

ORIGINAL

Decision No. 66812

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application
of EVERGREEN SERVICE COMPANY for
authority to increase rates charged
by it for water service.)

Application No. 45730
(Filed September 3, 1963)

Peter R. Andre, for applicant.
Eli Luria, for Luria-Towbes Company; Arnold L. Nickson, in propria persona; and Homer W. Bale, for Property Management Corporation, interested parties.
David F. LaHue and L. L. Thormod, for the Commission staff.

O P I N I O N

By this application, Evergreen Service Company, a corporation, seeks authority to increase its rates for water service.

This application was heard before Examiner Catey at Santa Maria on December 18, 1963, and was submitted on that date. Copies of the application and notice of hearing were served in accordance with this Commission's rules of procedure. Testimony on behalf of applicant was presented by its president; the Commission staff presentation was made by an accountant and an engineer; and four representatives of main extension refund contract holders testified or made statements in favor of the application. There were no protests.

Service Area and Water System

Applicant's original service area consisted of some 95 acres in Santa Barbara County, subdivided into 213 lots and known as Evergreen Acres Tract. This area, located about three miles south of Santa Maria, was certificated to applicant in 1952.

Mains have been extended from the initial system into adjacent subdivisions since 1952, resulting in a service area approximately four times the size of the original area, with about 740 customers.

Water is obtained from two wells, equipped with electric motors and pumps capable of producing a total of 1,700 gpm. The water is stored in two tanks with a combined capacity of about 195,000 gallons, whence it is boosted into the distribution system by four electrically driven pumps of various sizes. The distribution system consists of about 50,000 feet of mains, varying from 4 to 8 inches in diameter.

Rates

Applicant's present rates were established by Decision No. 63501, dated April 3, 1962, in Application No. 43470. They provide for general metered service and public fire hydrant service. Decision No. 64695, dated December 20, 1962, in Application No. 44592, reaffirmed that these rates would produce a fair and reasonable return and denied applicant's request for a further increase.

Following is a comparison of applicant's present general metered service rates, those requested in this application, and those authorized by this decision:

<u>Quantity</u>	<u>Present</u>	<u>Requested</u>	<u>Authorized</u>
First 1,000 cu.ft. or less	\$2.75	\$4.00	\$3.00
Next 1,000 cu.ft., per 100 cu.ft.	.18	.30	.20
Over 2,000 cu.ft., per 100 cu.ft.	.18	.20	.18

The requested rates also provide for increases in minimum monthly charges for meters of one-inch size and smaller. No increases are requested in minimum monthly charges for meters of 1½-inch size and larger, nor for public fire hydrant service.

The requested rates would result in an increase of about 35 percent in applicant's annual revenue.

Customer Complaints and Service Improvements

The Commission staff investigation indicates that applicant provides satisfactory service. The staff report, Exhibit No. 1, states that there have been no informal complaints received by the Commission relating to this company during the last two years. During the summer, however, the present booster equipment has difficulty at times in maintaining pressures above a desirable minimum at the higher elevations in the service area. The staff concurs that applicant's proposal to install a variable-speed gas-powered booster pump is the best solution to this deficiency.

Results of Operations

Applicant's president and the Commission staff have each analyzed and estimated applicant's operational results. Summarized below, from Exhibit No. 1 presented by the staff and Exhibit No. 2 presented by applicant as a revision of Exhibit "G" to the application, are the estimated results of operations for the year 1963 under applicant's present rates. The tabulation also shows, for comparison, the revenues, expenses and rate bases adopted as reasonable herein under present rates and the resulting rate of return, as discussed in more detail in subsequent paragraphs.

<u>Item</u>	<u>Staff</u>		<u>Appli-</u>	<u>Adopted</u>	
	<u>Basis A*</u>	<u>Basis B*</u>	<u>cant</u>	<u>Basis D*</u>	<u>Basis E*</u>
	<u>Basis C*</u>				
Operating Revenues	\$ 60,200	\$ 60,200	\$ 57,480	\$ 57,500	\$ 57,500
Deductions:					
Operating Expenses	33,600	33,600	35,167	33,800	33,800
Taxes (Excl. Inc. Taxes)	3,410	3,410	3,577	3,400	3,400
Income Taxes	3,170	1,570	3,509	1,800	1,400
Depreciation	7,340	6,920	8,370	7,400	6,700
Total Deductions	\$ 47,520	\$ 45,500	\$ 50,623	\$ 46,400	\$ 45,300
Net Revenue	\$ 12,680	\$ 14,700	\$ 6,857	\$ 11,100	\$ 12,200
Rate Base	\$170,500	\$209,600	\$215,824	\$183,000	\$199,000
Rate of Return	7.4%	7.0%	3.2%	6.1%	6.1%

* Assumed bases for terminating refund agreements:

- A. Past terminations at 30% of unrefunded balance.
- B. Past terminations at 30% of unrefunded balance; future at 61%.
- C. Delinquent refunds paid; past and future terminations at 61%.
- D. Delinquent refunds paid; past terminations at 30%.
- E. Delinquent refunds paid; past and future terminations at 30%.

The Commission staff included in Exhibit No. 1 an estimate of 1964 operations. In view of the present restriction against extensions resulting from applicant's main extension rule and the further restriction set forth in the ensuing order, the year 1963 is adopted as indicative of future operations.

Operating Revenues

The staff estimates of revenues for the year 1963 under present rates were based upon the revenues billed for the twelve-month period ended in November 1963. Adjustment was made by the staff for an estimated increase in revenues for December 1963, over December 1962, levels. Further staff adjustments were made to place a new trailer park and car wash on a full-year revenue

basis and to include additional revenue from shopping center air conditioners which appeared to have been receiving free water.

Applicant's president testified that, due to vacancies in some of the homes in the area, the December revenue was actually lower in 1963 than in 1962. He also testified that the air conditioners for the shopping center had been served by the same meters which supplied water for other purposes at the center and that, after December 13, 1963, considerably less water would be used, due to a recirculating system planned for operation of the air conditioners after that date.

In view of all of the evidence, \$57,500 is adopted as 1963 revenues under present rates.

Operating Expenses, Taxes and Depreciation

Applicant's original estimate of 1963 operating expenses shown in Exhibit "G" to the application was \$37,793, whereas the staff estimate is \$33,600. The difference is due primarily to the staff's exclusion of the salary of a former maintenance man who was replaced in 1962 but did not retire until March 31, 1963. The other primary reason for the difference is that the staff spread legal fees of about \$1,000 over a three-year period to arrive at estimated normal annual expenses.

Testimony of refund contract holders indicates that lawsuits are imminent for collection of delinquent refunds from applicant. On this basis, and because of the three rate applications it filed in the last three years, applicant contends that its estimated \$1,000 legal expense for 1963 should not be spread over a three-year period.

As discussed later in this opinion, applicant's delinquent refunds result from its stockholders' failure to protect their

investment by providing additional equity capital as refunds of advances become due. Applicant's customers should not be penalized for this by making them pay the abnormal legal expense in proceedings before this Commission and in the courts resulting from delinquent refunds. The staff estimate of 1963 operating expenses is adopted with a \$350 increase to compensate for services performed by an employee of an affiliated land company, partly offset by a nominal reduction to reflect lower production cost consistent with the lower revenue estimate adopted herein.

The staff estimates of taxes other than on income are slightly lower than applicant's estimates. This is to be expected, inasmuch as the estimates include payroll taxes and the staff's payroll estimates are lower than applicant's. The staff estimates are adopted herein.

The staff's calculation of estimated income taxes differs in several respects from that of applicant. Aside from differences in estimates of revenues, expenses, taxes other than on income, and depreciation expense, applicant failed to give any consideration to interest expense and the investment tax credit. The staff's basis is adopted, with appropriate modifications consistent with the adoption of different revenues, expenses and rate bases, as discussed herein.

In estimating depreciation expense for the year 1963, the staff excluded one third of the accrual related to an automobile used jointly by applicant and an affiliated land company. The staff also excluded depreciation on the estimated amount of contributed plant which would have resulted from the termination of refund agreements at their estimated prevailing market price, as discussed in more detail hereinafter. Full-year depreciation on applicant's

proposed new gas-powered booster pump was added to 1963 expenses by the staff to reflect normal future operations. Applicant's Exhibit No. 2 indicates that the automobile depreciation chargeable to the land company might reasonably be considered as offsetting certain tasks performed without charge for applicant by land company personnel, so the staff estimate of expenses is modified accordingly. The depreciation expense adopted herein takes into consideration the adopted modifications in staff estimates of contributed plant, as discussed hereinafter.

Termination of Refund Agreements

During the year 1962, the wife of the president (and major stockholder) of applicant purchased three refund agreements from the previous holders thereof for about \$22,000, in cash. Subsequently, applicant terminated these agreements by payment to its president's wife of \$40,193.07, in the form of a 6 percent promissory note, payable on demand. Applicant has now negotiated a loan in its own name from a bank, part of the proceeds of which would be used to retire the demand note. Applicant's president testified that the entire transaction was proper because the termination price was determined strictly in accordance with applicant's then effective main extension rule. He stated that the \$18,000 profit his wife would make on her \$22,000 short-term investment was justified because she accepted a promissory note initially from applicant in lieu of cash. He further stated that the transaction should not be considered as being with an affiliate because he, and not his wife, was president and stockholder, and his wife used her own funds, not community property, to acquire the agreements.

We cannot agree with applicant's president. It is not in the interest of the corporation, much less the utility customers,

for it to incur an indebtedness of over \$40,000 upon termination of refund agreements through an intermediary when it could have terminated the same agreements directly for about \$22,000. This would be true even if the intermediary were not related to a corporate officer.

While disagreeing with applicant's president, we do not imply that his actions were not technically permissible under applicant's filed main extension rule. His objective of reducing the level of construction advances was commendable, but he was operating under the mistaken impression that he could not obtain a deviation from the termination price specified in the rule.

In fact, the rule merely permitted, rather than required, termination of refund agreements on the "present worth" basis. It was naturally presumed that a utility would exercise that option only if it were in its own interest so to do. If the prevailing purchase price on an arms-length transaction were at 35 percent of the outstanding balance, it would not be prudent for the utility to pay almost twice that amount. Section A.5. of applicant's then effective rule would have permitted applicant to request authority to terminate the agreements at the prevailing market price, inasmuch as the "present worth" provision was obviously impracticable and unjust under the prevailing circumstances.

The officers of a utility must use reasonable judgment in the application of tariffs, especially when dealing with affiliates. For example, although a utility may have alternative flat rates and meter rates, it may not reasonably apply flat rates to affiliates and meter rates to all others. Similarly, the refund transaction with the wife of applicant's president was not in violation of the filed tariffs, but merely an imprudent

application thereof, for which applicant's customers should not be made to suffer. ✓

With additional proceeds of the bank loan it has negotiated, applicant shows in Exhibit "J" to the application that it intends to terminate its remaining \$54,369 of refund obligations at about 60%. The record does not show whether these transactions are to be directly with the original contract holders or through an intermediary. Fortunately, applicant's present main extension rule, recently prescribed for all water utilities by this Commission, requires specific Commission authorization for such transactions, so a close scrutiny can be made when such authorization is requested.

Rate Base

The difference between the rate base estimates presented by the applicant and the staff results almost entirely from the differences in treatment of past and future terminations of refund agreements.

The staff's principal showing was based upon the assumption that the prior termination of refund agreements should have been at 30 percent of the unrefunded balance, and that the rest of the agreements would not be terminated during 1963. A supplementary staff showing was presented to indicate the potential effect of applicant's proposed termination of all remaining refund agreements at about 61 percent of the residual refund obligations, assuming full-year weighting at the amount proposed to be paid.

Applicant's estimate was based upon the assumption that a return would be allowed on the full amount of the note issued in the prior termination of three agreements. The estimate also reflected the assumed payment of all delinquent refunds and termination of all remaining refund agreements at about 61 percent of the

residual refund obligation, but the effect of such assumed refunds and terminations was given only one-half weighting in applicant's estimate of rate base for the year 1963.

The staff financial and accounting witness estimated 30 percent to be the prevailing discounted price of refund agreements, based upon his knowledge of similar transactions involving utilities in other areas of the State. Applicant's president testified that he did not know exactly how much his wife paid for the three agreements she purchased, but he estimated that the discounted price was more nearly 35 percent. His estimate appears reasonable inasmuch as part of the outstanding refunds were delinquent and presumably could have been collected before discounting the future refund obligations. The rate bases adopted herein permit applicant a return on 100 percent of the delinquent refunds and on 30 percent of the nondelinquent balance of the three prior refund agreements at the time of their termination.

In developing the 1963 rate bases, the staff treated delinquent refunds as deductions, along with future refund obligations. There are, however, impending lawsuits by contract holders, and applicant admits the delinquency of the refund payments. The end result of the threatened litigation would therefore presumably be the payment of delinquent refunds by applicant with funds raised by it or its stockholders, or the ultimate acquisition of a financial interest in the corporation by its creditors. In either event, the presently delinquent refunds would no longer be appropriate deductions in determining rate base. This conclusion is reflected in the adopted rate base because the testimony of contract holders shows that enforced satisfaction of applicant's delinquent refund obligations is imminent.

An alternative approach to the determination of rate base would be to allow a return on the probable arms-length termination price of remaining refund agreements. This determination would assume repayment of delinquent refunds and subsequent termination of residual refund obligations at 30 percent, with full-year weighting of the effect on rate base.

Financial and Rate Requirements

Applicant contends that its rates should be established at a high enough level that the revenues produced therefrom would cover operating expenses, interest on debt, refunds of construction advances, and retirement of debt. Conflicting testimony was presented by the applicant and the staff as to whether or not the present rates would produce sufficient funds to cover all of applicant's cash requirements. For the purpose of determining reasonableness of rates, however, this question is not relevant. A utility such as applicant cannot reasonably be expected to quadruple its original service area without obtaining additional equity financing. The advances provided by subdividers under the utility's water main extension rule defer the utility's investment in new areas but, unless the rate of growth is quite slow, do not relieve the utility of the responsibility ultimately of providing the necessary capital from funds other than those generated by the operation itself.

Applicant's stockholders and their relatives have provided funds to the utility on several occasions since the initial development of the service area but such funds have been merely loaned to, not invested in, the utility. Applicant's president was questioned as to his willingness and ability to convert some of the utility's promissory notes into equity. He indicated that he did not favor

such conversion, apparently because of Federal Income Tax advantages which result from deductions for interest on the notes.

Because of applicant's unwillingness or inability to obtain additional equity financing, any further expansion by it would tend to deteriorate further its already weak capital structure. This situation will continue even after the level of outstanding main extension advances is reduced below 50 percent of net plant, above which point applicant's main extension rule prohibits further expansion without specific Commission approval. The ensuing order restricts applicant to its present service area.

Exhibit No. 1 shows that the rates requested by applicant would result in an increase of about 35 percent in operating revenues. Based upon the modified estimates of revenues, expenses and rate base adopted herein, an increase of \$3,500 in annual revenues, about one-sixth of the increase requested, will provide the seven percent return found to be reasonable for this utility in its two recent rate proceedings. The rates set forth in Appendix A to the order herein are designed to produce the required \$3,500 increase. The present monthly charge for an assumed average consumption of 3,000 cubic feet of water is \$6.35; at the authorized rates, such charge will be \$6.80, an increase of seven percent.

Findings and Conclusions

The Commission finds that:

1. Applicant is in need of increased revenues but the rates it proposes are excessive.

2. The adopted estimates, previously summarized and discussed herein, of operating revenues, operating expenses and rate bases for the year 1963 reasonably represent the results of applicant's operations, and a rate of return of seven percent on

either of said rate bases is reasonable for the purposes of this proceeding.

3. The increase in rates and charges authorized herein is justified, the rates and charges authorized herein are reasonable, and the present rates and charges, insofar as they differ from those prescribed herein, are for the future unjust and unreasonable.

4. Applicant's present low proportion of equity in its capital structure makes further expansion of its service area adverse to the public interest.

The Commission concludes that the application should be granted to the extent set forth in the ensuing order and that applicant should be restricted to its present service area until further order of the Commission.

O R D E R

IT IS ORDERED that:

1. After the effective date of this order, applicant Evergreen Service Company is authorized to file the revised schedule of rates set forth in Appendix A to this order. Such filing shall comply with General Order No. 96-A. The revised rate schedule shall become effective for service rendered on and after March 16, 1964, or on and after the fourth day following the date of filing, whichever is later.

2. Applicant shall not extend service outside of the service area delineated on its present tariff service area map, nor file any revised service area map indicating its willingness

to so extend service, without first having obtained authorization therefor by further order of this Commission.

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

Dated at San Francisco, California, this 18th day of February, 1964.

William L. Burnett
 President

~~*[Signature]*~~

~~*[Signature]*~~

George H. Grover

Fredrick B. Holcomb
 Commissioners

APPENDIX A

Schedule No. 1

GENERAL METERED SERVICEAPPLICABILITY

Applicable to all metered water service.

TERRITORY

The areas known as Evergreen Acres, Majestic Homes, Tract 10003, Tract 10017, Country Club Estates and Bel Aire Estates, and vicinity, located approximately three miles south of Santa Maria, Santa Barbara County.

RATES

	<u>Per Meter</u> <u>Per Month</u>	
Quantity Rates:		
First 1,000 cu.ft. or less	\$ 3.00	(I)
Next 1,000 cu.ft., per 100 cu.ft.20	(I)
Over 2,000 cu.ft., per 100 cu.ft.18	(N)
Minimum Charge:		
For 5/8 x 3/4-inch meter	\$ 3.00	(I)
For 3/4-inch meter	4.25	(I)
For 1-inch meter	6.50	
For 1 1/2-inch meter	12.00	(I)
For 2-inch meter	15.00	
For 3-inch meter	25.00	
For 4-inch meter	50.00	

The Minimum Charge will entitle the customer to the quantity of water which that minimum charge will purchase at the Quantity Rates.