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Decision No. 78923

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of )  
CALIFORNIA-AMERICAN WATER COMPANY, )  
a corporation, for authority to )  
increase its rates and charges for )  
water service in its Monterey Penin- )  
sula Division in Monterey County. )

Application No. 52039  
(Filed July 15, 1970;  
Amended August 5, 1970)

Bacigalupi, Elkus, Salinger & Rosenberg, by  
Claude N. Rosenberg and Charles de Y.  
Elkus, Jr., Attorneys at Law, for applicant.  
Edwin B. Lee, for himself, Carmel Valley Property  
Owners Association and Carmel Valley Residents,  
Protestants.  
William C. Marsh, Attorney at Law, interested  
party.  
Michael J. Stecher, Attorney at Law, John E.  
Johnson and Harry G. Scheibe, for the  
Commission staff.

### O P I N I O N

After due notice, public hearing in this matter was held before Examiner Coffey at Monterey, California on December 14 and 15, 1970. On February 5, 1971, applicant requested submission be set aside and the proceeding reopened for the purpose of taking additional evidence relating to the rate of return. Applicant's request for reopening the proceeding having been granted on March 9, 1971, further hearing was held at Monterey on April 5, 1971, and at San Francisco on April 19, 1971. The matter was resubmitted on May 13, 1971, upon the receipt of briefs and the reporter's transcript of the hearing.

Applicant, a wholly owned subsidiary of the American Waterworks Company, Inc. of Wilmington, Delaware, is a California corporation operating public utility water systems in portions of the Counties of Los Angeles, San Diego, Ventura and Monterey. Applicant's Monterey Peninsula Division water system serves approximately 27,000 customers within the Cities of Monterey, Pacific Grove, Carmel-by-the-Sea, Del Rey Oaks and Sand City, portions of the City of Seaside and certain unincorporated areas in Monterey County known as "Carmel Valley", "Carmel Highlands", "Pebble Beach" and "Robles del Rio".

In addition to the Monterey Peninsula Division, applicant's other Divisions are designated as (1) San Gabriel Valley Division in Los Angeles County; (2) San Diego Bay Division in San Diego County, and (3) Village Division in Ventura County (all in California).

Rates

The following tabulation compares applicant's present and proposed rates for metered water service:

General Metered Service

		Per Meter			Per Month		
		Present Rates			Proposed Rates		
		: 1st	: 2nd		: 1st	: 2nd	
Gravity : Elevation : Elevation		Gravity : Elevation : Elevation	Gravity : Elevation : Elevation		Gravity : Elevation : Elevation	Gravity : Elevation : Elevation	
Zone : Zone : Zone		Zone : Zone : Zone	Zone : Zone : Zone		Zone : Zone : Zone	Zone : Zone : Zone	
Quantity Rates:							
First	300 cu.ft. or less	\$ 2.10	\$ 2.25	\$ 2.35	\$ 2.60	\$ 2.75	\$ 2.90
Next	1,700 cu.ft., per 100 cu.ft.	.40	.45	.48	.51	.56	.60
Next	18,000 cu.ft., per 100 cu.ft.	.32	.37	.40	.40	.46	.50
Next	80,000 cu.ft., per 100 cu.ft.	.27	.32	.35	.33	.39	.43
Next	700,000 cu.ft., per 100 cu.ft.	.24	.29	.32	.30	.36	.40
Over	800,000 cu.ft., per 100 cu.ft.	.20	.25	.28	.25	.31	.35
Minimum Charge:							
For	5/8 x 3/4-inch meter	\$ 2.10	\$ 2.25	\$ 2.35	\$ 2.60	\$ 2.75	\$ 2.90
For	3/4-inch meter	2.40	2.60	2.70	3.00	3.25	3.35
For	1-inch meter	3.00	3.25	3.35	3.70	4.00	4.15
For	1 1/2-inch meter	5.50	6.00	6.50	6.80	7.50	8.00
For	2-inch meter	9.00	9.00	9.00	11.50	11.50	11.50
For	3-inch meter	18.00	18.00	18.00	22.50	22.50	22.50
For	4-inch meter	30.00	30.00	30.00	37.50	37.50	37.50
For	6-inch meter	60.00	60.00	60.00	75.00	75.00	75.00
For	8-inch meter	90.00	90.00	90.00	112.50	112.50	112.50

The minimum charge will entitle the customer to the quantity of water which that minimum charge will purchase at quantity rates.

The Pollock Water Service, Inc., was granted increased rates by Decision No. 75958, dated July 29, 1969 in Application No. 50518, dated August 30, 1968. The authorized rate adjustments were made effective in two steps, 12 months apart. The first year increase of approximately 60 percent of the amount authorized was effective on August 21, 1969; the rates in the second year (effective as of August 18, 1970) make up the balance of the total rate adjustment authorized. The total rate adjustments authorized by said decision placed the rates charged (predecessor) Pollock customers at identically the same level as those presently charged customers of the Monterey Peninsula Division. On December 23, 1969, by Decision No. 76601 in Application No. 51519, dated December 1, 1969, applicant was authorized to acquire outstanding stock of Pollock and merge Pollock into applicant.

The rates proposed in this application will apply to customers formerly served by Pollock. This is reasonable considering applicant's recent and budgeted expenditures to improve the quality of water service to former customers of Pollock.

No change is proposed in the rates of any rate schedule other than General Metered Service and Street Sprinkling Service. The rate charged for water service for street sprinkling would be increased from \$.34 to \$.42 per month per 100 cubic feet.

#### Results of Operation

The following tabulation compares the estimated summary of earnings for the test year 1971, under present and proposed rates, prepared by the applicant and by the staff, with the summary of operations adopted for the purposes of this proceeding.

Summary of Earnings  
Estimated Year 1971

Item	Applicant Estimated		Staff Estimated		Adopted
	Present	Proposed	Present	Proposed	
	Rates	Rates	Rates	Rates	Rates
(Dollars in Thousands)					
Operating Revenues	\$ 2,579.1	\$ 3,149.5	\$ 2,592.8	\$ 3,204.5	\$ 2,980.6
<u>Operating Expenses</u>					
Oper. & Maint.	734.5	740.4	720.6	722.9	722.2
Admin., Gen., & Misc.	194.3	194.3	186.9	189.3	188.5
Taxes Other Than Inc.	431.0	432.6	432.4	433.8	433.3
Depreciation	320.0	320.0	320.0	320.0	320.0
Allocated Common	90.4	90.4	83.3	83.3	83.3
Subtotal	1,770.2	1,777.7	1,743.2	1,749.3	1,747.3
Income Taxes	109.6	400.3	172.6	485.4	371.0
Total Expenses	1,879.8	2,178.0	1,915.8	2,234.7	2,118.3
Net Operating Revenues	699.3	971.5	677.0	969.8	862.3
Deprec. Rate Base	11,110.6	11,110.6	11,055.0	11,055.0	11,055.0
Rate of Return	6.29%	8.74%	6.12%	8.77%	7.8%

A staff witness testified that applicant's estimate of revenues at 1971 present rates is not based upon the proper application of rates to water use and customer spread data. The remaining difference stems mainly from the staff's lower estimate of customer growth and the pricing at filed tariff rates of water sales under the contract with Del Monte Properties, consistent with treatment accorded in the last rate proceeding, Decision No. 55359, dated August 5, 1957.

The lower operation and maintenance expenses estimated by the staff is due in general to the partial exclusion of advertising expense, in the amount of \$7,000, and estimated (not firm) pay rate increases in 1971 of about \$8,000. Charges had been made to advertising expense, Account 783, for items which should have been classified as donations or charitable contributions.

The lower administrative, general and miscellaneous expense estimate by the staff results from the staff also excluding \$2,100 for certain dues, charitable contributions and like items in Account 792, Office Supplies and Expense; and \$800 for Chamber of Commerce Dues in Account 799, Miscellaneous General Expense. The balance of the difference stems from the staff treatment of estimated pay-rate increases and applicant basing its property insurance expense, Account 793, (an allocation from the parent company) on revenues from proposed rates.

The lower allocated common expense estimate by the staff again results from the exclusion by the staff of \$2,200 in Account 792; \$3,900 in Account 798, Outside Services; and \$800 for certain charitable contributions in Account 799.

The lower depreciated rate base proposed by the staff is due to a staff accounting adjustment of \$18,000 in Account 303, Other Intangible Plant, for engineering services, the staff estimate of Account 131, Materials and Supplies, being \$2,800 below applicant's because of a difference in interpretation of recorded figures, and the staff's 1971 estimate of working cash being \$34,500 below applicant's mainly because of an error in applicant's calculations and partly because applicant based its estimate on 1969 revenue and expense figures, whereas the staff used its 1971 estimated figures.

We find the staff estimates of present and proposed revenues, expenses, and rate base reasonable, but in our adopted results will include an allowance for recent increases in postal rates.

Rate of Return

The rate of return to be allowed on property used and useful in rendering public utility water service is the major issue to be resolved in this proceeding. Applicant advocates a rate of return of 8.75 percent and the staff recommends a rate of return in the range of 7.5 percent to 7.8 percent.

It is necessary to review the history of applicant with respect to its original authorization to provide public utility water service to California consumers.

In Decision No. 70418, issued March 8, 1966, California Water and Telephone Company was granted authority to sell and transfer its public utility water business to applicant. Applicant paid a cash purchase price of \$41,734,768 for the properties involved. The pro forma balance sheet presented in that proceeding shows an acquisition adjustment of \$12,285,371 for the payment in excess of the book value of the properties purchased. (65 Cal. P.U.C. 283 (1966).) The decision contains the following statement with respect to the acquisition adjustment:

"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." (65 Cal. P.U.C. 281, 286.)

The staff maintains that any attempt by applicant to burden the rate-payers, in any way, with financing the acquisition adjustment is contrary to the Commission's ruling in said decision.

Applicant contends that the deduction by the staff of the entire portion of the acquisition cost adjustment from common equity for the purpose of determining capital ratios and return on equity was erroneous. Applicant presented the following tax savings allowance made by the Commission in Decision No. 70418 as a basis for this argument:

"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 sub-account 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." (65 Cal. P.U.C. 284-285.)

Applicant argues that the above language recognizes that part of the acquisition cost adjustment is assignable to debt and, therefore, that the entire amount thereof should not be assigned to common equity, as did the staff, for the purpose of computing a return on equity.



The staff submits that applicant's citation does not support its contention.

The purpose of including the above language in the decision was to allow applicant the benefit of the lower tax costs attained because of the higher interest and depreciation charges it would show over the predecessor company. Since the Commission did not allow the excess purchase price over the book value of the assets purchased, it deemed it proper that applicant should receive the benefit of the so-called tax savings in connection therewith.<sup>1/</sup>

For the purpose of establishing the reasonableness of water rates to be authorized it is not appropriate to assign any portion of the acquisition cost adjustment to debt. Applicant has been clearly and repeatedly advised that if it chose to pay for the properties substantially more than the depreciated original cost, it could expect not to be allowed earnings on the acquisition cost adjustment. Holders of debt have had no such notice and have no reason to anticipate a lower return on their investment because of applicant's managerial discretion. Applicant is permitted to recoup its investment in excess of depreciated original cost because it creates no added burden on ratepayers. This is all applicant can reasonably expect. We find reasonable the deduction of the entire portion of the acquisition cost adjustment from common equity for the purpose of determining capital ratios and return on equity. To do otherwise is to circumvent the long standing policy of this Commission of fixing rates on the basis of original cost by the simple device of the sale of operating utilities for amounts in excess of depreciated original cost.

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<sup>1/</sup> Applicant receives an allowance of almost \$400,000 per year because of this treatment which will offset the acquisition adjustment in its entirety over an approximate 35-year period.

Applicant argues that certain other Class A water utilities in the State are authorized returns on equity of 10.5 percent to 11.6 percent as compared to the 9.21 percent that would be earned pursuant to the upper range of the staff's recommendation. These utilities for the five years ending 1969 had an average equity ratio of 38.4 percent<sup>2/</sup> as compared to applicants advocated equity ratio of approximately 50 percent. Due to this substantial difference in capital structures, applicant and said utilities have different financial risks, and thus, are not comparable on this basis.

Said utilities are likewise not comparable with applicant because none of them has a parent-subsidary relationship, as does applicant.

The average equity ratio of the parent for the year ending 1970 was approximately 14 percent. Applying the concept of "secondary leverage", the highest equity allowance of 9.21 percent as recommended by the staff would result in a greater equity return for the parent, one which is considerably in excess of the returns authorized for said California utilities.

The returns on equity of said utilities are likewise not comparable with that for applicant because of the acquisition adjustment.

The evidence introduced by applicant in the re-opened hearings was directed to a showing that a 8.75 percent rate of return is reasonable and necessary if applicant is to have the income that it requires in order to effectuate needed financing in the immediate future. Applicant's 1971 construction budget is approximately \$2,500,000, of which \$811,000 will be expended in the Monterey

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<sup>2/</sup> California Water Service - 43.77%  
Southern California Water - 36.37%  
San Jose Water - 35.06% (Exh. 6, Table 4)

Peninsula Division. Approximately \$1,000,000 of this amount will be provided by depreciation accruals leaving a net amount of \$1,500,000 to be obtained through financing.

Witness for applicant testified that applicant owes \$550,000 on a note which matured March 31, 1971, and \$2,800,000 against a maximum \$3,000,000 line of bank credit. The \$550,000 is to be funded at once, and the \$2,800,000 should be funded by long term debt as soon as possible so that thereafter financial requirements may be met by further short-term borrowings which can, in turn, be replaced by permanent financing.

Evidence produced by applicant shows need for a minimum of approximately \$5,000,000 of long-term debt financing, of which applicant has been granted authority to issue \$1,000,000 of First Mortgage Bonds. The proceeds of this issue is intended to pay off past due bank indebtedness of \$550,000 and the balance of \$450,000 to reimburse applicant's treasury for moneys previously expended.

Applicant indicated that its indenture under which its long term debt is issued requires that there be a coverage of 1.75 times interest payable on bonds outstanding, and because of this restriction it would not be able to issue long term debt at the staff's recommended rate of return. The staff contends that the 7.5 percent - 7.8 percent rate of return range would be sufficient for applicant to meet its future financial requirements. Applicant stipulated that on the basis of the 12 months' operations ending December 31, 1970, it would have a coverage of 1.8 times after the issuance of the \$1,000,000 of First Mortgage Bonds, with the \$550,000 bank loan outstanding, with no rate increases for the Monterey Peninsula Division or the Village District

of the California American Water Company,<sup>3/</sup> but with rate increases authorized in 1970 annualized. (Tr. 259,260.)

The staff argued that applicant is striving to attain a crisis based on its alleged times interest coverage requirements and that applicant has "presumed" that the only method of acquiring additional capital is through the issuance of long term debt. The staff took exception to this "presumption" by indicating that the applicant has two alternatives to this long term financing, namely, the issuance of additional stock to the parent and the furnishing of advances from the parent until such time as the pseudo-crisis is at an end.

In reply to applicant's statement that, "there is no evidence as to the ability of the parent company to provide ample equity funds", the staff argues that the burden of proving that it has no other reasonable means of attracting capital is placed upon it and not the staff. (Southern Counties Gas Co., 58 CPUC 27 (1960).)<sup>4/</sup>

We find reasonable a rate of return of 7.8 percent for the test year which will produce a return of 9.21 percent on common equity after deducting therefrom the unamortized portion of the acquisition adjustment in the amount of approximately \$10,800,000.

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<sup>3/</sup> The Village District has pending a rate increase application.

<sup>4/</sup> It should be noted that the parent, American Waterworks Company, is the largest water utility holding company in the United States and paid \$12,285,371 in excess of book value of the properties purchased to establish its subsidiary as a California water utility.

Public Presentation

Customers testified in opposition to the requested rate increase, complained of inadequate water quality and service. Applicant investigated and reported in Exhibit No. 9 on thirteen complaints presented in person or by letter at the hearing.

The staff reported that its field investigations disclosed that service quality was adequate with the exception of two general areas.

Since applicant has installed at the troublesome wells treatment facilities which will permit full production in 1971, and in view of Exhibit No. 9, there appears no further action is required of the Commission at this time, pending evaluation of action taken by applicant to improve water quality and service.

The President of the Carmel Valley Property Owners' Association complained that applicant's operation of pumps in the Lower Carmel Valley river basin has lowered the water table to cause destruction of the riparian vegetation along the banks of Carmel River. Said destruction is alleged to have resulted in erosion of banks and land and threaten to cause:

1. Further erosion of land,
2. Destruction of homes due to the river breaking out of destroyed river banks,
3. Damage to one or more golf courses and a retirement home should course of river change,
4. Expenditures for concrete lining of river banks if pumping damage cannot otherwise be controlled, and
5. Increased capital investments to effect changes in applicant's operating procedures so that water may be pumped without destroying river banks.

Said complainant desires that approval of this application be withheld until applicant has indicated a means of protecting the safety and welfare of people of Carmel Valley while engaging in pumping operations and until applicant has included the cost of said means in a rate increase application.

Applicant argued that if a civil tort should occur and damage were to follow, the proper forum for redress would be the courts and not the Commission.

Said complainant stated that a use permit for a well in 1966 had been granted by the local county government without the river bank protective provisions requested by complainant, the county holding it had no responsibility or authority in this situation since the jurisdiction was with the State.

Applicant agreed to investigate the circumstances of this complaint and report to the Commission. Said report has been received by the Commission and sent to complainant. Applicant states in the report:

"The California-American Water Company recognizes the importance of this visual focus of the valley and stands ready to cooperate fully in its preservation."

Since this record does not include sufficient evidence on methods and costs of preservation, no order will be made at this time on this issue; either applicant or complainant may request such further Commission action or determination as may be appropriately within its jurisdiction should community and utility cooperation not resolve the mode of utility operation or sharing of costs. Generally it can be assumed that all reasonable costs incurred in the reasonable operation of a water system will be recovered in the rates charged for water service to customers.

Findings and Conclusion

The Commission finds that:

1. Applicant is in need of additional revenues, but the proposed rates set forth in the application are excessive.
2. The adopted estimates, previously discussed herein, of operating revenues, operating expenses, and rate base for the test year 1971, reasonably indicate the results of applicant's operations in the near future.
3. A rate of return of 7.8 percent on the adopted rate base for the year 1971 is reasonable. It is estimated that such rate of return will provide a return on common equity of approximately 9.21 percent after deducting therefrom the unamortized acquisition adjustment.
4. The increases in rates and charges authorized herein are 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.

The Commission concludes that the application should be granted to the extent set forth in the order which follows.

O R D E R

IT IS ORDERED that after the effective date of this order California-American Water Company is authorized to file the revised rate schedules attached to this order as Appendix A, to withdraw

and cancel Schedules Nos. PWS-1, PWS-4H, PWS-5, PWS-6, PWS-7 and PWS-10, and to revise the territory description of all Monterey Division rate schedules to include the territory of Pollock. Such filing shall comply with General Order No. 96-A. The effective date of the revised schedule shall be four days after the date of filing. The revised schedules shall apply only to service rendered on and after the effective date thereof.

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

Dated at San Francisco, California, this 13<sup>th</sup> day of 7 JULY, 1971.

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Chairman  
*William J. ...*  
\_\_\_\_\_  
*James L. ...*  
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\_\_\_\_\_  
Commissioners

Commissioner J. P. Vukasin, Jr., being necessarily absent, did not participate in the disposition of this proceeding.

Commissioner D. W. Holmes, being necessarily absent, did not participate in the disposition of this proceeding.



APPENDIX A  
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## Schedule No. M-1

Monterey Peninsula Tariff AreaGENERAL METERED SERVICEAPPLICABILITY

Applicable to all water furnished on a metered basis.

TERRITORY

Monterey, Pacific Grove, Carmel-by-the-Sea, Del Rey Oaks, Sand City, (C)  
and a portion of Seaside, and vicinity, Monterey County. (C)

RATES

		Per Meter Per Month			
		Gravity Zone	1st Eleva- tion Zone	2nd Eleva- tion Zone	
Quantity Rates:					
First	300 cu.ft. or less	\$ 2.45	\$ 2.60	\$ 2.80	(I)
Next	1,700 cu.ft., per 100 cu.ft.	.46	.52	.56	
Next	18,000 cu.ft., per 100 cu.ft.	.37	.43	.46	
Next	80,000 cu.ft., per 100 cu.ft.	.31	.37	.40	
Next	700,000 cu.ft., per 100 cu.ft.	.28	.34	.37	
Over	800,000 cu.ft., per 100 cu.ft.	.23	.29	.32	
Minimum Charge:					
For	5/8 x 3/4-inch meter	\$ 2.45	\$ 2.60	\$ 2.80	
For	3/4-inch meter	2.80	3.00	3.20	
For	1-inch meter	3.50	3.80	4.00	
For	1 1/2-inch meter	6.40	7.00	7.60	
For	2-inch meter	11.00	11.00	11.00	
For	3-inch meter	21.00	21.00	21.00	
For	4-inch meter	35.00	35.00	35.00	
For	6-inch meter	70.00	70.00	70.00	
For	8-inch meter	105.00	105.00	105.00	(I)

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

SPECIAL CONDITION

The boundaries of the three zones in which the above rates apply are as set forth in the Preliminary Statement and delineated on the Tariff Service Area Maps filed as part of these tariff schedules.

(D)

APPENDIX A  
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Schedule No. Mo-7

Monterey Peninsula Tariff Area

STREET SPRINKLING SERVICE

APPLICABILITY

Applicable to water service furnished to municipalities on a metered basis for street sprinkling.

TERRITORY

Monterey, Pacific Grove, Carmel-by-the-Sea, Del Rey Oaks, Sand City, (C)  
and a portion of Seaside, and vicinity, Monterey County. (C)

RATE

Per Month

For all water used, per 100 cu.ft. ....	\$0.40	(I)
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