

ORIGINAL

Decision No. 70418

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application)
of)

CALIFORNIA WATER & TELEPHONE)
COMPANY, a corporation, and)

CALIFORNIA-AMERICAN WATER)
COMPANY, a corporation,)

for an Order authorizing:)

A. California Water & Telephone)
Company to sell and transfer and)
California-American Water Company)
to purchase and receive the water)
utility business of California)
Water & Telephone Company,)
including the properties used in)
its water utility business; and)

Application No. 48170
Filed January 7, 1966
and Amendment
Filed January 31, 1966

B. California Water & Telephone)
Company to withdraw from the)
water utility business; and)

C. California-American Water)
Company to engage in and carry)
on the water utility business)
of California Water & Telephone)
Company; and)

D. California-American Water)
Company to assume certain)
obligations of California Water)
& Telephone Company; and)

E. California-American Water)
Company to issue and sell shares)
of its common stock.)

Bacigalupi, Elkus, Salinger & Rosenberg, by Claude N. Rosenberg and Tadini Bacigalupi, Jr., for California Water & Telephone Company, applicant;
Graham James & Rolph, by Boris H. Lakusta and E. Myron Bull, Jr., for California-American Water Company, applicant;
Paul D. Engstrand and John H. Whitney, for South Bay Irrigation District, interested party;
Parke L. Boneysteel and Sidney J. Webb, for the Commission staff.

O P I N I O N

California Water & Telephone Company and California-American Water Company have filed this application for an order of the Commission (a) authorizing the former to sell and transfer its water utility business, together with related rights and properties, to the latter; (b) authorizing the latter to issue and sell 250,000 shares of its capital stock without par value for a total cash consideration of \$25,000,000; and (c) granting certain incidental authority.

After due notice, a public hearing in this matter was held before Examiner Donovan in San Francisco on February 3 and 4, 1966, at the conclusion of which the matter was taken under submission. The staff of the Commission's Utilities Division opposed the proposed transfer on the basis of its concern that a number of the features would inevitably create a future need for higher rates. The staff of the Commission's Finance and Accounts Division opposed the proposal for amortizing a portion of the resulting utility plant acquisition adjustments by charges to an operating revenue deduction account instead of to an income deduction account.

California Water & Telephone Company is a California corporation engaged in the business of (1) rendering public utility telephone service in portions of the Counties of Imperial, Los Angeles, Riverside and San Bernardino; (2) rendering public utility water service in portions of the Counties of Los Angeles, Monterey and San Diego; and (3) serving water under private contract to Del Monte Properties

Company in Monterey County. It is a wholly-owned subsidiary of General Telephone & Electronics Corporation, a New York corporation.

California-American Water Company is a California corporation organized, on or about December 7, 1965, primarily for the purpose of engaging in the operation of a public utility water business within the State of California. It proposes to become a wholly-owned subsidiary of American Water Works Company, Inc., a Delaware corporation.

In accordance with an Agreement dated December 16, 1965, a copy of which is attached to the application as Exhibit F, California Water & Telephone Company proposes to sell all of its water utility business and related assets, together with certain non-operating property, for a total cash purchase price of \$41,734,768, subject to adjustment for transactions after August 31, 1965 to date of transfer, to California-American Water Company, which will assume certain obligations of the former including advances for construction and customers' deposits amounting to \$2,185,020 and \$11,608, respectively, as of August 31, 1965. For the purpose of obtaining funds to meet said purchase price and for providing cash working capital, California-American Water Company proposes to sell 250,000 shares of its common stock to American Water Works Company, Inc. for \$25,000,000 and to obtain \$20,000,000 through open account advances from the latter, which advances would bear interest at the rate of 5-1/4% per annum.

In support of an exemption from competitive bidding for the proposed stock issue, the record shows that the creation of California-American Water Company and the purchase of its stock by American Water Works Company, Inc. are integral and essential features of the plan presented in this proceeding. Moreover, the Articles of Incorporation of the transferee have been amended to give pre-emptive rights to holders of its outstanding stock.

A pro forma balance sheet of California-American Water Company as of August 31, 1965, giving effect to the proposed acquisition and financing, obtained from Exhibit E attached to the amendment to the application, follows:

Assets

Utility plant in service, less reserve for depreciation	\$33,931,077
Construction work in progress	540,722
Utility plant acquisition adjustments	12,285,371
Other physical property, less reserve for depreciation	39,101
Current and accrued assets	3,825,899
Deferred debits	<u>60,000</u>
Total	<u>\$50,682,170</u>

Liabilities

Common stock	\$21,500,000
Capital surplus	3,500,000
Advances from American Water Works Company, Inc.	20,000,000
Customers' deposits	11,608
Advances for construction	2,185,020
Contributions in aid of construction	<u>3,485,542</u>
Total	<u>\$50,682,170</u>

The \$12,285,371 shown in the pro forma balance sheet as utility plant acquisition adjustments includes an amount of \$3,485,542 which results from the carrying forward to the transferee of the amount shown on the transferor's records as contributions in aid of construction. California-American Water Company proposes to amortize the \$3,485,542 by annual charges of \$91,725 to Account 270, Capital Surplus, with concurrent credits to Account 252, Reserve for Amortization of Utility Plant Acquisition Adjustments, the balance in the contributions in aid of construction account to be accounted for in accordance with the prescribed instructions contained in the Uniform System of Accounts for Water Utilities. With respect to the remaining \$8,799,829 of utility plant acquisition adjustments, the transferee seeks authority to effect an amortization by annual charges to Account 505, Amortization of Utility Plant Acquisition Adjustments, in the amount of \$226,642, with concurrent credits to said Account 252. The transferee estimates that it will realize annual savings in taxes based upon income equal in amount to the \$226,642 proposed to be charged to Account 505. Such savings are attributable to increased depreciation and interest deductions which would result from the transfer according to the computation set forth on the last page of said Exhibit H.

The Uniform System of Accounts for Water Utilities (Class A, Class B and Class C) prescribed by this Commission contains two accounts to which annual amortization of utility plant acquisition adjustments may be charged; namely,

Account 505, Amortization of Utility Plant Acquisition Adjustments, which is classified as an operating revenue deduction and Account 537, Miscellaneous Amortization, which is an income deduction account.

If the Commission were to authorize the use of Account 505 in this proceeding, such authorization might imply that it is proper to amortize the excess cost of the properties by annual charges to the operating revenue deductions which are considered in determining the reasonableness of rates paid by consumers. On the other hand, utilization of Account 537 clearly indicates that the net amortization charged thereto is to be absorbed by the stockholder.

The accounting treatment to be accorded the annual amortization of the utility plant acquisition adjustments described herein has been carefully reviewed. In our opinion, annual amortization through Account 505 should not be approved. The purchaser, in this instance, willingly has agreed to pay a price substantially in excess of the seller's original cost, therefore, annual amortization of such excess cost should be accounted for as an income deduction charge to Account 537.

The record shows that California-American Water Company, upon acquiring the properties, will be allowed certain additional deductions from taxable income which are not otherwise available to California Water & Telephone Company. Such deductions consist principally of (a) a \$117,669 increase in depreciation expense for tax purposes because of the higher tax basis of the property and

(b) additional interest expense associated with the financing of the acquisition adjustments. Since the balance in the utility plant acquisition adjustments account will be eliminated from future rate base determinations, it is equitable that the related reduction in taxes based on income should be considered as an offset to the annual amortization.

For accounting purposes, California-American Water Company will be permitted to amortize a portion of the utility plant acquisition adjustments account over a 38½-year period by recording annually a debit of \$226,642 in Account 537, Miscellaneous Amortization, with a concurrent credit to Account 252, Reserve for Amortization of Utility Plant Acquisition Adjustments. In connection with such amortization, the company will be authorized to record in said Account 537 an annual credit for the tax savings, with an offsetting charge to a subaccount under Account 507, Taxes, in an amount equal to (a) the decrease attributable to additional depreciation expense for tax purposes, plus (b) the reduction derived from additional interest expense after effecting an interest expense allocation which considers the relationship of the unamortized balance in the acquisition adjustments account to total capitalization and recognizes changes in effective interest rates as well as significant changes in capital structure.

The Commission has considered this matter and finds that:

1. Anticipated savings in taxes based upon income do not support the proposed charges to Account 505, Amortization of Utility Plant Acquisition Adjustments.
2. California-American Water Company has failed to justify its proposed use of said Account 505.
3. There will be no increase in rates as a result of the proposed transfer, provided that charges contemplated to be reflected in Account 505 are recorded instead in Account 537.
4. The proposed journal entries, filed in this proceeding as a portion of Exhibit E, are proper.
5. The proposed transfer, subject to the accounting treatment herein authorized, will not be adverse to the public interest.
6. The proposed sale of common stock directly to American Water Works Company, Inc., rather than by an offering through competitive bidding, will not be adverse to the public interest.
7. The money, property or labor to be procured or paid for by the issue of the stock herein authorized is reasonably required for the purpose specified herein, and such purpose is not, in whole or in part, reasonably chargeable to operating expenses or to income.

On the basis of the foregoing findings we conclude that the application should be granted, except as it relates to the employment of Account 505 in connection with the amortization of utility plant acquisition adjustments not related to contributions in aid of construction, and denied with respect to such accounting, the charges to be made instead to Account 537.

In issuing our order herein, we place California-American Water Company on notice that we do not regard the number of shares outstanding, the total stated value of the shares nor the dividends paid as measuring the return it should be allowed to earn on its investment in plant and that the authorization herein given is not to be construed as a finding of the value of its stock or properties nor as indicative of amounts to be included in proceedings for the determination of just and reasonable rates. The authorization to make certain journal entries is for accounting purposes only and the Commission reserves the right to review such entries in further detail should they become an issue in any proceeding.

The record contains a substantial amount of material which is not essential to the disposition of a financing, accounting and transfer proceeding, but would be appropriate for a rate proceeding. Our failure to discuss this material in connection with this matter is not to be regarded as an indication of the position the Commission would take with respect to any such material in a rate proceeding. It is essential, however, that there be no misunderstanding of this Commission's policy as regards the treatment of any excess purchase price in a rate proceeding, and for this reason it is herein stated that it is the policy of this Commission to fix rates on the basis of an original cost rate base and that the plant acquisition adjustment is not included as an element of such a rate base. The purchaser's president testified under cross-examination that he understood such rate-making treatment to represent Commission policy and that he would not urge a treatment inconsistent with such policy. Tr. 86-87. Moreover, the witness

for the California-American Water Company stated that it was his understanding that the low return to common shareholders of California-American Water Company resulting from the purchase at a price substantially in excess of the original cost less depreciation of the properties being acquired would not be used or claimed as a basis for the filing of a rate increase application. Tr. 147.

In conjunction with the American Water Works Company, Inc. and its subsidiaries, there is a separate corporation, American Water Works Service Company, Inc. which provides various services for the affiliated operating companies. The record shows, however, that California-American Water Company will, itself, perform the functions normally rendered to other American Water Works Company, Inc. subsidiaries by the service company. Therefore, the service company does not plan to establish a separate division specifically to provide service for California-American Water Company. California-American Water Company's president testified that it will make use of the service company services only in various limited instances, such as the mass purchase of certain types of materials or where California-American Water Company would benefit from consultation or advice. California-American Water Company agreed to provide and make available to the Commission in the future answers to any inquiries concerning the costs of the service company and to supply supporting information upon request. Tr. 109-110.

For income tax purposes, American Water Works Company, Inc. has in the past filed a consolidated federal income tax return. California-American Water Company indicated its willingness to furnish the federal income tax returns and

California Bank and Corporation Franchise Tax combined reports that apply to California operations to this Commission upon request. Tr. 122-124.

The order which follows will dispose of the requests contained in the application, as amended.

O R D E R

IT IS ORDERED that:

1. California Water & Telephone Company may sell and transfer to California-American Water Company, and the latter may purchase and acquire, all of the public utility water business and related rights and other assets of the former.

2. In connection with the sale and transfer herein authorized California Water & Telephone Company and California-American Water Company may carry out all of the terms and conditions, subject to the modification referred to in the amendment to the application, of the Agreement dated December 16, 1965, copies of which are filed in this proceeding as Exhibit F.

3. The issue and sale by California-American Water Company of 250,000 shares of its no par value common capital stock are hereby exempted from the Commission's competitive bidding rule which is set forth in Decision No. 38614, dated January 15, 1946, as amended by Decision No. 49941, dated April 20, 1954, in Case No. 4761.

4. California-American Water Company, for the purpose set forth in this proceeding, may issue and sell 250,000 shares of its no par value common capital stock with a stated value of \$86 per share for a total cash consideration of \$25,000,000, and may credit to capital surplus the \$3,500,000 resulting excess over the aggregate stated value.

5. California-American Water Company may account for the purchase of said water properties in the manner set forth in the proposed journal entries filed in this proceeding as a portion of Exhibit H.

6. California-American Water Company shall amortize the balance in Account 100-5, Utility Plant Acquisition Adjustments, resulting from this acquisition, and shall effect such amortization by (a) annual charges to Account 537, Miscellaneous Amortization, in the amount of \$226,642 and (b) annual charges to Account 270, Capital Surplus, in the amount of \$91,725, with concurrent credits to Account 252, Reserve for Amortization of Utility Plant Acquisition Adjustments.

7. California-American Water Company shall credit to said Account 537 the tax savings related to the utility plant acquisition adjustments in the manner described in the foregoing opinion. Applicant's annual reports shall contain an appropriate summary of its calculations with respect to the amount of annual tax savings. The offsetting charge shall be to a subaccount under Account 507, Taxes, which the company shall report separately in all financial statements and exhibits containing such account to be filed with this Commission.

8. On or before the date of actual transfer, California Water & Telephone Company shall refund all deposits, if any, which its public utility water customers are entitled to have refunded. Any unrefunded deposits of public utility water customers shall be transferred to and shall become the obligation for refund of California-American Water Company.

9. On or before the date of actual transfer, California Water & Telephone Company shall transfer all advances for construction held by it with respect to its public utility water properties to California-American Water Company and the latter shall assume the obligation for repayment of such advances. Applicants, within thirty days after the date of transfer, shall jointly file with this Commission a certified copy of an appropriate instrument showing the names of all persons or corporations in whose favor such obligations exist and the amounts thereof.

10. On or before the date of actual transfer, California Water & Telephone Company shall transfer and deliver to California-American Water Company all records, memoranda and papers pertaining to the construction and operation of the properties herein authorized to be transferred and the latter shall receive and preserve such records, memoranda and papers.

11. If the authority herein granted to transfer properties is exercised, California-American Water Company, within thirty days thereafter, shall notify the Commission, in writing, of the date of completion of such transfer.

12. California-American Water Company shall file, within five days after the effective date of the transfer, a notice of adoption of the presently filed public utility water tariff schedules of California Water & Telephone Company.

13. Within sixty days after the consummation of the transfer herein authorized, California Water & Telephone Company and California-American Water Company shall file with the Commission a copy of each journal entry used to record the transfer on their books of account.

14. California-American Water Company shall file with the Commission a report, or reports, as required by General Order No. 24-B, which order, insofar as applicable, is hereby made a part of this order.

15. On or before the end of the third month after the consummation of the transfer as herein authorized, California Water & Telephone Company shall file with the Commission, in such form as the Commission may prescribe, an annual report, or reports, related to its public utility water operations for the period commencing with the first day of the current year to and including the effective date of the transfer.

16. Upon compliance with the terms and conditions of the transfer, California Water & Telephone Company shall stand relieved of all further public utility obligations in connection with the operations of the public utility water systems herein authorized to be transferred.

17. The request of California-American Water Company to use Account 505, Amortization of Utility Plant Acquisition Adjustments, is hereby denied.

18. The effective date of Ordering Paragraph No. 17 shall be twenty days after the date hereof. In all other respects the effective date of this order is the date hereof.

Dated at San Francisco, California,
this 8th day of MARCH, 1966.

Frederick P. Holbrook
President
J. E. Mitchell
George G. Grover
Augustus
William W. Bennett
Commissioners