

**ORIGINAL**

Decision No. 70394

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Investigation on the Commission's own motion into the operations, rates, tariffs, contracts, practices, equipment, facilities, and service of CREST WATER COMPANY, a corporation.

Case No. 7937  
(Filed July 7, 1964)

Gibson, Dunn & Crutcher, by Raymond L. Curran, and Deadrich, Bates & Lund, by Kenneth H. Bates, for Crest Water Company, respondent.  
Raymond C. Clayton and William R. Horsley, for City of Bakersfield, interested party.  
Elinore C. Morgan, John J. Gibbons and John D. Reader, for the Commission staff.

O P I N I O N

The Commission instituted this investigation into the operations, rates, tariffs, contracts, practices, equipment, facilities, and service of respondent Crest Water Company (Crest) to determine whether or not they are reasonable or adequate for the purpose of rendering water service to the public.

Public hearing was held before Examiner Catey at Bakersfield on February 2, 3 and 4, 1965 and on March 16, 1965. Testimony was presented by an engineer and an accountant of the Commission's staff, by four of Crest's customers, by the Director of Water Resources of the City of Bakersfield, by Crest's vice president, by its consulting engineer and by an accountant it had retained. The matter was submitted at the conclusion of the fourth day of hearing, subject to receipt of briefs. Concurrent briefs were filed on June 10, 1965, by the Commission staff, by Crest, and by the City of Bakersfield.

Respondent

Crest is a public utility water corporation organized to supply and distribute water in the northeastern part of the City of Bakersfield, Kern County, and in certain unincorporated territory contiguous thereto.

By Decision No. 53233, dated June 12, 1956, in Application No. 37744, Crest was granted a certificate to construct a water system to serve a 320-acre area. From time to time, Crest extended service to a total of about 600 acres of additional territory.

Crest's 1964 annual report to the Commission shows, as of the end of 1964, that water was obtained from four wells, from which it was pumped into four storage and three pressure tanks for distribution through 23 miles of mains which supplied 1,534 flat-rate services, 44 metered services, one private fire connection and 120 public fire hydrants.

Water Quality

A key issue in this proceeding is the quality of water supplied by Crest. The degree of customer dissatisfaction with the color, odor, taste and turbidity of the water varies, but Crest's vice president testified that water quality has been the utility's biggest problem.

The record is quite complete as to the problems encountered with the water from Crest's wells. Crest has sought advice from other utilities and from consulting engineers and chemists. The principal treatment and procedures recommended to and adopted by Crest consist of maintaining high chlorine residuals in the distribution system and instituting a flushing program. It is apparent that the water from Crest's wells needs more extensive treatment but the record does not show what type of treatment plant would be

effective, what its installation cost would be, nor what additional operating expense would be incurred.

A solution to the water quality problem is presented by the purchase of Crest's water system by California Water Service Company, as authorized by Decision No. 70242, dated January 18, 1966, in Application No. 48069. The latter utility proposes to utilize the superior quality water from its adjacent Bakersfield Tariff Area system to supply the Crest area.

#### Operating Expenses and Rate Base

Upon transfer of the water system to California Water Service Company, the method of operation and resulting operating expenses could be significantly different from those of Crest. Also, during the early transition period, the new owner may have operating expenses quite different from those it will eventually have. Although the estimates of respondent's expenses presented in this proceeding are not applicable to the new owner, certain rate base matters should be resolved herein to provide a reasonable starting point in future rate proceedings involving the Crest Tariff Area of California Water Service Company. The various issues raised by the Commission staff relative to rate base items are discussed in subsequent portions of this opinion.

#### Initial Issue of Common Stock

In Application No. 37744, Crest requested, among other things, authority to issue common stock with an aggregate par value of \$475,000 to finance all of the cost of the water system to be installed for the entire 320-acre certificated area. Decision No. 53233, dated June 12, 1956, in that proceeding authorized Crest to issue only \$235,000 of the requested \$475,000 par value of common stock. The amount authorized was based upon an estimate presented

by Crest of its capital requirements for the first twelve months' construction. A copy of that estimate is Exhibit No. 10 herein.

Exhibit No. 10 shows that \$65,360 of Crest's then estimated first year's capital requirements was for mains, services and fire hydrants. Neither Exhibit No. 10 nor Decision No. 53233 shows which tract was intended to be exempted from the provisions of Crest's filed main extension rule which required advances from subdividers to finance mains, services and hydrants. At that time the Commission had not yet adopted its present practice of specifying clearly in its decisions any areas to which the water main extension rule of a newly formed utility is found not to be applicable. To further complicate this matter, some of the construction was delayed for several years, certain tract boundaries were revised, and larger distribution mains than originally planned were installed in some areas to comply with the requirements of the City of Bakersfield.

In any event, the record shows that Crest treated only Tract No. 1866, the initial development constructed during the years 1955 and 1956, as being exempt from the provisions of the main extension rule. All backup facilities<sup>1/</sup> and \$40,005 of in-tract facilities<sup>2/</sup> were financed by issuance of stock, without any advances from the affiliated developer. Up to that point, Crest's actions were entirely in accordance with Decision No. 53233, including the implied authority therein to exclude the initial tract from the otherwise applicable provisions of Crest's main extension rule.

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<sup>1/</sup> As used herein: production, pressure, storage and metering facilities.

<sup>2/</sup> As used herein: mains, services and hydrants.

The next development, Tract No. 2155, was completed in the year 1958. The unaffiliated developer advanced the cost of in-tract facilities in accordance with Crest's main extension rule.

The next developments, Tracts Nos. 2096, 2130 and 2174 and the Crest Arms Development, were completed in the years 1958 and 1959. The affiliated developers advanced the cost of in-tract facilities. Crest financed backup facilities through issuance of stock in accordance with Decision No. 53233 and later orders which extended the time within which Crest could issue such stock. The main extension agreements, providing for long-term refund of the \$69,671 advanced by the developers, were assigned by the developers to an individual for \$3,483. That individual assigned the agreement to some of Crest's officers and stockholders, at no profit or loss. Crest then terminated the agreements by issuing \$69,660 in common stock to the contract holders. Neither the termination of the agreements nor the issuance of Crest's stock for such purpose has ever been authorized by this Commission.

One of the next developments, Tract No. 2352, was completed in the year 1960. The affiliated developer advanced the cost of in-tract facilities. The agreement, providing for long-term refund of the \$20,485 advanced by the developer, was terminated by Crest, by issuing \$20,485 in common stock to the developer. Neither the termination of the agreement nor the issuance of stock for such purpose has ever been authorized by this Commission.

The Commission staff recommends that \$64,790 of the proceeds of the initial common stock issue used by Crest to terminate main extension agreements held by affiliates, officers and stockholders be considered permanently as outstanding advances deductible from rate base. The \$64,790 represents the difference between the

\$65,360 estimated cost of in-tract facilities for the initial development shown in Exhibit No. 10 and the \$130,150 of the original issue of common stock actually used by Crest for such purposes and for termination of main extension agreements. Crest contends that it was the Commission's intention to authorize the sale and issuance of \$235,000 worth of common stock to finance that portion of the system which was originally planned to be completed within the first year, without any specific limitations as to the purposes for which such funds could be expended. On that basis, Crest argues that the staff's recommendation not be adopted. Crest argues further that if some portion of the face amount of terminated agreements be considered as advances still outstanding, recognition be given to the amounts which would have been refunded if the agreements had not been terminated.

Decision No. 53233 authorized the issuance of stock to finance the system referred to in the decision "or some portion of such system". The use of that stock to terminate main extension agreements was not authorized. We find that, for rate-making purposes, the outstanding level of advances should be computed as though the \$90,156 face amount of main extension agreements had not been terminated but refunds had been paid when due under the terms of the agreements. We also find that Crest's treatment of Tract No. 1866 as the initial development, to which in this case the main extension rule filed by Crest did not apply, was reasonable and proper. The order herein requires Crest to furnish studies showing the amounts of advances which would have been refunded under each contract terminated by the original issue of common stock.

Second Issue of Common Stock

In Application No. 41991, Crest requested authority to include the cost of backup facilities in the amounts to be advanced by developers for main extensions to serve Tracts Nos. 2290, 2321, 2345, 2350 and 2352. At the hearing therein, Crest advanced a substitute proposal to require non-affiliated developers to advance a prorated portion of the cost of backup facilities but to sell common stock to affiliated developers to finance their share of the cost of backup facilities. Decision No. 60943, dated October 25, 1960, in that proceeding denied both the original and substitute proposals and, instead, authorized Crest to issue \$30,000 par value of common stock to finance a portion of the backup facilities installed in the year 1960.

Instead of using the \$30,000 in common stock for backup facilities, Crest issued \$17,610 to an affiliated developer for termination of main extension agreements covering all of Tract No. 2350 and part of Tract No. 2345 and issued \$12,390 to an affiliate for engineering and overhead charges.

The Commission staff recommends that the \$30,000 proceeds of the second common stock issue be considered permanently as outstanding advances deductible from rate base. Crest alleges that about one-fourth of the \$17,610 of agreements, had they not been terminated, would have been refunded by the end of the year 1964. Crest also shows, in Exhibits Nos. 16 and 17, that about one-half of the \$12,390 proceeds used for paying engineering and overhead charges is applicable to backup facilities.

We find that, for rate-making purposes, the outstanding level of advances should be computed as though the \$17,610 face amount of main extension agreements had not been terminated

but refunds had been paid when due under the terms of the agreements. We also find that the \$6,690 of common stock issued to cover engineering and overhead charges on backup facilities was proper but that the \$5,700 represented by common stock issued for similar charges against in-tract construction should be treated, for rate-making purposes, as additional advances for construction related to the various tracts set forth in detail in Exhibit No. 17. Although the use by Crest of arbitrary percentages of construction cost in determining engineering and overhead charges is not proper, staff Exhibit No. 1 states that the net effect on Crest's plant accounts was minimal.

#### Issue of Preferred Stock

In Application No. 44105, Crest requested, among other things, authority to sell 5½ percent, non-cumulative, non-voting preferred stock with an aggregate par value of \$200,000 to various affiliated and non-affiliated developers to finance the cost of backup facilities. Decision No. 63198, dated February 6, 1962 in that proceeding granted the preferred stock authorization requested by Crest.

Dividends on the preferred stock are payable only if Crest's directors choose to declare them. None have ever been declared. The Commission staff therefore recommends that the portion of Crest's capitalization represented by preferred stock held by non-affiliated developers be considered cost-free in determining the rate of return to be allowed on Crest's rate base. Crest argues that it would then never be in a position to pay the dividends to which the holders of the preferred stock are, in all fairness, entitled.

Customers should not pay a normal return on rate base if part of the plant included in that rate base is financed by cost-



free capital. On the other hand, forcing such capital to be perpetually cost free would be unfair to the holders of the preferred stock. This problem is overcome by the impending purchase of the system by California Water Service Company, at which time the preferred stockholders apparently will have first preference to the proceeds of the liquidation of Crest's utility assets.

Adjustments to Actual Cost

Crest's present and previous main extension rules provide that the estimated cost of an extension be advanced by the developer, but that the amount of advance be adjusted after actual cost of the extension is determined. Crest did not collect an additional advance when the cost exceeded the estimate nor did it refund part of the advance when the estimate exceeded the cost.

Based upon the preliminary results of an investigation by an independent accounting firm retained by Crest, the Commission staff determined the net effect of Crest's failure to make the adjustments required by its filed rules. Exhibit No. 1 shows that actual costs exceeded estimates by \$22,404 for all agreements not terminated by the issuance of stock and that the corresponding deficiency in advances for all agreements is \$34,362.

A more detailed study by Crest's accountants showed that \$3,196 of the apparent deficiency in advances was due to an error in the preliminary report. That report misclassified a supply line as an in-tract rather than a backup facility.

Crest contends that about \$17,370 of the apparent deficiency in advances is represented by the cost of oversizing mains and that the cost of such oversizing is not subject to being advanced by the subdividers. The amount is derived in Exhibit No. 24 by multiplying \$1.88, Crest's estimate of the difference between the cost of 10-inch

and 6-inch mains, by 9,240, the number of feet of 10-inch and 12-inch pipe in the system. Crest's contention thus is founded on two assumptions: first, that 6-inch mains would have been adequate to serve the particular development without provision for future extensions in each case where 10-inch and 12-inch mains actually were installed; second, that none of the oversizing was done to comply with the fire-flow or other requirements of the City of Bakersfield. No showing on either assumption was presented by Crest and, in fact, it presented testimony that the city's requirements did cause Crest to put in larger facilities than originally planned. Crest's present and previous main extension rule provides that the cost of any oversizing to comply with the requirements of a public authority shall be included in the amount advanced by the developer.

We find that, for rate-making purposes, the outstanding level of advances should be computed as though the advance for each extension had been adjusted to actual cost, resulting in \$17,370 of additional advances.

#### Tariff Revisions

The Commission staff recommends that certain rate changes, tariff simplifications and additional flat-rate categories be incorporated in Crest's tariffs. In view of the impending purchase of the system by California Water Service Company, it is appropriate to postpone tariff revisions until operations under the new owner can be reviewed. The order authorizing the transfer permits the initial continuation of the present rates by the new owner.

#### Violations

It is apparent from the foregoing discussion of issues that Crest and its officers have done many things not in accordance with orders of the Commission, accounting practices prescribed by the

Commission, provisions of the Public Utilities Code, and provisions of Crest's own filed tariffs. These actions, however, seem to stem from the fact that Crest's officers failed to become sufficiently familiar with proper procedures of regulated public utilities. There is no evidence that the various infractions were willful violations nor that Crest attempted to conceal them.

Under these circumstances, we will not attempt to invoke the various penalties to which Crest and its officers might be subject. Our principal concern, at this point, is to ensure that the public will not in the future be penalized by Crest's actions. Over a period of years, the effect of the various rate base adjustments will diminish, but it is appropriate that Crest now set up memorandum records upon which future revised rate base adjustments can be made. The order herein so provides.

#### Findings and Conclusion

In addition to the detailed findings throughout the foregoing opinion, the Commission finds that:

1. Crest has failed to follow the provisions of its tariffs which require it to revise advances for construction to reflect differences between estimated and actual costs and has terminated some of its main extension agreements without Commission authorization by issuance of common stock.

2. The impending sale of Crest's water system to California Water Service Company and the proposed subsequent change in methods of operation will alleviate or solve the problems outlined in the foregoing opinion relating to water quality and Crest's failure to pay dividends on its preferred stock, and will require a review of the new owner's operations to determine whether any revision of tariffs is appropriate.

The Commission concludes that Crest should be required to prepare memorandum records which will show the correct level of advances for construction.

O R D E R

IT IS ORDERED that:

1. Within thirty days after the effective date of this order, Crest Water Company (Crest) shall prepare and file in this proceeding a study of each main extension agreement entered into since the inception of the company. The study shall derive and show:

- a. The amount which was actually advanced for each main extension.
- b. The amount which should have been advanced for each extension reflecting the actual cost as discussed in the foregoing opinion.
- c. The amount actually refunded for each extension as of December 31, 1965.
- d. For each agreement which has been terminated, the amount which would have been refunded as of December 31, 1965 if the agreement had not been terminated.
- e. A map showing the property served and to be served directly by each extension.

2. Within thirty days after the transfer of Crest's Water Company to California Water Service Company, as authorized by Decision No. 70242, dated January 18, 1966, in Application No. 48069, Crest shall file in this proceeding a written statement showing the date of transfer.

3. Upon compliance with all of the conditions of this order and of the order in Decision No. 70242, Crest shall stand relieved of its public utility obligations in connection with the transferred system.

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

Dated at San Francisco, California, this 1<sup>st</sup> day of MARCH, 1966.

Frederick B. Hallock  
President  
John E. Mitchell  
George L. Grover  
Augustin  
Commissioners

Commissioner William M. Bennett, being necessarily absent, did not participate in the disposition of this proceeding.