405-acre area for ultimate construction of custom-built homes on lots of a minimum size of not less than 20,000 square feet. The model home in the first unit sold for $100,000 cash. Both Holmes and the utility, in negotiating plans for a water supply to serve the entire area, considered the whole project as a unit, to be developed in tracts of from 30 to 100 lots over a period of some

seven to ten years. The terrain is hilly, with an elevation variation of some 900 feet. The ultimate development will require a large reservoir in the approximate center - but outside the boundaries - of the area, as well as various pressure zones and related booster facilities. The required engineering was discussed at the initial meetings of the parties. The financial arrangements, incorporated in the type of agreement executed for the initial tract, were also concluded at that time. The evidence shows that the motivation for such arrangements was, on the utility's part, the lower cost of money to it by paying refunds with 3% stock in lieu of higher cost cash and, from the developers' standpoint, the tax advantage in taking refunds in stock instead of cash.

Construction on the project has advanced to the point that, in Tracts 24476-7, containing 65 lots, all backup plant and on-site facilities were installed in 1959 and by July 1961 there were 20 houses completed, eight under construction, two ready to start construction and 16 lots sold but with no construction commenced. In Tracts 24479-80, for which agreements - similar to the prototype contract - were concluded in the latter part of 1959, the in-tract distribution pipelines were installed during the late spring of 1961, several lots were sold prior to July 1961, one house was under construction and construction of other homes was expected to commence soon thereafter, despite the existence of a Real Estate Commissioner's subdivision report on Tract 24479, dated April 26, 1961 (Exhibit 4) that "the ability and legal authority of the company to supply this tract" (with water) "has not been verified as yet." This report, required by law to be shown to prospective buyers, has adversely influenced the marketability of land in Tracts 24479-80, both of which lie outside the utility's presently

certificated service area and, as stated by the report, are subject to the restriction imposed by Decision No. 58716, supra, relating to unauthorized extensions.

4. Commission Staff Position

The Commission staff, represented by members of the Utilities Division and the Division of Finance and Accounts who prepared and presented studies concerning various aspects of the application, has approached the issues from two points of view, not necessarily mutually exclusive.

The Utilities Division, in a report (Exhibit 5) based on field investigations and a review of applicant's proposals in light of its past main extension practices, has estimated potential charges against ratepayers expected to result from the type of agreement for which applicant here seeks authorization. The gist of the study, adopting the assumptions used in developing results, is that the effect of applicant's proposed method of refund on the company's rate base and revenue requirements would be minor, compared to total operations, if restricted to the initial development described in the contract of March 20, 1959, but would be "pronounced" if applied to the development of the entire area, estimated by both the utility and the developer to be in the neighborhood of perhaps 1,200 lots of a minimum size of 20,000 square feet.

Incorporation here of detailed results of the report, without also including the textual treatment underlying use of the various assumptions upon which they rest, would not only unduly prolong this discussion but would tend to confuse anyone not familiar with the record. In substance, the results estimated under four assumed sets of conditions, as developed in the report

(Exhibit 5, Table 6-A), tend to indicate that if the cost of on-site and booster facilities for the initial tract (24476-7) were refunded under any of the options of the current main extension rule (revenue, proportionate cost, or present worth), there would be, in effect, a contribution by the developer to the extent that the full cost might be unrefunded and that such contribution would be reflected in the utility's rate base as a deduction from fixed capital, thus inhibiting pressure for increased revenue requirements. No such contribution, it appears, would occur under applicant's proposal here, since, under the modified proportionate cost method advanced by applicant, the utility's rate base would reflect the full cost of mains, averaging 86 feet per added customer, as compared with an investment of the cost of only 65 feet of main per customer if the proportionate cost cash refund method of the present rule were used.

The position taken by the representative of the Division of Finance and Accounts, who neither endorsed nor opposed the granting of the requested authority because, as he stated, "of the many engineering problems that are involved", was limited to the conclusion that the use of 3% preferred stock in lieu of cash refunds, as proposed by applicant, would not be objectionable as a financial operation if the application were otherwise justifiable from an engineering and economic standpoint.

In his memorandum report (Exhibit 6), the witness has concluded that it would be good business judgment - and it would have no adverse effect on the consumer - for any utility which can get 3% permanent capital to do so and thereby freeze a large segment of low cost capital into its structure. The report points out that

applicant has been constantly faced with the problem of obtaining bondable plant, and that the issuance of 3% preferred stock in satisfaction of advances, as requested in this application, will relieve the cash drain on the utility to make refunds of subdividers' advances, will improve the working capital and will provide a broader base of equity capital which, in turn, should permit the utility to obtain borrowed money when it needs it and at more reasonable rates for financing the cost of plant required to back up tract extensions, for which the extension rule makes only limited provision in the case of specially-required storage or pressure facilities.

The report further observes that the cost of borrowed money, for small water utilities, is now approaching 6% and that it is unlikely that the cost of preferred stock money, with a public offering, would be less than 7%. Hence, with rates of return ranging from 6% to 6.5%, it is obvious, the author concludes, that it is necessary for water utilities to get lower cost of some segments of their capital and for this reason it is desirable for such utilities, if they can, to build up their equity through the issue of 3% preferred stock. The evidence shows that preferred stock with dividend rates ranging from 3% to 3.5% is issued by a number of business concerns, including public utilities.

5. Contiguity of Penobscot Project to Existing Service Areas

Since we are considering this application on its merits, any authority herein granted for proceeding in accordance with the basic plan evolved by the utility and the developer in March 1959, would necessarily involve relaxation of the restriction imposed by Decision No. 58716 on further extensions outside the utility's certificated areas without appropriate authorization.

The evidence shows that the initial tract of the Penobscot project (Tract 24476) contains about 14 acres and is located outside of but contiguous to the northern boundary of the utility's Whittier District certificated service area at the intersection of Santa Catalina Avenue, Sixth Street and Mar Vista Street (a prolongation easterly of Sixth Street along the southerly boundaries of Tracts 24476 and 24477). The record reveals that Suburban has served a Standard Oil Company installation, located at the intersection of Santa Catalina Avenue and Sixth Street, from the utility's 12-inch main in Sixth Street through a 2-inch meter installed in 1949 and for several years prior thereto, and that the booster plant for Tract 24476 is located immediately adjacent to the Standard Oil Company booster station on a piece of property in the southwest corner of Lot 1 of that tract acquired by the utility from the developer. Suburban has also served water, since July 1956, in Tract 19096, the northerly boundary of which runs along Sixth Street and coincides with the southwest corner of Tract 24476 near the Standard Oil Company property.

Tracts 24479 and 24480, located in the southeasterly portion of the 405-acre project, are not within the utility's presently certificated service area but are contiguous to other tracts (17922, 20087) developed several years ago and served by Suburban.

Were it not for the restriction imposed by Decision No. 58716, supra, the four tracts mentioned in the amended application would be available to the utility for extensions, as contiguous territory, pursuant to the provisions of Section 1001 of the Public Utilities Code, without further certification.

Summary, Findings and Conclusions

The Penobscot project has been under construction since about April 1959, under conditions clearly at variance with applicant's main extension rule and, if considered as separate tracts rather than a staged total development, in violation of the restriction imposed by Decision No. 58716 with respect to tracts to which the utility has extended its facilities subsequent to the effective date of that decision.

Total development of the 405 acres will entail on-site costs alone, on the basis of the staff engineer's estimate of 650 lots, of the order of roughly $500,000. If, as indicated by the developer and the utility, the completed project might include some 1,200 lots, the in-tract costs will be substantially greater.[1/] The utility's investment in backup plant to supply the ultimate area, while not necessarily coincident with each stage of the development, will certainly be, at the minimum, at least equal to the cost of the in-tract facilities but probably considerably more.

In view of the utility's alleged chronic shortage of cash, a solution to the current problem should be possible without adverse effects on utility customers. The developers could advance sufficient funds to the utility to enable it to install the production, pressure, storage and metering facilities for the new areas, such advance to be refunded with appropriate securities in lieu of cash, on an 86-foot proportionate cost basis. In addition, the developers could advance the funds for in-tract facilities as required by the utility's main extension rule and the utility could be authorized to deviate from the percentage-of-revenue refund provision, which it normally utilizes when making cash refunds, by

1/ In-tract costs for Tract 24476, including an allocation of the cost of a booster plant, were estimated at $600 per lot.

making such refunds as they become due with appropriate securities.

This solution to the problem would:

1. Avoid the issuance of stock, and inclusion of amounts in rate base, related to backup plant in excess of the proportionate utilization of such plant.

2. Avoid the issuance of stock, and inclusion of amounts in rate base, related to in-tract facilities in excess of the amount of advance which would be refunded under the utility's normal application of its main extension rule.

3. Relieve the utility of the normal obligation to raise funds for backup plant and refunds of advances.

4. Provide the developers with refunds reasonably equivalent to those which would result from the utility's normal application of its main extension rule.

If the utility proposes and supports the foregoing solution by appropriate application, we will reconsider concurrently the utility's request to serve the additional areas covered by this application.

We find, on the basis of this record and in light of all the circumstances in which this application has been involved since its inception, that the plan evolved by the developer and the utility, in 1959, for supplying water to the Penobscot project will have an unjustified, adverse effect on the utility's ratepayers.

We, therefore, conclude that the application should be denied.

O R D E R

Public hearing having been held herein, the matter having been submitted for decision, the Commission having considered the evidence and argument and basing its decision

on the findings and conclusions contained in the preceding opinion,

IT IS ORDERED that the application be and it hereby is denied.

The effective date of this order shall be twenty days after the date hereof.

Dated at San Francisco, California, this 2nd day of April, 1962.

President

Commissioners