Decision 90 02 045 FEB 23 1990 ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of Apple Valley Ranchos Water Company (U 346 W) for authority to increase rates as authorized by NOI 89-06-050.

Application 89-07-011
(Filed July 3, 1989)

Hill, Farrer & Burrill, by David A. Ebershoff, Attorney at Law, for Apple Valley Ranchos Water Company, applicant.

Judith Allen, Attorney at Law, for Division of Ratepayer Advocates and Commission Advisory and Compliance Division.

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OPINION

Summary

Apple Valley Ranchos Water Company (Ranchos, applicant) requests authority to increase existing rates $1,881,600 (72.1%) for the test year 1990, $602,400 (13.6%) for the test year 1991, and $97,700 (1.9%) for the attrition year 1992. Applicant requests a return on equity of 13% and a return on rate base for the test years 1990 and 1991 of 12.52% and 12.57%, respectively. Applicant alleges the present rates do not produce adequate revenue to yield a fair, just, and reasonable return on capital invested and to be invested in plant, property, and other equipment devoted to providing utility service. Applicant is presently operating at a loss.

The Division of Ratepayer Advocates (DRA) and the Commission Advisory and Compliance Division (CACD) conclude that the rate increase requested is excessive. DRA/CACD calculate a reasonable rate increase to be $1,568,500 in 1990, $454,800 in 1991 and $74,400 in 1992. DRA recommends imputing common equity in the capital structure of 75%, 70%, and 65% for 1990, 1991, and 1992, respectively. Based upon this imputed capital structure, DRA recommends a constant return on equity of 11.4% and a return on rate base of 11.37%, 11.38%, and 11.35% for 1990, 1991, and 1992, respectively. In the area of rate design, CACD recommends a special rate for the Desert Knolls district, the elimination of lifeline rates and the increase of fixed costs collected in the service charge from 15% to 40%. DRA opposes the collection of interest on revenues deferred from 1990 to 1991 for a period prior to the effectiveness of this decision.

Public participation hearings and evidentiary hearings were held in Victorville on November 6-9, 1989. Evidentiary hearings were concluded in Los Angeles on November 13, 1989.

Oral Argument before Commissioner Ohanian was held in San Francisco on December 13, 1989 to address applicant's request for emergency interim relief. The basis of applicant's request is the undisputed revenue losses now and projected for 1990 and the lack of opposition to its request by DRA/CACD. Applicant's request for interim relief is denied because no financial or operational emergency presently exists. The facts alleged to support the request for interim relief are considered in setting the returns on rate base and common equity. However, rates authorized herein are made effective immediately to minimize Ranchos' undisputed revenue losses projected under present rates for 1990.

We find reasonable and authorize a rate increase of $1,620,100, in 1990 (62.8%), $463,600 in 1991 (11.0%), and $77,100 in 1992 (1.6%). We adopt the rate design recommended by CACD except the elimination of lifeline rates. We authorize the collection of interest on revenues deferred until 1990 from the effective date of this decision. We adopt a return on rate base of 11.71% for 1990 and 11.73% for 1991 and 1992. We adopt a return on equity of 11.9% for 1990, 1991 and 1992. We agree that Ranchos' common equity ratio is excessive for ratemaking purposes and order phased reductions of 76% in 1990, 72% in 1991 and 69% in 1992. Our authorized rates appear in Table 1, below.

We decline to order the preparation of economic studies upon which to base separate rates for the Desert Knolls area of applicant's service territory. We order Ranchos to comply with notification requirements for advance contract limits in its Main Extension Rule 15.

The proposed decision in this matter was filed on January 25, 1990. Both parties orally agreed to waive one day of the 30-day review period required under P. U. Code § 311 prior to the signing of a final decision. Parties placed their written agreement in the comments on the proposed decision. The waiver of one day will not shorten the 20-day comment period or five-day reply period. The proposed decision has been revised to reflect corrections indicated in parties' comments and to increase the return on equity.

Table 1

Apple Valley Ranchos Water Company
SUMMARY OF EARNINGS
Test Year 1990

Item	Utility Proposed Rates	Staff Proposed Rates	Adopted Rates
(000)			
OPERATING REVENUES	$4,352.3	$4,149.5	$4,201.1
DEFERRED REVENUES	(8.5)	(8.5)	(8.5)
TOTAL REVENUES	$4,360.8	$4,158.0	$4,209.6
OPERATIONS & MAINTENANCE			
PAYROLL - OPERATIONS	201.6	201.6	201.6
OPERATIONS - OTHER	67.7	67.7	67.7
PURCHASED POWER - ELEC.	659.1	659.1	659.1
PURCHASED POWER - GAS	34.9	34.9	34.9
CHEMICALS			
PAYROLL - CUSTOMERS	92.4	92.4	92.4
CUSTOMERS - OTHER	92.4	92.4	92.4
UNCOLLECTIBLES	9.2	8.7	8.8
PAYROLL - MAINTENANCE	135.0	135.0	135.0
MAINTENANCE - OTHER	355.3	355.3	355.3
SUBTOTAL O & M	1,647.6	1,647.1	1,647.1
ADMINISTRATIVE & GENERAL			
PAYROLL	219.5	219.5	219.5
PAYROLL - BENEFITS	106.9	106.9	106.9
INJURIES & DAMAGES	158.9	158.9	158.9
FRANCHISE TAX	43.6	41.6	42.1
REG. COMM. EXPENSE	19.4	19.4	19.4
OUTSIDE SERVICES	79.1	79.1	79.1
OFFICE EXPENSE	81.5	81.5	81.5
A & G TRANSFERRED	(78.6)	(78.6)	(78.6)
MISCELLANEOUS	16.1	16.1	16.1
MAIN OFFICE ALLOCATION			
A & G EXPENSES	261.8	261.8	261.8
DATA PROCESSING	59.5	59.5	59.5
SUBTOTAL A & G	967.7	965.7	965.7
AD VALOREM TAXES	77.7	77.7	77.7
PAYROLL TAXES	66.5	66.5	66.5
REFUND OVERCOLLECTION	(116.0)	(116.0)	(116.0)
DEPRECIATION	322.9	322.9	322.9
CA INCOME TAX	86.1	62.8	68.3
FEDERAL INCOME TAXES	386.7	309.1	327.2
TOTAL EXPENSES	3,439.2	3,335.8	3,350.2
NET REVENUES	921.6	822.2	849.5
RATE BASE	7,285.6	7,256.0	7,254.4
RATE OF RETURN	12.65%	11.33%	11.71%

Public Participation

On August 17, 1989, Ranchos held an informal public meeting in its service area to explain the basis of the rate request and to answer customer concerns. Approximately 250 customers and CACD attended this informational meeting. After this meeting, 11 letters of protest from Ranchos' customers were received by the Commission. Several customers requested that the evidentiary hearings be held in Victorville. This request was granted.

On November 6 and 7, 1989, public participation hearings were held in Victorville. Approximately 25 customers made statements opposing the magnitude of the proposed increase. Customers were not appeased by the CACD/DRA recommendation in its opening statement that a 50% increase in 1990 and a constant return on equity of 11.4% was justified. Customers believe these recommendations are also excessive. In the customers' opinion, the increased rates would be difficult to pay by those with a fixed, retirement income.

Customers raised additional questions which were answered by the parties: 1. Is Ranchos raising its rates to later sell the utility at a better price? 2. Can a discount rate be given to senior citizens? 3. Why can a utility receive a return greater than the 8% interest rate on savings accounts? and, 4. Does Ranchos realize how inequitable and frustrating it is to be enticed to retire in Apple Valley by prior owners who were land developers, only to be assessed rates one cannot afford after retirement?

One customer supported the applicant's proposed increase.

The majority of customers opposing the requested increase stated that the quality of service on the whole was good. However, several customers, who live in areas targeted for water main replacement, complained of excessive water leaks.

Evidentiary Hearings

Evidentiary hearings were held in Victorville on November 7, 8, and 9 and concluded in Los Angeles on November 13, 1989. Numerous customers attended the evidentiary hearings in Victorville. Parties presented testimony to specifically elaborate on the issues raised by customers. Ranchos' witnesses, Jordan and Clarke, provided the historical background of Ranchos which placed many of the customer's concerns in perspective.

Jordan, Vice President-Revenue Requirement, testified that Park Water Company (Park, parent) owns 100% of the outstanding capital stock of Ranchos, acquiring the company in 1987. Park also owns Santa Paula Water Works, Ltd. and Mountain Water Company. Prior to being acquired by Park, Ranchos was acquired in succession by Reserve Oil and Gas Company (1966), Getty Oil Company (1980) and Texaco Producing, Inc. (1984). During the time of ownership by the oil companies, the water company operations were not of primary importance, resulting in inadequate maintenance and improvement of the system. Thus, upon acquisition, substantial delayed maintenance and improvements were needed. In addition, the oil companies had subsidized the water company expenses, such as payroll, capital improvements, insurance and workmen's compensation. This subsidization resulted in a level of rates that does not reflect total water service expenses.[1] Since compliance with the Commission's Uniform System of Accounts has been achieved, Ranchos' monthly financial statements show that from 1987 to 1989 the total expenses of water operations have exceeded the revenues. Ranchos is undisputedly operating at a loss and projects a net revenue loss of $294,000 in 1990. The last adjustment to Ranchos'

1 D.82-09-068, Ranchos' 1982 general rate decision, orders Ranchos to comply with the Commission's Uniform System of Accounts. These accounting revisions were completed in 1984, as discussed in D.87-08-024, p. 52.

rates was made in 1985 pursuant to a step increase authorized in its 1982 general rate proceeding.[2]

Clarke, Vice President and General Manager, supported the testimony of Jordan and explained that the prior owners' main objective was to sell the water company. When a buyer did not materialize, the philosophy on capital improvements to the 30-year old system was to make only repairs which were necessary. Upon Park's acquisition, the newer plant was in good condition. However, the system condition varied from good to poor with many parts of the system needing major repairs.

Throughout the system, war surplus pipe had been installed in the late 1940's and 1950's. This pipe is now severely deteriorated because the walls are thin and it tends to corrode from moisture in the dirt. Few utilities use it today. In 1987, Ranchos implemented a main replacement program to replace this pipe.[3] Park has advanced over $3 million for Ranchos' system improvements. Currently, Ranchos has 9 miles of severely deteriorated mains and 55 miles of mains with small leaks. Clarke presented the number of leaks for each year from 1986 to 1989. (Exhibit 6.) This exhibit shows the number of leaks increasing from 1,044 to 1,513 during this period. Clarke explained as mains are repaired or replaced, smaller leaks are more prevalent. In

2 D.87-08-024, Ranchos' previous general rate case decision, denies a rate increase. The Commission adjusted the rate of return and return on equity, but concluded that based on these returns, that 1986 rates were too high and 1987 rates were too low, both in the same amounts. Therefore, increased rates were not justified.

3 The improvement plan was required as a condition of acquisition by D.89-03-013. The decision notes that improvements of $300,000 - $400,000 are needed. Ranchos is periodically required to submit progress reports on system improvements.

Clarke's opinion, the repair of leaks will enhance the conservation of water.[4]

Clarke described Ranchos' conservation program which was implemented in 1985 and is being revised in 1990. Pursuant to its Urban Water Management plan, Ranchos distributed water conservation kits to its customers. The kit contains disks to limit water flow in showerheads of faucets and a bag to limit the capacity of toilet tanks. Messages regarding ways to conserve are included in bills and a periodic newsletter. Ranchos participates in an area conservation seminar, the Xeriscape Conference, by distributing various brochures, performing demonstrations and printing samples of drought resident plants. As a result of conservation efforts, the average amount of water use has decreased substantially.

Clarke explained that the lot sizes in its service territory were 1/2 acre and that many customers attempt to maintain lawns and trees on their property. Under desert conditions and the increase in water rates for the years, this becomes an expensive policy. Clarke was familiar with several of the customers' properties who complained at the public participation hearing of excessive rates. These customers fit the category of having large acreage and many plants and trees. Ranchos is presently constructing a display of landscape comprised of attractive drought resistant plants.

Clarke and CACD witness, Loo, agreed that the present Commission rate design policy eliminates lifeline rates with no known exceptions.[5] In an effort to minimize the impact of a large increase in the service charge, CACD revised its recommendation that Ranchos collect 50% of its expenses in the

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4 CACD concluded that Ranchos' present 9% water loss was reasonable.

5 Lifeline rates were not eliminated in Ranchos' previous rate case proceeding because the revenue requirement was not changed (D.87-08-024).

service charge. CACD and Ranchos stipulated to the collection of 40%.

During the evidentiary hearings, Ranchos and DRA/CACD stipulated to numerous test year estimates and expenses. (Exh. 24-B, p. 2.) We have reviewed these estimates and expenses and find them reasonable. The parties do not dispute that attrition year rates should be authorized for 1992. The revenue adjustment is calculated by multiplying operational attrition (drop in 1991 rate of return from 1990 assuming no increase in rates) plus the financial attrition (change in authorized rate of return from 1990 to 1991) times the net-to-gross multiplier times the adopted 1991 rate base. The issues discussed below are: those in dispute; and rate design.

<u>Rate Base</u>

The difference in Ranchos' and CACD's rate base estimates result from differences between their respective estimates of materials and supplies inventory. This difference is carried forward into the working cash allowance causing these estimates to also vary according to the parties' projected inventories.

Ranchos requests $192,300 in 1990 and $216,900 in 1991 for material and supplies expenses. Ranchos' estimates are derived from the average ratio of materials and supplies to the plant-in-service for recorded years, 1984-1988, (approximately 1%) applied to the undisputed projection for plant-in-service for 1990 and 1991. Ranchos considers it more appropriate to estimate materials and supplies as a function of the plant which this inventory is kept on hand to repair. Ranchos asserts that there is no direct relationship between customers and plant, or between customers and materials and supplies inventory. Ranchos argues that its methodology in this proceeding was approved by the Commission in two previous cases, Santa Paula Water Works (D.88-12-082) and Apple Valley Ranchos (D.87-08-024).

CACD's estimates for materials and supplies are 36% and 39.8% lower than Ranchos' estimates for the test years 1990 and 1991. CACD recommends $156,300 and $177,100 for 1990 and 1991, respectively. CACD's estimates are derived from the average recorded 1986 to 1988 ratio of materials and supplies per customer, escalated to 1990 and 1991 using undisputed non-labor inflation factors and applied to the undisputed projection of customers in 1990 and 1991.

CACD distinguishes the two prior Commission decisions cited by Ranchos. CACD argues that the Commission rejected CACD estimates in these two cases, but did not reject the cost-per-customer methodology itself. In one case, the comparable utilities used by CACD included utilities with disproportionate distances between the supplier and the applicant. In the other case, CACD's data survey period of one year was found inadequate. In CACD's opinion, the cost-per-customer method recommended in this proceeding has not previously been rejected by this Commission. CACD argues that the materials and supplies estimate in this proceeding derived from this method is in compliance with the Commission's policy to choose the most accurate estimate under reliable methodology.

CACD points out its 1986-88 historical data base includes data for a period of 18 months after Park acquired Ranchos in 1987. In comparison, Ranchos' historical data base from 1984 to 1988 includes 3-1/2 years before Park owned Ranchos. CACD argues that its average of more recent inventory data is more representative of the utility's current practices for ordering and stocking materials and supplies. CACD asserts that its methodology excludes the effects of the older, less efficient inventory methods and questionable accounting practices of prior owners. In addition, CACD asserts that its estimates are not largely based upon new plant which requires little or no repair in the near future. CACD argues that its methodology incorporates existing inventory levels, increased cost of the inventory due to inflation and the expected growth in inventory as the customer base grows.

Discussion

CACD accurately summarizes our conclusions in D.88-12-082 and D.87-08-024. Our general goal is to choose the most accurate estimate of a future expense which is based upon reasonable, reliable methodology. The methodology itself may be a reliable means of deriving an estimate, while the input of data or subjective decisions made in using the method may be unreasonable. The cost-per-customer method is often used and accepted by this Commission in water general rate cases to estimate a variety of future expenses. (D.87-11-021 and D.87-08-024.) Generally, this method produces an expense estimate derived from a comparative analysis of similar costs of similar utilities. (Ibid.) In Ranchos' prior rate proceeding, CACD's subjective judgement in deriving an estimate under the cost-per-customer methodology was criticized and rejected. CACD's estimate was rejected because it did not consider the longer distance from Ranchos' supplier in comparison to other urban and suburban utilities. This was a flaw in the subjective selection of comparable utilities. We concluded that the Ranchos estimate was more reasonable because its method included this important factor. We did not comment on the issue of which methodology was best.

In this proceeding, CACD uses actual recorded data of only Ranchos to form the basis of an average ratio of cost-per-customer. Thus, in this proceeding, CACD provides estimates based upon Ranchos' actual inventory for the past two years which includes the element of Ranchos' actual two-hour distance from its supplier.

In this proceeding Ranchos is able to present recorded materials and supplies for 18 months which record and track Ranchos' operating expenses under its own management practices of stocking supplies. This period also reflects the actual economic impact of the ongoing main replacement program. We agree that selecting a period which minimizes past management practices provides a more accurate estimate of future operations under Ranchos.

The historical period selected by Ranchos includes the circumstances of having to maintain a large inventory to make large system repairs. (D.87-08-024, p. 67.) This is not the same status of Ranchos' system today, nor will it be the same in the test period. In the past, Ranchos' method of estimating materials and supplies at a 1% of plant may have been reasonable based upon the status of its repair program and the need to make large emergency repairs. However, this period is now over. We find that CACD's estimate is more reliable for 1990 and 1991 and will adopt it. This finding is in accordance with our goal to choose the most accurate estimate of future operations.

Desert Knolls' Special Rate

Desert Knolls is located at one of the highest elevations in Apple Valley above or near its reservoir. There is no dispute that service to any new homes built in this area in the future will require a new pressure tank, booster pumps, an air compressor, an internal combustion engine, relay controls, batteries and facilities to house this equipment. No estimated costs for these facilities were presented by either party. At present there are no customers in this area. However, Ranchos anticipates providing service to 6-10 customers at an undetermined date in the future.

CACD recommends that Ranchos establish special rates in the Desert Knolls area of Apple Valley to reflect the higher costs of providing service to this area. The additional expense to existing customers in the remaining service area for this development is estimated by CACD to be $10 per month. CACD argues that this additional cost dictates a special rate to customers in Desert Knolls. CACD relies upon the Commission's discussion of rate design in D.86-12-091 (Pacific, Gas and Electric ECAC) as precedents for its recommendation in this proceeding. CACD argues that this recommendation is in compliance with the existing Commission electric rate design practice of assessing rates for a sub-group within a customer class based upon the higher than average cost of service to the sub-group.

CACD recommends that Ranchos prepare and submit an economic study of these additional facilities prior to the filing of a special tariff containing rates for this area. CACD emphasizes that the total costs of the entire service territory should not be included in this study, contrary to Ranchos' assertion. The recommended economic study need only address the additional facilities required to serve Desert Knolls.

Ranchos opposes this recommendation. It argues that it is the general policy of the Commission to set rates for a customer class based on the average cost of service for the class, without geographical distinctions. Ranchos points out that no two customers in a service territory have exactly the same cost of service. In Ranchos' opinion, all customers are either subsidizing or being subsidized by other customers to a certain extent. Ranchos argues that other water companies with a greater variation in elevation in their service territories and have two or more pressure zones. These different pressure zones require greater or lesser amounts of pumping, yet do not have different rates.

Ranchos asserts that the additional $10 per month additional cost for service to Desert Knolls' equates to an additional cost of $0.0003 per ccf. to each existing customers. Ranchos argues that this amount is virtually lost in the rounding of numbers, while CACD's recommendation is to charge Desert Knolls customers 30% more than other customers for service.

Ranchos alleges that there are other factors which affect cost of service, such as, supply source proximity and customer density. Ranchos implies that these factors must be included in any cost study, which it asserts is a large and complex task. In considering these two factors, the cost to serve customers in the Desert Knolls area is less than CACD calculates. Ranchos considers CACD's proposal inequitable since no cost study of all customers is presented to ascertain whether other groups of customers pay less than the cost to serve them.

Ranchos argues that setting separate rates within its service territory would add to its administrative and billing costs and increase customer dissatisfaction across area boundary lines.

Discussion

While our general policies regarding rate design may be similar for gas, electric, telecommunications and water utilities, water utilities alone often have separate geographic districts where the rates vary. CACD's recommendation for a special rate in Desert Knolls equates to a request for a separate district with a rate higher than that in the remainder of the service territory.

In approving separate water districts with varying rates, certain factors underlie our approval. The segregated service district is geographically and operationally separate. It often has a different weather pattern, different rate base, different amounts of water use per customer and different water supply costs. (Suburban Water Company, D.87-01-059.) Under these circumstances and in the absence of opposition, we have agreed that separate districts are appropriate.

In this proceeding, it is true that Desert Knolls is not geographically separate. It is also true that none of the other segregating factors described in Suburban above exist for Desert Knolls. In fact, the parties agree that only a small portion of the rate base will be dedicated to Desert Knolls customers and the source of supply is the same. Thus, we cannot conclude that Desert Knolls meets existing criteria to justify a separate district.

Although the total cost of the additional facilities is not clear in the record, the additional cost to serve Desert Knolls appears negligible when spread to all customers. This evidence alone does not convince us that a separate rate is justified.

CACD argues, however, that the basis of its request is not geography, but the additional cost to serve Desert Knolls and the resulting inequity to existing customers. While it is true that sub-classes with varying rates occur in energy rate design, the rationale for doing so is not just the cost of service, but includes an analysis of time-of-day use, a concept absent from this proceeding. We do not believe the comparison of energy sub-group rates and separate water utility districts is valid. While there may be similarities, there are also crucial differences in the rationale for the rate design of these two types of utilities. Ranchos appropriately points out that we have ignored the sub-group rate distinction in water utility rate design where varying pressure zones have varying costs of service.

In addition, we believe the ramifications on the rate design of all water utilities by setting this new trend must be addressed. The requested separate rate district would set a precedent for future litigants to follow. Undoubtedly, there are other water utilities with inequities in the cost of service and authorized rates. Every water utility with varying pressure zones potentially has such alleged inequities. In fact, similar inequities may exist in Ranchos' service territory. We have no analysis that such precedents should be established for other regulated water utilities to follow and we are unable to limit such an exception to the facts and utility involved in this proceeding. This issue may be one which is generic to all such utilities. As such, it is not appropriately addressed on a case-by-case basis.

While we are aware that customers complain about the impact of new customers on existing rates, Ranchos appropriately observes that granting CACD's request may lead to equally troubling customer complaints about boundaries and corresponding rates. We do not believe it is reasonable to trade one set of complaints for another.

Weighing CACD's evidence to support this request and the advantages and disadvantages of granting the request, we cannot conclude that a separate rate district for Desert Knolls is warranted. CACD may pursue this issue, if it desires, in a future forum.

Since we find below that Ranchos has surpassed Main Extension Rule 15 limits for voluntary advances, we note that Ranchos must request our approval to extend service to Desert Knolls.

Interest on Deferred Revenues

Although CACD concludes that a 60% increase in Ranchos' present rates is justified, it recommends a 50% increase in 1990 with the remaining 10% deferred until 1991. CACD bases this recommendation on the Commission's 50% annual rate increase maximum established in 1982. In making this recommendation to defer part of the rate increase, CACD recommends that interest accrued on the deferred revenues be calculated from the effective date of an order authorizing increased rates. CACD asserts that this is its position, even if interim relief is denied and the effective date of a decision in this proceeding is later than January 1, 1990.

At the time concurrent briefs were submitted, Ranchos' request for interim relief was still pending. In the opinion herein, this request is denied. However, Ranchos argues that it is entitled to interest on a full year's increased revenues, even though the increased rates may only be collected for a portion of 1990.

Ranchos' rationale for collecting this interest is twofold. First, there is no dispute between the parties that a reasonable revenue requirement is the $4,149,500 recommended by CACD and this level of revenue is the minimum to be adopted in a final decision. Second, Ranchos argues that if a full year's sales estimate at the adopted rates will be assumed when calculating rates to generate the 1990 revenue requirement, it is inconsistent to prorate interest on deferred revenues from the time of the final decision in 1990. Ranchos asserts that even if it will not receive a full year of its reasonable 1990 revenues, this fact should not be an excuse for withholding a portion of its 1991 rates.

In CACD's opinion, it is retroactive ratemaking if Ranchos is allowed to collect interest which accrued prior to the effective date of an order authorizing a rate increase. If Ranchos bases its request upon interim relief being granted, CACD believes Ranchos misunderstands the nature of interim relief.

Discussion

The sole, final decision herein which sets general rates for 1990, 1991, and 1992 is effective the date of this order. Under these circumstances, we agree that the rule prohibiting retroactive ratemaking prevents our authorization for Ranchos to accrue interest on deferred revenues during a period which is prior to the effective date of the Commission decision authorizing these revenues.

Ranchos mischaracterizes our calculation of revenue requirement when rates are effective for a period less than 12 months. The revenue requirement is set on an annual basis. However, because Ranchos bills bi-monthly, this annual amount is divided by six to derive bi-monthly rates. The bi-monthly rate is the rate authorized to be collected. Because of the rule prohibiting retroactive ratemaking, interest can only be authorized on rates which are authorized but deferred. This is the prorated amount, not the annual amount. Accordingly, interest on deferred revenues will be accrued from the effective date of this decision.

Main Extension Reporting Requirements

Ranchos' main extension rule, Rule 15, Section A.2 specifies:

"a. Whenever the outstanding advance contract balances reach 40 percent of total capital

> (defined, for the purpose of this rule, as proprietary capital, or capital stock and surplus, plus debt and advances for construction) the utility shall so notify the Commission within thirty days.
>
> "b. Whenever the outstanding advance contract balances plus the advance on a proposed new extension would exceed 50 percent of total capital, as defined in Section A.2.a plus the advance on the proposed new extension, the utility shall not make the proposed new extension of distribution mains without authorization of the Commission. Such authorization may be granted by a letter from the Executive Director of the Commission.
>
> "c. Whenever the outstanding advance contract balances reach the above level, the utility shall so notify the Commission within thirty days."

Ranchos takes the position that the reporting requirements for advances on construction contained in Rule 15, Section A.2.a apply to Park and its subsidiaries as a whole and not to Ranchos as a separate entity.

Ranchos' advance ratios exceed the 40% and 50% limits of Rule 15. Park's advance ratios, on the other hand, do not exceed these limits.

CACD recommends that Ranchos be required to notify the Commission when its advance contracts exceed Rule 15 limits. CACD requests that Ranchos be required to specifically request a waiver of Rule 15 limits based on Park making all excess refund payments necessary on the utility's behalf.

One important basis of the water main extension rule when adopted was to protect the water utility and its customers from the adverse effects of uneconomic and speculative extensions. (Water Main Extension Rule, (1982) 7 CPUC 2d 778, 783). These limits of expansion provide our oversight and review of expansions which may cause undesirable cash flow and financing problems. To expand these limits removes our scrutiny of individual utility financial status at a time when it may be crucial. We do not believe this is desirable even in the case of a utility being financed by a parent company. Regardless of the existence of a parent, each utility must pay its expenses from its own revenues generated by providing service, an argument which Ranchos strenuously advances in this proceeding. We believe the limits of Rule 15 are best applied to the individual utility in order to assess the utility financial status to protect the interests of its customers. To do otherwise muddles the analysis from the perspective of the ratepayers of each utility. We will require that Ranchos comply with Rule 15 notification requirements for advance contract limits and request a waiver should it desire to exceed those limits. If such a request is made in the future, CACD may recommend that any waiver be conditioned upon Park making all excess refund payments necessary on the utility's behalf. We decline CACD's request to order this condition in this proceeding where no evidence or analysis of the amount of excess advance payments has been made.

Rate of Return

Ranchos requests a rate of return of 12.65% for 1990 and 12.72% for 1991. Ranchos did not include a cost of capital request for 1992. Ranchos bases its request on the projected capital structure of its parent, Park, which is projected to be 18.46% debt and 81.54% common equity in 1990 and 16.40% debt and 83.60% common equity in 1991.

Ranchos derives its requested rates of return from the methodology commonly used by DRA to derive rate of return. The capital structure is divided into the components of long-term debt and common equity. Each component is assigned a percentage value of the total capital structure. The effective cost of each component is determined. The total of the weighted cost of each component equals the return on rate base requested. Ranchos does not include debt allocated to Mountain Water Company, a sister subsidiary located in Montana. Ranchos requests that its proposed capital structure be approved for use in future California rate case proceedings of other Park subsidiaries.

Park is aware that its proposed common equity is a greater percentage of equity than the Commission has traditionally considered to be the optimum, cost effective percentage of common equity. Ranchos argues that since it has traditionally been recognized as a 100% equity company, the use of the common capital structure is a step toward the cost effective objective. Ranchos asserts that it is entitled to a percentage of common equity greater than the optimum 50% because of its unique needs. While this optimum level of equity may apply to large utilities, it is not the appropriate level for Park or Ranchos. Ranchos contends that it and Park are more comparable to a Class B water company since Park and its subsidiaries have approximately 45,000 connections in California and 16,000 in Montana.

Ranchos argues that because of Park's small size, it must retain a large equity to debt ratio in order to obtain favorable financing rates. It asserts that its parent may need to raise additional capital to meet unforeseeable future circumstances.

Ranchos contends that it has increased business risks because water quality standards and testing requirements are becoming more stringent and complex. Ranchos considers it impossible to accurately estimate the economic impact of such requirements. In Ranchos' opinion, such stringent requirements may mandate new sources of supply and unanticipated water treatment. Ranchos believes the chance of these circumstances occurring has increased.

Ranchos contends that a policy of not paying dividends and financing its capital requirements with retained earnings maintains Park's borrowing capacity to react to emergency requirements. Ranchos does not believe that the cost or availability of debt placements in the future will necessarily be favorable. Park does not want to suddenly need large amounts of capital and be faced with a lending market so difficult that capital improvement projects will be delayed. Therefore, Park believes its proposed high equity is necessary to insure the continuation of high quality of service to its customers.

DRA, on the other hand, does not consider Ranchos' size to be a controlling factor in a capital structure recommendation. In DRA's opinion, the projected Park common equity of 81.54% in 1990 and 83.60% in 1991 results in the ratepayers being economically disadvantaged. According to DRA, ratepayers derive little benefit from these high equity ratios and should not pay for unwarranted levels of equity. DRA concluded these levels of equity were too high and recommends the imputed capital structures based upon an analysis of Park's business and financial risk and the examination of the capital structures of nine California Class A water utilities and 14 California and regional water utilities. Based upon these analyses, DRA recommends imputing common equity of 75% in 1990, 70% in 1991 and 65% in 1992. Based upon its recommended capital structure, DRA recommends a rate of return on ratebase of 11.33% for test year 1990, 11.37% for test year 1991 and 11.38% for attrition year 1992.

DRA does not agree that Park's business risks justify its requested high equity ratio because, in DRA's opinion, Park's revenues are dependable, it has a stable customer base and less competition. In DRA's opinion, Park can assume more debt because of its assured revenues. DRA does not believe Park's business risk is as great as energy or telecommunications utilities because it does not face the threats of customer bypass. DRA contends that unlike energy and telecommunications utilities, water utilities earn a return on construction-work-in-progress and do not face regulatory deregulation or competition.

DRA considers Park's financial risk low because its contractually fixed obligations are low. DRA recognizes that as debt financing increases, a company's financial risk increases and its debt financing becomes more expensive. DRA does not deny that the continuity of service is threatened under financial instability. However, it does not agree that Park falls in this category. DRA considers Ranchos' requested capital structure to result in excessive rates and the loss of tax benefits attributable to debt.

DRA contends that financial stability is measured by ratepayers and investors by a review of company bond ratings assigned by bond rating agencies. Under this criteria, Park's interest coverage and cash flow indicate that its financial ratings are excellent. In fact, DRA asserts that this excellent financial rating can be maintained with lower common equity ratios.

In setting lower equity ratios, DRA is guided by the 1988 average range of common equity for nine comparable Class A California water utilities, 56.57%, and the average range for 14 comparable California and regional water utilities, 44%.

Using Park's last authorized equity ratio of 79.65% for 1989 as the starting point, DRA reduced this ratio by five percentage points for each year of the three years in the test period. Even with these reductions, Park remains above the common equity ratios of the two comparable groups. DRA argues that its recommendations are consistent with Commission policy on capital structure for water utilities, citing D.89-09-048, the San Gabriel Water Company rate case. DRA contends that imputing equity is not a concept new to the Commission, citing Roseville Telephone Company, D.82-09-030.

Ranchos considers CACD's comparison with other Class A water utilities to be in error. Ranchos argues that the rationale underlying its request is consistent with recent Commission rate of return policy for energy utilities established in the annual return on equity proceeding. (D.89-11-068.) Ranchos asserts that this decision supports its argument that rate of return must be set according to the unique circumstances of each utility. Since it is a small Class A water utility, Ranchos considers itself comparable with other Class B, C, or D water utilities which are also closely held and have 100% equity.

Ranchos argues that in the San Gabriel decision cited by DRA the Commission required only a 1% reduction in the common equity ratio in the first test year because any greater change would be abrupt.

Ranchos contends that DRA's analysis of business risk inappropriately presumes that since Park's revenues have grown over the past five years, all revenue growth is attributable to California utilities, while DRA admits that the revenues reviewed included the revenues of Park's Montana subsidiary. Ranchos asserts that DRA's review of Park's gross revenues, not net revenues, is unreliable and that the small ratio of net revenues to operating expenses has not been considered. Ranchos considers the risk of water quality regulation, potential condemnation, taxability of contributions under 1986 tax law revisions and continuing product liability to be equal to risks faced by energy utilities.

Ranchos contends that DRA's analysis of financial risk does not include offsetting factors for doubts regarding future adequacy of supply and quality of water supply.

Ranchos contends that DRA's bond rating analysis is in error by not considering that its 1987 debt issuance was obtained at 10.96%, an interest rate 250 basis points above the then 20-year treasury rate.

DRA disagrees that Ranchos must pay higher interest on debt if it is more highly leveraged. First, the higher debt/equity ratio would affect only new debt offerings since the interest rate on existing debt is fixed by contract. Second, the cost of debt has decreased since Park's last debt issue in 1987. DRA contends that interest rates increased July-October, 1987, but have steadily declined since that period.

DRA disagrees with Ranchos' allegation that Park would not have adequate equity to borrow to meet unexpected capital expenditures under DRA's imputed capital structure. A lender looks at actual, not imputed debt, in determining borrowing capability of a company. In addition, DRA's imputed capital structure does not violate the terms of Park's indenture agreement with Security Pacific Bank. This agreement contains a restriction that Park cannot issue more than 50% debt. DRA asserts that Ranchos' alleged unexpected capital expenditures which create a need for a debt issuance are speculative and unaudited.

DRA asserts that Ranchos has failed to show that water utilities are riskier than electric or telecommunications utilities. According to DRA, Ranchos' witnesses conceed that bypass is not a significant contribution to business risk, the taxes paid by Ranchos for contributions are recoverable through rates and Ranchos faces no contamination problems at present. In DRA's opinion, any increased risk faced by water companies is offset by accounting mechanisms which minimize these risks, such as, balancing accounts, construction work in progress and the collection of up to 50% of fixed costs in the service charge. DRA points out that the same Ranchos arguments were rejected in its last general rate case proceeding.

Although the parties agree upon the cost of existing debt, if the Commission adopts DRA's recommended imputed capital structure, the cost of imputed debt for the test year is disputed. Ranchos alleges that based upon DRA's testimony, the cost of debt in the future will be higher than existing debt and that under Ranchos' calculations, the current cost of debt is above 11.9%.

DRA believes the ratepayer should not be assessed an additional cost factor for nonexistent debt. Even if Park were to obtain additional debt, DRA believes the cost of new debt would be the same or lower based upon the current downward trend of interest rates.

Discussion

We have previously held in the San Gabriel decision that ratepayers will not bear the increased financial burden of excessive levels of common equity and forego the advantages which debt provides. In arriving at this conclusion, we rely on the presumptions that water utilities are not as risky as energy and telecommunications utilities, water utility financial status can be evaluated by equivalent bond rating analysis, individual utility interest coverage, and cash flow factors. We are not persuaded by the evidence and argument in this proceeding that this policy, its basis of quantitative analysis or its presumptions should be changed.

In setting imputed lower levels of common equity, we rely on the analysis of the common equity levels of comparable water utilities. We are not persuaded that this analysis in this proceeding is flawed because Ranchos is allegedly smaller than the average Class A water utility. Park has experienced no injurious financing arrangements or any inability to obtain financing due to its size. Ranchos' evidence and argument of a need for extensive financing are speculative at this time. There are no facts to indicate that the events alleged will occur or that they will create financing needs in the magnitude projected by Ranchos.

However, while adhering to previously approved principles of analysis of business and financial risk, certain undisputed facts in this proceeding have not been weighed in this analysis. In order to set a reasonable level of common equity for Ranchos, we believe these facts warrant consideration. Park purchased Ranchos in 1987. At that time the estimated system improvements needed were $300,000 to $400,000. However, Ranchos' witnesses have testified in this proceeding without dispute that Park has advanced over $3 million since 1987 for Ranchos' capital improvements. We believe this occurrence increases the business risk of Ranchos. Therefore, in setting a reduced common equity ratio to correspond to Ranchos' business risk, we believe imputing a level somewhat higher that DRA recommends is reasonable.

We also believe the degree of reduction in the common equity ratio recommended by DRA is too severe. We will order that common equity be imputed at 76% in 1990, 72% in 1991 and 69% in 1992. This capital structure is based upon the circumstances of Ranchos and, therefore, may not be appropriate for sister subsidiaries or for future Ranchos test periods not considered in this proceeding.

We agree that since the trend in interest rates for 1990-1992 is substantially the same as that in 1987, future debt coupon rates and costs should be substantially the same. Moreover, it is unreasonable to assess costs for debt which does not exist. Ranchos voices no intent to incur debt in the future. Therefore, the existing cost of debt should be used for imputed debt.

<u>Return on Equity</u>

Ranchos requests 13% return on equity based upon its alleged similar business risk of electric, gas and telecommunications utilities. Because Park and its subsidiaries are smaller companies than energy companies, Ranchos alleges that the potential relative magnitude of the impact of unexpected occurrences can be greater. Therefore, Ranchos argues that it should not be penalized by authorizing a reduced return on equity. Ranchos considers the resulting slight increase in revenue requirement from a commensurate return on equity to be a legitimate cost of business for a company of its size and circumstances.

DRA recommends a return on equity of 11.4% based upon quantitative analysis using the discounted cash flow and risk premium analyses and its judgement.

The DCF analysis indicates the expected investor return based upon the current and estimated dividend yield added to the estimated historical and sustainable growth rate of a similar investment. This analysis predicts an expected investor return in the test period of 11.90% based upon a three-month average expected yield of 6.70% and average growth rate of 5.20%. It predicts a return of 11.96% based upon a six-month average expected yield of 6.76% and average growth rate of 5.20%. Thus, the DCF analysis estimates an investor return in the range of 11.90% - 11.96% and an average of 11.93% for the test period.

The risk premium analysis predicts the differential between the returns of common stocks and bonds. When this differential is added to the cost of a debt instrument, the result is the estimated return on equity. DRA developed the historical premiums on "AA" utility bond yields, 3-5 year, 10-year and 30-year government issues. DRA added a premium to the August, 1989 long-range forecasted yields for these investments to obtain an expected range or investor return of 11.14% to 11.72%. The overall average of the expected returns produced by the risk premium method is 11.48%.

While recognizing that empirical data analysis is not precise, in DRA's judgement, it concludes that a range of return on equity of 11.50% to 12% is an appropriate guideline. However, DRA reduces its recommended return on equity to 11.4% because of several factors. DRA concludes that Park has done well financially, retaining all of its available earnings, which led to the build-up of equity and concurrently a reduction of financial risk. In DRA's opinion, Park's business does not appear to be erratic or undependable, indicating a minimal business risk. DRA recognizes that the authorized rates of return for class A water utilities has declined from roughly 14.50% in 1984 to 12% in 1989. In DRA's opinion, Park's extremely high equity ratio warrants a lower return on equity than the range derived from quantitative analysis. DRA contends that interest rates and the yield on AA rated utility bonds and 30-year treasury bonds have declined since

1987 when Park was authorized an 11.46% return on rate base and 12% return on equity. Therefore, DRA believes a current return on equity lower than the above range, or 11.4%, is reasonable.

Ranchos argues that DRA's analysis is erroneous and flawed. Ranchos reiterates that water utilities are as risky as energy utilities. Ranchos advances the same arguments of increased business risk in setting the return on equity that it asserted for establishing the capital structure.

Ranchos presented the beta risks produced by the capital asset pricing model to verify that a 13% return on equity recommendation is reasonable.[6] DRA criticizes the data sample of six stocks as being too small to yield credible results. Ranchos responds that even though DRA disputes its data size, it does not dispute that this model produces credible results.

Ranchos alleges its specific circumstances are not considered, the most crucial being its small size. Ranchos asserts that DRA ignored the recent condemnations of other parts of Park's system which impacts the stability of its revenues and the actual cost of debt in its 1987 debt offering. Ranchos considers DRA's judgment in recommending a return to be unreasonable, relying exclusively on financial models.

Ranchos alleges that DRA recommends a return on equity of 11.4% while having information that its last debt issuance was at a coupon rate of 10.96% and an effective cost of 11.37%. Ranchos contends that its present cost of debt is above 11.9%. Ranchos disputes DRA's reasoning that its return on equity should be lower than the one authorized for its Central Basin division in 1987. Ranchos updates the interest rate forecast presented in 1987 to

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6 A beta of 1.0 indicates a stock with an average business risk. Utilities are estimated to be less than 1.0 because they are perceived to be less risky than average risk common stocks.

show that the cost of debt has increased in the range of .57% - 1.33%. Therefore, Ranchos asserts that the return on equity of 12% authorized in 1987 must be increased to a range of 12.57% - 13.33%.

Ranchos alleges the DCF analysis is erroneous because it: 1) bases dividends upon 1988 data; 2) includes Philadelphia Suburban which is not primarily a water utility and which has insufficient growth data in the ten years surveyed; and 3) omits part of the measure of sustainable growth called "VS growth".

DRA responds that: 1) Ranchos' method of using current dividends which are annualized by multiplying the quarterly dividend by four results in an excessive dividend expectation; 2) Philadelphia Suburban derives 70% of its revenues from water service which meets DRA's criteria of comparability; and, 3) a VS growth factor has never been adopted by this Commission and is inappropriate since there is no book value for Park's stock which is not publicly traded.

Ranchos alleges the risk premium analysis does not reflect the increased risk and volatility in today's market. DRA responds that the capital asset pricing model which generates these estimates is not the dominant method for determining return on equity accepted by this Commission.

Ranchos points out that DRA's historical analysis including expected returns on equity of 11.28% and 11.25% in 1987 and 1988 is lower than actual returns authorized for water utilities by this Commission for the same years. The authorized returns were in the range of 12.5% to 13%.

Ranchos disagrees with DRA's representation that recent authorized returns on equity are roughly 12.25%. Ranchos points out that in recent energy decisions, the Commission has disagreed with DRA's recommendations, finding returns on equity from 1.0% to 1.4% above those recommended, resulting in authorizations of 12.95% - 13.28% and 13.28% to 13.66% (D.89-10-031, p. 278, Pacific

Telephone and GTEC) and 12.85% to 13.05% (D.89-11-068, Southern California Gas).

Discussion

Ranchos' arguments for comparison with electric, gas and telecommunications utilities are not new. We decline to overturn previous decisions which find this comparison invalid.

We accept DRA's DCF analysis as a reasonable guide for setting the return on equity. We believe Ranchos dividend calculation results in an excessive expected return on equity because it does not include sufficient recorded dividend payments. We concur that Philadelphia Suburban is an appropriate comparable utility. DRA accurately points out that the capital asset pricing model is not the predominant methodology used by this Commission in setting return on equity. We find DRA's risk premium analysis reasonable.

We agree that a reasonable range of return on equity is 11.5% - 12%. However, we consider Ranchos' continuing system improvements due to past neglect to constitute an increase in its business risk. While the inverse relationship between common equity and the return on equity points to a rate of return toward the lower end or below this range, the unique circumstances of Ranchos must also be considered. Ranchos is still undergoing system improvements inherited from its prior owners. These improvements will continue during test periods. We consider these future circumstances to be above the normal business risk incurred by the average utility. Accordingly, we will authorize a return on equity of 11.9% for a period of three years.

The following table contains the authorized capital structure and rates of return.

Table 2

Authorized Capital Structure and Rates of Return

	Capital Ratio (a)		Cost Factor (b)		Weighted Cost (c)
Test Year 1990:					
Long-Term Debt	24.00%	X	11.12%	=	2.67%
Common Equity	76.00%	X	11.90%	=	9.04%
Total	100.00%				11.71%
Test Year 1991:					
Long-Term Debt	28.00%	X	11.30%	=	3.16%
Common Equity	72.00%	X	11.90%	=	8.57%
Total	100.00%				11.73%
Attrition Year 1992:					
Long-Term Debt	31.00%	X	11.35%	=	3.52%
Common Equity	69.00%	X	11.90%	=	8.21%
Total	100.00%				11.73%

Rate Design

Both parties in this proceeding concur that lifeline rates should be eliminated because existing Commission policy is to do so. However, we will decline to remove lifeline rates at this time. Just as we seek to minimize the financial impact of system improvements on the company and its parent, it is equally appropriate to minimize the impact of significantly increased rates on customers residing in a district which is experiencing service improvement. We must give customers under such a strain an incentive and opportunity to conserve and reduce consumption without the increased penalty of high rates. To remove the incentive of reduced rates at this time would be a disservice to Ranchos customers.

Ranchos presently has three metered service schedules filed in its tariffs. Two are for the former Apple Valley

Resources, Inc. territory which it acquired in early 1989. The staff agrees with the Ranchos' proposal to combine basic rates for service in all territories into one rate schedule, with the exception of Desert Knolls, discussed above. Therefore, concurrent with the adoption of new rates for service, the tariff schedules for the territory formerly served by Apple Valley Resources, Inc. should be cancelled and withdrawn and new service maps prepared.

The parties agree that Ranchos' tariff schedules on file with the Commission require revising to reflect current format and language requirenents. We will require updating of the Preliminary Statement, the user fund schedule, and the rules and regulations in Ranchos' tariff schedules.

Findings of Fact

1. We have reviewed the estimates for the test years and attrition year stipulated by the parties and find that they comply with Commission ratemaking policy and are reasonable.

2. Ranchos provides satisfactory water service and the water furnished meets current state drinking water standards.

3. Ranchos requests $192,300 for 1990 and $216,900 for 1991 material and supplies expenses. Ranchos estimates are derived from the average ratio of materials and supplies to the plant-in-service for recorded years, 1984-1988 (approximately 1%), applied to the undisputed projection for plant-in-service for 1990 and 1991.

4. CACD estimates $156,300 and $177,100 for 1990 and 1991, respectively, for material and supplies expense. CACD's estimates are derived from the average recorded 1986 to 1988 ratio of materials and supplies per customer, escalated to 1990 and 1991 using undisputed non-labor inflation factors and applied to the undisputed projection of customers in 1990 and 1991.

5. The period of data analyzed by CACD in estimating materials and supplies expenses, 1986-88, includes data for 18 months after Park acquired Ranchos in 1987. In comparison,

Ranchos' period of 1984-1988 includes 3-1/2 years before Park owned Ranchos.

6. CACD's average of more recent inventory data is more representative of the utility's current practices for ordering and stocking materials and supplies. CACD's methodology excludes the effects of the older, less efficient inventory methods and questionable accounting practices of prior owners. CACD's estimates are not largely based upon new plant which requires less repair in the test period. CACD's methodology incorporates existing inventory levels, increased cost of the inventory due to inflation and the expected growth in inventory as the customer base grows.

7. The historical data selected by Ranchos upon which to base its estimate for materials and supplies expense includes circumstances of having to maintain a large inventory to make large system repairs, a period which is now over.

8. At the present, there are no existing customers in Desert Knolls. Ranchos estimates this area will serve 6-10 customers in the future.

9. There is no geographical difference, nor difference in weather pattern, total rate base, amount of water use per customer or water supply cost which warrants a separate rate for future Desert Knolls service.

10. The parties agree that a portion of rate base, namely, a pressure tank, booster pumps, an air compressor, internal combustion engine, relay controls, batteries and facilities to house this equipment are needed to serve this area.

11. The estimated additional expense to serve future customers in Desert Knolls is $10 per month to Desert Knolls' customers, or $0.0003 per ccf. for each existing customer.

12. Current water utility rate design does not distinguish in rates charged customers in different pressure zones.

13. To authorize the collection of interest on deferred revenues for the period January 1, 1990 to the effective date of this decision would be to authorize the collection of rates before they are approved by the Commission.

14. Applying the main extension rule advance contract reporting requirements to Ranchos protects its customers from any adverse effects of uneconomic and speculative extensions; whereas, applying these limits to its parent, Park, lessens this protection.

15. In order to provide protection from cash flow and financing problems, it is reasonable to require that Ranchos notify the Commission when main extension advance contract limits are reached, should Ranchos desire to exceed these limits, it must request a waiver. A waiver of these requirements and any conditional approval of a waiver must be evaluated on a case-by-case basis.

16. The ratepayer bears an unreasonable financial burden for excessive levels of common equity.

17. Estimated common equity levels of 81.54% in 1990 and 83.60% in 1991 are excessive.

18. Water utilities and energy utilities bear different financial and business risks.

19. The small size of a water utility does not justify excessive levels of common equity.

20. Significant financing requirements and the need for new sources of supply due to more stringent water quality standards and testing requirements are speculative at this time.

21. Although Ranchos' revenues are dependable, they are insufficient to cover operating expenses.

22. System improvements in an amount which is 10 times greater than estimated is an increased business risk.

23. Ranchos faces no contamination problems or potential condemnation at this time.

24. Taxes paid by Ranchos for contributions is recoverable through rates.

25. Balancing accounts, construction-work-in-progress and the collection of up to 50% of fixed costs in the service charge minimize Ranchos' business risk.

26. The 1988 average range of common equity for nine comparable Class A water utilities is 56.57% and for 14 comparable California and regional water utilities is 44%.

27. Ranchos is comparable with other Class A water utilities selected by DRA except for the increased business risk associated with system improvements.

28. Reducing common equity to the amount of 75% in 1990, 70% in 1991 and 65% in 1992 is unreasonable.

29. For ratemaking purposes, imputing common equity in the amounts of 76% in 1990, 72% in 1991 and 69% in 1992 is reasonable.

30. The trend of interest rates for 1990-1992 is the same as that which existed in 1987, indicating a cost of debt for the future which is substantially similar to existing debt.

31. It is not reasonable to assess a cost factor for imputed debt which is greater than existing debt because there is no present intent to incur future debt.

32. The capital structure imputed for Ranchos may not be appropriate for other Park subsidiaries or for Ranchos in future rate case proceedings.

33. DRA's DCF analysis is reasonable. The DCF analysis indicates an expected investor return for the test period in the range of 11.90% to 11.96% for the test period, with an average of 11.93%.

34. DRA's risk premium analysis is reasonable. The risk premium analysis projects an expected investor return for the test period in the range of 11.14% to 11.72%, with an average of 11.48%.

35. An overall reasonable range of return on equity is 11.5% to 12%. Due to the level of common equity imputed, DRA recommends

CORRECTION

THIS DOCUMENT HAS

BEEN REPHOTOGRAPHED

TO ASSURE

LEGIBILITY

24. Taxes paid by Ranchos for contributions is recoverable through rates.

25. Balancing accounts, construction-work-in-progress and the collection of up to 50% of fixed costs in the service charge minimize Ranchos' business risk.

26. The 1988 average range of common equity for nine comparable Class A water utilities is 56.57% and for 14 comparable California and regional water utilities is 44%.

27. Ranchos is comparable with other Class A water utilities selected by DRA except for the increased business risk associated with system improvements.

28. Reducing common equity to the amount of 75% in 1990, 70% in 1991 and 65% in 1992 is unreasonable.

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33. DRA's DCF analysis is reasonable. The DCF analysis indicates an expected investor return for the test period in the range of 11.90% to 11.96% for the test period, with an average of 11.93%.

34. DRA's risk premium analysis is reasonable. The risk premium analysis projects an expected investor return for the test period in the range of 11.14% to 11.72%, with an average of 11.48%.

35. An overall reasonable range of return on equity is 11.5% to 12%. Due to the level of common equity imputed, DRA recommends

a return on equity of 11.4%. However, because Ranchos will continue in the test years to incur costs for past neglected system improvements, a reasonable return on equity is 11.9% to reflect this continuing business risk.

36. Park is financially stable according to Standard & Poors financial indicators. Park could retain its financial stability if the level of financial indicators is lowered.

37. The capital asset pricing model is not the predominant methodology approved by this Commission for setting return on equity.

38. In applying the DCF analysis, the use of current dividends derived from multiplying quarterly dividends by four achieves excessive annual dividends resulting on an excessive investor expectation.

39. Philadelphia Suburban which derives 70% of its revenues from water operations meets DRA's criteria of comparability.

40. Ranchos requested return on common equity of 13% is excessive.

41. Eliminating lifeline rates is not in the best interests of customers faced with significant rate increases and will interfere with conservation efforts.

Conclusions of Law

1. The ratemaking principle prohibiting retroactive ratemaking prevents our authorization for Ranchos to accrue interest on deferred revenues during a period which is prior to the effective date of the Commission decision herein authorizing the collection of these revenues.

2. The rates herein authorized are reasonable.

3. An annual rate increase should not exceed 50%.

4. Because of the need to establish the authorized rates immediately, this order should be effective today.

5. The application should be granted to the extent provided by the following order.

6. Lifeline rates should not be eliminated.

O R D E R

IT IS ORDERED that Apple Valley Ranchos Water Company (Ranchos) shall:

1. File the revised rate schedules in Appendix A in compliance with General Order Series 96 after the effective date of this order. The revised schedules shall apply only to service rendered on and after that effective date, which shall be 5 days after filing. Concurrent with the adoption of revised rate schedules, the tariff schedules for the territory formerly served by Apple Valley Resources, Inc. should be cancelled and withdrawn.

2. Within 30 days after the effective date of this order, Ranchos shall update its tariff to conform to the currently required format and language and revise its service and maps to correspond with the revised rate schedules.

3. Common equity of 76% shall be imputed in Ranchos' 1990 capital structure effective today. Common equity of 72% and 69% shall be imputed on January 1, 1991 and January 1, 1992, respectively.

4. On or after January 1, 1991, Ranchos is authorized to file an advice letter, with appropriate supporting workpapers, requesting the step rate increases for 1991 included in Appendixes or to file lesser increases, in the event that the rate of return on rate base, adjusted to reflect the rates then in effect and normal ratemaking adjustments for the 12 months ending December 30, 1990, exceeds the later of (a) the rate of return found reasonable by the Commission for applicant for the corresponding period in the then most recent rate decision, or (b) 11.73%. This filing shall comply with GO 96. The requested rates shall be reviewed by the staff to determine their conformity with this order and shall go into effect upon the staff's determination of conformity. Staff

shall inform the Commission if it finds that the proposed rates are not in accord with this decision, and the Commission may then modify the increase. The effective date of the revised schedules shall be no earlier than January 1, 1991, or 40 days after filing, whichever is later. The revised schedules shall apply only to service rendered on and after their effective date.

5. On or after January 1, 1992, Ranchos is authorized to file an advice letter, with appropriate supporting workpapers, requesting the step rate increases for 1992 include in Appendixes, or to file lesser increases for any district, in the event that the rate of return on rate base for that district, adjusted to reflect the rates then in effect and normal ratemaking adjustments for the 12 months ending December 30, 1991, exceeds the later of (a) the rate of return found reasonable by the Commission for applicant for the corresponding period in the then most recent rate decision, or (b) 11.73%. This filing shall comply with GO 96. The requested rates shall be reviewed by the staff to determine their conformity with this order and shall go into effect upon the staff's determination of conformity. Staff shall inform the Commission if it finds that the proposed rates are not in accord with this decision, and the Commission may then modify the increase. The effective date of the revised schedules shall be no earlier than January 1, 1992, or 40 days after filing, whichever is later. The revised schedules shall apply only to service rendered on and after their effective date.

6. Ranchos shall comply with the advance limit notification requirements contained in its Main Extension Rule 15.

This order is effective today.

Dated FEB 23 1990, at San Francisco, California.

G. MITCHELL WILK
President
FREDERICK R. DUDA
STANLEY W. HULETT
JOHN B. OHANIAN
PATRICIA M. ECKERT
Commissioners

I CERTIFY THAT THIS DECISION WAS APPROVED BY THE ABOVE COMMISSIONERS TODAY

Neal J. Shulman

NEAL J. SHULMAN, Executive Director

AO

Schedule No. 1 (T)

GENERAL METERED SERVICE

APPLICABILITY

Applicable to all metered water service.

TERRITORY

Town of Apple Valley and vicinity, San Bernardino (T)
County. (T)

RATES

Quantity Rate:

	Per Meter Bimonthly (Every two Months)	
First 600 cu. ft., per 100 cu. ft. ...	$ 0.44	(I)
Over 600 cu. ft., per 100 cu.ft.	$ 0.55	(I)

The above rates shall be reduced by $0.02 per 100 cu.ft. for a period of 12 months from the effective date of this schedule to amortize overcollection in the balancing account. (N)

The above rates are authorized to be increased by $0.06 for a period of 12 months beginning January 1, 1991, to recover revenue which was deferred in 1990 for the purpose of limiting the 1990 revenue increase to 50%. (N)

Service Charge:

For 5/8 x 3/4-inch meter.......	$ 16.57	(I)
For 3/4-inch meter.......	18.23	
For 1-inch meter.......	24.86	
For 1-1/2-inch meter.......	33.14	
For 2-inch meter.......	44.74	
For 3-inch meter.......	82.85	
For 4-inch meter.......	112.68	
For 6-inch meter.......	187.24	(I)
For 8-inch meter.......	278.38	(N)

The Service Charge is a readiness-to-serve charge which is applicable to all metered service and to which is to be added the bimonthly charge computed at the Quantity Rates.

Schedule No. 2

NON-METERED FIRE SERVICE

APPLICABILITY

Applicable to water service for privately-owned fire-hydrant and fire-sprinkler systems where water is to be used only for the purpose of fire suppression or for periodic system testing.

TERRITORY

Town of Apple Valley and vicinity, San Bernardino County.

RATES

Size of Service	Per Service Per Month
2-inch	$ 8.00
3-inch	12.00
4-inch	16.00
6-inch	24.00
8-inch	32.00

SPECIAL CONDITIONS

1. The fire service connection shall be installed by the utility with the cost thereof paid by the applicant. Such payment shall not be subject to refund.

2. The minimum diameter for fire service shall be two (2) inches, and the maximum diameter shall be not more than the diameter of the main to which the service is connected.

3. If a distribution main of adequate size to serve a private fire system in addition to all other normal service does not exist in the street or alley adjacent to the premises to be served, then a service main from the nearest main of adequate capacity shall be installed by the utility and the cost thereof paid by the applicant. Such payment shall not be subject to refund.

4. Service hereunder is for private fire systems which are regularly inspected by the local fire protection agency having jurisdiction and to which no connections for other than fire suppression purposes shall be made. Service shall be installed according to specifications of the utility and shall be maintained to the satisfaction of the utility. The utility will install a detector meter listed by the Underwriters Laboratories, Inc. or other device to indicate unauthorized use, leakage, or waste of water. The cost of such installation but not the cost of the meter or other device shall be paid by the applicant. Such payment shall not be subject to refund.

5. The utility undertakes to supply water only at such pressures as may be available at any time through the normal operation of its system.

6. Any unauthorized use of water shall be charged at the regular established rate as set forth under Schedule No. 1. Repeated unauthorized use shall warrant the immediate disconnection of the service without liability to the company.

* * *

The following tariff schedules shall be withdrawn and cancelled:

Schedule No. R-1
Schedule No. E-1
Schedule No. W-1
Schedule No. TRA-1.

The Service Area Map shall be revised to reflect withdrawal and consolidation of schedules authorized herein.

* * *

(End of Appendix A)

APPENDIX B

Each of the following increases in rates may be placed into effect on the date indicated by filing a rate schedule which adds the appropriate increase to the rate which would otherwise be in effect on that date:

Schedule No. 1

General Metered Service

	Per Meter Bimonthly (Every two Months) Jan. 1, 1991	Per Meter Bimonthly (Every two Months) Jan. 1, 1992
Quantity Rate:		
First 600 cu. ft., per 100 cu. ft.	$ 0.06	$ 0.00
Over 600 cu. ft., per 100 cu. ft.	0.07	0.00
Service Charge:		
For 5/8 x 3/4-inch meter	$ 2.39	$ 0.99
For 3/4-inch meter	2.63	1.09
For 1-inch meter	3.58	1.49
For 1-1/2-inch meter	4.78	1.98
For 2-inch meter	6.45	2.67
For 3-inch meter	11.95	4.95
For 4-inch meter	16.25	6.73
For 6-inch meter	27.01	11.19
For 8-inch meter	40.15	16.63

* * *

(End of Appendix B)

APPENDIX C
Page 1

Adopted Quantities

Apple Valley Ranchos Water Company

1. Net-to-Gross Multiplier: 1.6941

2. Federal Tax Rate: 34.12%

3. State Tax Rate: 9.30%

4. Local Franchise Tax Rate: 1.00%

5. Uncollectible Rate: 0.21%

6. Ad Valorem Taxes (not including main-office allocation):

	Tax Year 1989-90	Tax Year 1990-91	Tax Year 1991-92
Assessed Value (000)	$5,584.5	$8,739.5	$10,389.4
Effective Tax Rate	1.05%	1.05%	1.05%
Ad Valorem Tax (000)	$ 58.6	$ 91.8	$ 113.8

	Test Year 1990	Test Year 1991
7. Groundwater Replenishment Tax	$ 0	$ 0
8. Water-Quality Laboratory Expense	31,750	16,643
9. Water Sales and Production:		
Residential, Ccf	4,238,234	4,391,630
Commercial	613,070	634,119
Industrial	1,000	1,500
Public Authority	176,300	184,900
Total Sales, Ccf	5,028,604	5,212,192
Water Loss, Ccf	497,334	515,492
Consumption, per Customer:		
Residential, Ccf	414.7	414.7
Commercial	657.8	657.8
Industrial	500.0	500.0
Public Authority	4,300.0	4,300.0
Overall Average, Ccf	449.8	449.8

APPENDIX C
Page 2

	Test Year 1990	Test Year 1991
Number of Customers:		
Residential	10,220	10,590
Commercial	932	964
Industrial	2	3
Public Authority	41	43
Total Customers	11,195	11,600

10. Power (Natural Gas and Electric):

Well Number	Rate Schedule	Type of Energy	Test Year 1990 Amount	Test Year 1990 Expense	Test Year 1991 Amount	Test Year 1991 Expense
4	GN-6	Gas	44,902	$17,434	46,539	$18,059
7	PA-1	Elect.	16,185	1,966	16,775	2,018
9	TOU-PA-5	Elect.	852,545	63,373	883,616	65,300
10R	PA-2	Elect.	62,138	8,159	64,402	8,331
11	TOU-PA-5	Elect.	464,157	36,831	481,073	37,842
12	TOU-PA-5	Elect.	619,446	48,506	642,021	49,949
15	GS-TP	Elect.	37,831	4,297	39,210	4,449
16	TOU-PA-5	Elect.	955,106	70,509	989,915	72,668
17	TOU-PA-5	Elect.	774,139	56,511	802,352	58,285
18	TOU-PA-5	Elect.	1,161,071	86,219	1,203,386	88,873
19	GN-6	Gas	44,930	17,445	46,567	18,070
20	TOU-PA-5	Elect.	942,188	70,772	976,526	72,900
21A	TOU-PA-5	Elect.	982,721	75,765	1,018,537	77,954
22	TOU-PA-5	Elect.	480,448	48,554	497,958	49,398
23	TOU-PA-5	Elect.	514,906	42,721	533,672	43,887
24	TOU-PA-5	Elect.	430,614	44,876	446,308	45,848
	TOTAL			$693,938		$713,831

Expenses are based on the amounts of gas energy in therms and electric energy in kiloWatt-hours calculated under the July 1989 rate schedule shown.

11. Adopted Income Tax Calculations:

Item	Test Year 1990	Test Year 1991
	(000)	
Operating Revenue	$4,209.6	$4,673.2
Expenses:		
Operating & Maint.	1,647.0	1,746.9
Administrative & Gen'l	965.7	1,046.1
Ad Valorem Taxes	77.7	105.2
Payroll Taxes	66.5	71.0
Refund Overcollection	-116.0	0.0
Unbilled Revenue Adjustment	-23.9	0.0
Subtotal	2,617.0	2,969.2
California:		
Tax Depreciation	671.3	764.6
Interest	186.4	242.6
Taxable Income	734.2	696.4
Tax	68.3	64.8
Federal:		
Tax Depreciation	376.6	447.0
Interest	186.4	186.4
Taxable Income	960.6	949.2
Tax	327.7	323.9
Investment Tax Credit	0.5	0.5
Net Tax	327.2	323.4
Total Income Taxes	395.5	388.2

12. Revenue Calculations:

Item	Amount
	(000)
Test Year 1990:	
Billed Revenue at Present Rates	$ 2,587.5
Authorized Rate Increase, 50% above Present	1,293.8
Total Collected Revenue	3,881.3
Plus: Refund of Balancing Account Overage	116.0
Total Revenue for Rate Design	3,997.3
Adopted 1990 Operating Revenues #	4,199.1
Annual Deferred Revenue (Revenue Requirement less Collected Revenue)	317.9
Monthly Deferred Revenue: $ 26.5	
Value of 10 months Deferred Revenue on 12/31/90 including interest	276.8
Test Year 1991:	
Adopted 1991 Operating Revenues #	4,663.2
Monthly Repayment of 12/31/90 Value of Deferred Revenue for 12 months: $ 24.6	
Annual Repayment of Deferred Revenue	294.7
Total Revenue for Rate Design	4,957.9

# Indicates amount shown is less $2,000 per year revenue from reconnection charges.

* * *

APPENDIX C
Page 5

13. Rate Base:

Item	Test Year 1990	Test Year 1991
(000)		
Plant in Service	$16,749,859	$18,885,571
Work in Progress	12,500	12,500
Materials & Supplies	156,300	177,100
Working Cash	273,855	309,368
Subtotal	17,192,514	19,384,539
Less:		
Accumulated Depreciation	3,918,281	4,302,394
Advances	3,215,220	4,164,121
Contributions	2,346,074	2,307,494
Unamortized ITC	167,839	163,001
Deferred Income Tax	615,982	782,292
Subtotal	10,263,396	11,719,302
Plus:		
Method 5 Adjustment	41,576	53,589
Resources Adjustment	50,000	50,000
Net District Rate Base	7,020,694	7,768,826
Main Office Allocation	233,727	216,189
Total Rate Base	7,254,421	7,985,015

* * *

(End of Appendix C)

APPENDIX D

Apple Valley Ranchos Water Company

RATE SUMMARY AND BILL COMPARISON

Test Year 1990:

Comparison of Bimonthly Service charges:

Meter Size	Present	Requested	Adopted
5/8 x 3/4"	$ 8.27	$19.93	$16.57
3/4"	9.13	22.00	18.23
1"	12.53	30.20	24.86
1-1/2"	16.53	39.84	33.14
2"	22.27	53.67	44.74
3"	41.50	100.02	82.85
4"	55.90	134.72	112.68
6"	93.80	226.06	187.24
8"	---	339.00	278.38

Quantity Rates:

Rate Block (Bimonthly)	Present	Requested	Adopted
First 6 Ccf, per Ccf	$ 0.30	-	$ 0.44
Over 6 Ccf, per Ccf	0.39	-	0.55
All Water, per Ccf	-	$ 0.62	

Comparisons for Bimonthly 5/8 x 3/4" Metered Bills

				Increase Over Present Rates	
Ccf per Bill	Present	Requested	Adopted	Amount	Percent
0	$ 8.27	$ 19.93	$ 16.57	$ 8.30	100.4%
6	10.07	23.65	19.21	9.14	90.8%
10	11.63	26.13	21.41	9.78	84.1%
25	17.48	35.43	29.66	12.18	69.7%
50	27.23	50.93	43.41	16.18	59.4%
70 (Average)	35.03	63.33	54.41	19.38	55.3%
100	46.73	81.93	70.91	24.18	51.7%
200	85.73	143.93	125.91	40.18	46.9%
500	202.73	329.93	290.91	88.18	43.5%

(End of Appendix D)

APPENDIX E
Page 1

Apple Valley Ranchos Water Company
SUMMARY OF EARNINGS
Test Year 1990

Item	Utility Proposed Rates	Staff Proposed Rates	Adopted Rates
	(000)		
OPERATING REVENUES	$4,352.3	$4,149.5	$4,201.1
DEFERRED REVENUES	(8.5)	(8.5)	(8.5)
TOTAL REVENUES	$4,360.8	$4,158.0	$4,209.6
OPERATIONS & MAINTENANCE			
PAYROLL - OPERATIONS	201.6	201.6	201.6
OPERATIONS - OTHER	67.7	67.7	67.7
PURCHASED POWER - ELEC.	659.1	659.1	659.1
PURCHASED POWER - GAS	34.9	34.9	34.9
CHEMICALS	.		
PAYROLL - CUSTOMERS	92.4	92.4	92.4
CUSTOMERS - OTHER	92.4	92.4	92.4
UNCOLLECTIBLES	9.2	8.7	8.8
PAYROLL - MAINTENANCE	135.0	135.0	135.0
MAINTENANCE - OTHER	355.3	355.3	355.3
SUBTOTAL O & M	1,647.6	1,647.1	1,647.1
ADMINISTRATIVE & GENERAL			
PAYROLL	219.5	219.5	219.5
PAYROLL - BENEFITS	106.9	106.9	106.9
INJURIES & DAMAGES	158.9	158.9	158.9
FRANCHISE TAX	43.6	41.6	42.1
REG. COMM. EXPENSE	19.4	19.4	19.4
OUTSIDE SERVICES	79.1	79.1	79.1
OFFICE EXPENSE	81.5	81.5	81.5
A & G TRANSFERRED	(78.6)	(78.6)	(78.6)
MISCELLANEOUS	16.1	16.1	16.1
MAIN OFFICE ALLOCATION			
A & G EXPENSES	261.8	261.8	261.8
DATA PROCESSING	59.5	59.5	59.5
SUBTOTAL A & G	967.7	965.7	965.7
AD VALOREM TAXES	77.7	77.7	77.7
PAYROLL TAXES	66.5	66.5	66.5
REFUND OVERCOLLECTION	(116.0)	(116.0)	(116.0)
DEPRECIATION	322.9	322.9	322.9
CA INCOME TAX	86.1	62.8	68.3
FEDERAL INCOME TAXES	386.7	309.1	327.2
TOTAL EXPENSES	3,439.2	3,335.8	3,350.2
NET REVENUES	921.6	822.2	849.5
RATE BASE	7,285.6	7,256.0	7,254.4
RATE OF RETURN	12.65%	11.33%	11.71%

APPENDIX E
Page 2

Apple Valley Ranchos Water Company
SUMMARY OF EARNINGS
Test Year 1991

Item	Utility Proposed Rates	Staff Proposed Rates	Adopted Rates
(000)			
OPERATING REVENUES	4,874.1	4,604.8	4,665.2
DEFERRED REVENUES	(8.0)	(8.0)	(8.0)
TOTAL REVENUES	$4,882.1	$4,612.8	4,673.2
OPERATIONS & MAINTENANCE			
PAYROLL - OPERATIONS	222.3	222.3	222.3
OPERATIONS - OTHER	71.9	71.9	71.9
PURCHASED POWER - ELEC.	667.7	667.7	667.7
PURCHASED POWER - GAS	36.1	36.1	36.1
CHEMICALS			
PAYROLL - CUSTOMERS	102.0	102.0	102.0
CUSTOMERS - OTHER	97.9	97.9	97.9
UNCOLLECTIBLES	10.3	9.7	9.8
PAYROLL - MAINTENANCE	149.0	149.0	149.0
MAINTENANCE - OTHER	380.3	380.3	380.3
SUBTOTAL O & M	1,747.5	1,746.9	1,746.9
ADMINISTRATIVE & GENERAL			
PAYROLL	241.1	241.1	241.1
PAYROLL - BENEFITS	132.6	132.6	132.6
INJURIES & DAMAGES	175.6	175.6	175.6
FRANCHISE TAX	48.8	46.1	46.7
REG. COMM. EXPENSE	19.4	19.4	19.4
OUTSIDE SERVICES	76.6	76.6	76.6
OFFICE EXPENSE	85.9	85.9	85.9
A & G TRANSFERRED	(85.8)	(85.8)	(85.8)
MISCELLANEOUS	17.5	17.5	17.5
MAIN OFFICE ALLOCATION			
A & G EXPENSES	274.2	274.2	274.2
DATA PROCESSING	62.9	62.9	62.9
SUBTOTAL A & G	1,048.8	1,048.1	1,048.1
AD VALOREM TAXES	105.2	105.2	105.2
PAYROLL TAXES	71.0	71.0	71.0
REFUND OVERCOLLECTION	0.0	0.0	0.0
DEPRECIATION	378.7	378.7	378.7
CA INCOME TAX	93.2	57.5	64.8
FEDERAL INCOME TAXES	418.0	299.4	323.4
TOTAL EXPENSES	3,862.4	3,704.8	3,736.8
NET REVENUES	1,019.7	908.0	936.7
RATE BASE	8,017.2	7,987.0	7,985.0
RATE OF RETURN	12.72%	11.37%	11.73%

(End of Appendix E)