

Decision 90 09 044 SEP 12 1990

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Alisal Water Corporation to (1) include the area formerly served by Matterhorn Estates Mutual Water Company in its service and (2) to establish rates for service.

**ORIGINAL**

Application 89-01-026  
(Filed January 19, 1989)

John J. Gibbons and R. T. Adcock, for Alisal Water Corporation, applicant.  
R. Ronald Mc Crea and Jasjit S. Sekhon, for the Commission Advisory and Compliance Division.

O P I N I O N

Application

Applicant Alisal Water Corporation (Alisal) requests Commission authority to include the area formerly served by Matterhorn Estates Mutual Water Company (Matterhorn) in its service area, and to establish rates for that service.

Alisal, doing business as Alco Water Service (Alco), is an established public utility serving water to approximately 4,300 customers in Monterey County. Its primary service area is the easterly portion of the City of Salinas. It also owns and operates various satellite water systems located in unincorporated areas north, south, and east of Salinas.

Matterhorn is a mutual water corporation serving customers in Matterhorn Estates located in the unincorporated area of Monterey County known as Prunedale. Matterhorn entered into the agreement to sell and transfer its water system to Alco.

Customers of Matterhorn were notified of the sale of Matterhorn to Alco on February 22, 1989. No protest letters were received by Alisal, Matterhorn, or the Commission. However, the

Commission Advisory and Compliance Division's Water Branch (Water Branch) opposes the application unless Alco stipulates to the recommendations in the Water Branch Report (Report).

Since Alco did not stipulate, an evidentiary hearing was held in Monterey before Administrative Law Judge Stalder on January 31, 1990. Robert Adcock (Adcock) and John Gibbons (Gibbons) testified for Alco. Donald McCrea (McCrea) testified for the Water Branch. Alco sponsored 13 exhibits and Water Branch sponsored two exhibits, all of which were received into evidence. The matter was submitted on February 23, 1990.

Matterhorn Water System

Matterhorn is located approximately 12 miles northwest of Alco's major service area and one-half mile north of its North Monterey County (NORMCO) distribution system in the Prunedale area. Matterhorn was established as a mutual water company in 1983 when homes located on Matterhorn Place in Matterhorn Estates were constructed. Matterhorn is owned by the 11 property owners.

The water supply is from a six-inch well located on Matterhorn Place. The well is 360 feet deep and is sealed to the 50 foot level. It is equipped with a three horsepower submersible pump which produces 20 gallons per minute (gpm) or 28,800 gallons per day (gpd).

The average system demand is 6,000 gpd with a maximum day demand of 12,000 gpd. System storage is provided by two 15,000 gallon steel storage tanks located on a hill at the north corner of the service area, and in close proximity to the homes it serves.

The water system consists primarily of six-inch polyvinyl chloride (pvc) pipe. There are two fire hydrants on the system, with test flow ranges of 500 to 1,000 gpm. The system has a combined well and storage flow capability of over 500 gpm for a one hour period. The majority of the mains in the system are capable of 1,000 gpm if required.

Water Branch believes that the system is in good condition, with minimal, if any, repair work required. However, it recommends that the electrical station, where Matterhorn obtains Pacific Gas and Electric Company electric service, be fenced to minimize possible vandalism.

Reason for Sale

Adcock testified that Matterhorn's Board of Directors contacted him requesting that he consider purchasing Matterhorn. Matterhorn wished to be relieved of its service obligation, because it was experiencing sand and pressure problems, and because the cost of liability insurance increased tenfold to approximately \$4,000 a year, or approximately \$30 per customer per month.

Alco believed it could solve the sand and pressure problems, due to its long experience in serving water. Adcock also testified that the location is ideal for connecting to the nearby NORMCO water system, which he estimates will take place in a year or two.

Alco will initially operate the Matterhorn system as a non-contiguous extension of the NORMCO water system. Once the two systems are connected, Alco will operate them as one system.

Sales Agreement

Alco entered into a sales agreement with Matterhorn to acquire Matterhorn's water system on June 16, 1988, seven months prior to filing this application. The agreement provides for Alco to pay Matterhorn \$3,000 for the system.

In return Alco receives from Matterhorn one well and well lot approximately 20' by 50', one deepwell submersible pump, two 15,000 gallon water storage tanks and storage tank lot approximately 30' by 40', two fire hydrants, the pressure system and distribution system, utility easements, and all other property and assets of Matterhorn associated with the operation of the water system.

Matterhorn Water Supply

Water is obtained from the single well located at the lower elevation end of the system. The storage tanks and pressure tanks are located at the other end of system at higher elevation. Since Matterhorn has only one source of supply, it does not satisfy the fire protection standards of General Order (GO) 103 that require each separately operated water system to have not less than two independent sources of supply.

Matterhorn Rates

Matterhorn's rate structure is a flat rate of \$25 per month which entitles each customer to unlimited water.

Rate Base

Alco proposes to record this acquisition based on the recorded rate base, which is the original cost of the facilities, less depreciation, plus the cost of the sand separator installed by Alco after the acquisition. This amount was \$38,558 on December 31, 1988. Considering the purchase price of \$3,000, and the \$4,500 cost of the sand separator, an acquisition adjustment of \$38,558 less (\$3,000 + \$4,500), or \$31,058 is needed to balance the accounting. Alco proposes to amortize the acquisition adjustment as a below the line credit over a period such as 30 years.

Water Branch agrees with Alco's rate base and acquisition adjustment amounts. However, Water Branch recommends that the acquisition adjustment immediately reduce rate base, and that \$240 in working cash be allowed. The result is a rate base of \$7,740 as of August 10, 1989. Table 1 compares the positions of Alco and Water Branch.

Table 1

	<u>Alco</u>	<u>Water Branch</u>
Line 1		
Utility Plant Acquired from Matterhorn	\$ 42,572	\$ 42,572
2		
Pump and Sand Separator installed by Alco after acquisition of system	4,500	4,500
3		
Retirement of Old Pump after acquisition of system	<u>(3,672)</u>	<u>(3,672)</u>
4		
Utility Plant in service 12/31/88	\$ 43,400	\$ 43,400
5		
Depreciation Reserve	4,842	4,842
6		
Net Utility Plant (1-2)	38,558	38,558
7		
Advance for Construction	-	-
8		
Contributions	-	-
9		
Acquisition Adjustment	-	31,058
10		
Working Cash	-	240
11		
Rate Base (6-7-8-9+10)	\$ 38,558	\$ 7,740

Gibbons testified that the Commission has, on occasion, held that when a public utility purchases a water system, the "original cost" of construction and not the purchase price, be charged to plant accounts. The difference between the original cost (actual cost less accumulated depreciation) and the price paid, either the excess or the deficiency, is then credited or debited as an acquisition adjustment below the line to be amortized over a period of years.

Gibbons states that this original cost method has been adopted in those cases where the entity selling a water system dedicated its water system to public use.

Gibbons cites Decision (D.) 63581 in Application (A.) 43428, dated April 17, 1962, in which we stated,

"It has been the policy of this Commission, for accounting and rate making purposes, to recognize the original cost of operating systems acquired by purchase and to disregard the purchase price paid by the transferees. Under such policy the customers' rates reflect those costs associated with the actual cost of constructing the facilities devoted to their use and will not be subject to variations which

might otherwise result in the event the purchase price, whether less than or in excess of the actual installed cost, were to be recognized for rate making purposes."

The Supreme Court of California denied a writ of review of D.63581.

Water Branch argues that "It has long been Commission policy that utility investors should only be allowed to earn on their actual investment...." The difference between net book value and the purchase price paid is then classified as an acquisition adjustment and is subtracted from rate base. Two cases are cited, Conejo Valley Water Co. (1965) 64 Cal PUC 212 and Fitch Mountain Water Co. (1965) 64 Cal PUC 558.

The latter cite is the decision that Gibbons refers to above. While McCrea does not offer specific areas, the decision does address the subject of adjustment of recorded cost, as follows:

"...the adjustment depends upon the appropriateness of using depreciated original cost under circumstances which suggest that it would be unrealistic or unfair.... We may also assume that, under such circumstances, we would disallow in rate base any premium (above the mutuals' depreciated original cost) which a regulated utility might pay to acquire the systems. Still it does not necessarily follow that we should ignore the payment, by a regulated utility, of a lower price than the mutuals' depreciated original cost."

In Conejo Valley Water Co. we stated:

"If a regulated utility purchasing dedicated property were allowed to pass on its customers a price higher than original cost, the parties to the transaction would be in a position to frustrate the application of the original cost standard by arranging a transfer of ownership at a premium. The seller would receive at the expense of future ratepayers, more than his original cost, and yet the willingness of the purchaser to pay such a premium would have

little significance since he himself would not bear the burden. On the other hand, the willingness of a seller to accept a price below his depreciated original cost can be persuasive evidence that the property has suffered a deterioration in value and is no longer worth depreciated original cost. The Commission may consider such evidence in establishing a rate base for ratemaking purposes."

We note that this example suggests that we may look at the reason why purchases are made at levels significantly below depreciated original cost, and may establish a different rate base level. In the case of Matterhorn, we have evidence that the system, which is relatively new, is of good quality, and has been properly maintained. We are satisfied that Matterhorn's low purchase price is not necessarily due to the property suffering a deterioration in value due to lack of maintenance or inferior materials.

There are other apparent reasons for the low purchase price.

- With only 11 customers, operating the system may be a burden. The limited potential for return on investment makes it difficult to justify the expense of employing personnel to handle the various tasks such as billing, maintenance, and system upgrades to alleviate problems such as the sand and pressure problem.

- The escalated cost of insurance is an increased burden to Matterhorn.

Gibbons acknowledges that the Commission has adjusted the depreciated original cost, using lower values for rate base in special circumstances. Included in the special circumstances are instances where using the depreciated original cost would result in a disproportionately high investment per customer.

McCrea calculates the investment per customer using Matterhorn's original cost at:

$$(\$38,558 + 240) \div 11 = \$3,527$$

This is approximately nine times the investment per customer of Alco's system, at approximately \$400.

Adcock states that if Water Branch's recommendation for rate base were adopted, the return allowed would not make operating the Matterhorn system worthwhile. Disregarding the \$4,500 investment in new equipment after the purchase, Alco would be allowed an opportunity to earn approximately 11.04% (the currently allowed rate of return on rate base for Alco) of \$3,240 (purchase price plus working cash) or \$358 per year. This is less than \$30 per month.

On the other hand, we observe that if original cost were used for rate base and Alco were authorized rates sufficient to allow an opportunity to earn the current 11.04% rate of return, Alco could earn 11.04% of \$38,558, which is \$4,257 per year, or \$355 per month. On a per customer basis, Alco could earn a return of approximately \$32 per month, which is more than the customers now pay Matterhorn per month for unlimited water. On actual investment including working cash, Alco could earn approximately 55% per year.

$$(\$4,257 + 7,740) \times 100 = 55\%$$

While we understand Adcock's concern that \$30 per month may not appear to be much reward for operating the Matterhorn system, we believe it would be unfair to expect Matterhorn's customers to pay more than double rates for water service in order to allow Alco a 55% rate of return, solely due to the purchase. Adding a fairly new system in good condition that serves 11 customers, to Alco's system of over 400 customers would not seem to add greatly to Alco's burden of operations, and Adcock testified that the addition of Matterhorn does not require more Alco personnel.

We consider Water Branch's recommended rate base level of \$7,740, developed as follows:



Purchase price	\$3,000
Plant additions (sand filter)	4,500
Working cash	<u>240</u>
Total	\$7,740

The purchase price is not in question. Water Branch agrees that the plant additions are new facilities that were required to overcome sand and pressure problems. The parties agree that working cash is a necessary operational component used in setting rates.

We conclude that the value of the Matterhorn system is reasonably determined by the purchase price. A system as small as Matterhorn is usually not profitable, and Matterhorn is no exception. Apparently no other buyers were interested in paying more than \$3,000. Alco certainly was not willing to pay near original cost. Rather, it paid approximately one-thirteenth, or less than 8% of the original cost. It would be unfair to Matterhorn's customers to allow original cost in rate base. Even if rates were set on a systemwide basis for Alco, the increase, although diluted, would remain unfair to all of Alco's customers.

We also consider the Matterhorn purchase relative to ownership of the system. Matterhorn is a system built to serve the houses and/or lots on Matterhorn Place. It was established as a mutual water company which is owned by the 11 customers. In purchasing their property, the 11 customers in effect paid for the water system, and the sale price of \$3,000 apparently will be shared by the 11. When the customer-owners of a mutual water company sell their water system for less than its original cost, they are essentially donating the property in the amount that the original cost exceeds the purchase price, and only the purchase price should be allowed in rate base.

In Conejo Valley Water Co. cited above, we further stated:

"Moreover, on the stated assumption that these were bona fide mutuals, it is important to bear in mind that they were, in effect, customer owned. Customer donations of plant to a public utility are normally disallowed in calculating rate base; it would be inequitable to permit the utility to earn on property provided by the customers themselves. Even if the property in question be deemed at the time of sale to have been still owned or controlled by the subdividers, any difference between its true value and the price paid by applicant is in reality a subdivider contribution and should be disallowed in rate base. Such an approach is analogous to the long-standing treatment accorded by the Commission to subdividers' advances under the water main extension rule; only the amount repaid to the subdividers by the utility is allowed in rate base."

We conclude that the purchase of Matterhorn is consistent with the above conditions.

Water Branch could have cited Mira Monte Water Company, D.91324, 3 CPUC 2nd 263, 267 for a similar, but even broader, principle:

"The Commission has definitively established a policy that a mutual water company when purchased by a private individual or entity, who thereby becomes a public utility, should be valued at no more than the new owner's actual investment. [Citation omitted.] This policy is no more than an application of a generally applicable ratemaking principle which has been long followed by this Commission. That rule requires that after a transfer, a utility's rate base must be valued at the lower of either depreciated original cost or purchase price." (Id., at p. 267.)

In Alisal Water Corporation, D.90-07-057, we reaffirmed the principle that utilities should earn a return only on the money they invest, absent extreme circumstances not present in that case. We found this policy superior to one which would allow utilities to earn a return on someone else's investment, whether it be plant

for by the customers of the mutual water company being acquired, by customer donations, or by any other means.<sup>1</sup>

For this reason, and for the reason that the sale price reflects the actual market value of the system, we conclude that Alco should be allowed the purchase price, plus capital additions of \$4,500 and working cash of \$240 in rate base.

We will adopt Water Branch's rate base as follows:

<u>Item</u>	<u>Amount</u>
Utility Plant in Service	\$43,400
Depreciation Reserve	4,842
Net Utility Plant	<u>38,558</u>
Advance for Construction	-
Contributions	-
Acquisition Adjustment	31,058
Working Cash	<u>240</u>

Net Rate Base (December 31, 1988) \$ 7,740  
(Net utility plant less  
acquisition adjustment +  
working cash)

We will order Alco to record \$7,740 in rate base as of December 31, 1988, to be used in future ratemaking proceedings.

An acquisition adjustment in the amount of \$31,058 is required to offset the difference between rate base and original cost. Alco may request an amortization period for the acquisition adjustment in a future filing.

#### Proposed Rates

Alco seeks to adopt the same water rates for Matterhorn as it currently charges its NORMCO service area, as shown in Appendix A. Compared to the flat rate charge of \$25 per month charged by Matterhorn, the proposed rates cross over at a usage of

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<sup>1</sup> We understand there are a number of Commission decisions which reached a different result. To the extent those decisions are inconsistent with the policy outlined in today's decision they should be followed no longer.

15 CCF per month (one CCF is 100 cubic feet), meaning that customers using less than 15 CCF would pay less, and customers using more than 15 CCF would pay more under the proposed rates, than under Matterhorn's rates.

Water Branch concurs with Alco's proposed rates.

We see no reason not to adopt the proposed rates, which we have authorized for the neighboring NORMCO service area. We will order Alco to file tariffs for these rates.

We adopt Water Branch's results of operations, based on present NORMCO rates as follows:

<u>Item</u>	<u>Amount</u>
Revenue	\$3,300
Expenses	
Subtotal operating expenses	2,326
Taxes other than income	206
Income Taxes	-
Depreciation Expense	<u>837</u>
Total Expenses	\$3,369
Net Income	( 69)

The adopted Summary of Earnings shows that Alco will be operating near the break-even level at Matterhorn. The cash received from Matterhorn will be nearly sufficient to pay all the bills associated with the water system's operations. There will not be a profit.

Income Tax Liability

McCrea testified that Alco may incur an income tax liability as a result of purchasing Matterhorn. The tax liability could result from the difference between original cost and purchase price being considered as contributions, which may be considered taxable income by the Internal Revenue Service (IRS). McCrea recommends that if this tax liability is incurred by Alco, ratepayers should not be required to pay for it.

McCrea expresses a further concern that such tax liabilities could adversely impact Alco's ability to serve its customers. The worst case tax to Alco due to the Matterhorn purchase would be about \$10,000, which would not seriously impact Alco's operations. However, McCrea is concerned that such a precedent may be dangerous in the future, if Alco acquires a large mutual water company and incurs a large tax liability as a result.

Adcock testified that his Certified Public Accountant believes that it is possible, but unlikely, that the acquisition would be viewed as a taxable contribution by the IRS. If Alco were allowed original cost rate base, it would be willing to absorb any tax liability.

Having concluded that we will not allow Alco original cost rate base, we now consider who should be responsible for the tax liability.

To a ratepayer, the acquisition of a water system does not change anything except ownership. There is no resulting change in plant facilities, water supply, or service. We are reluctant to require ratepayers to pay the tax liability, absent a compelling argument.

A further consideration is the timing of the acquisition. Because Alco entered into the agreement to acquire Matterhorn on June 16, 1988, any recovery of tax liability incurred as a result of the agreement may be construed as retroactive ratemaking. We will not consider the issue further at this time. If the tax liability actually occurs and Alco believes it is entitled to recover prospectively any of the costs from its ratepayers, Alco should file an advice letter seeking recovery of those costs. All affected Alco customers should be notified of this proposed filing.

#### Accounting Records

Alco proposes to keep only one set of books for its operations, in which Matterhorn would be a separate entry. The

decision to be filed December 1, 1990; March 1, 1991; June 1, 1991; and September 1, 1991 regarding the status of implementing the audit recommendations. Thereafter, semiannual reports shall be filed starting February 1, 1992 and continuing every six months until the date of the Commission decision in SoCalGas' next GRC. Parties may file comments on the status reports within 30 days. Parties should attempt to resolve any disputes that arise in the reports or comments. Any unresolved disputes regarding implementation of the audit recommendations will be addressed in SoCalGas' next GRC.

This proceeding dealt exclusively with Phase I of SoCalGas' management audit. As stated in Resolution G-2736, the project coordinator of CACD shall determine the scope and timing of Phase II of the audit. We understand that SoCalGas has requested that the Phase II audit be postponed in light of Order Instituting Rulemaking 90-02-008 and the continued restructuring of the gas industry. However, we believe valuable information can be ascertained by going forward with the Phase II audit on marketing and procurement policies at this time. Therefore, we direct CACD to continue in its efforts to conduct the Phase II audit and reiterate our directive to SoCalGas to cooperate fully. As the Phase II audit proceeds, we will issue a new OII at the appropriate time to address Phase II issues. This docket, being limited to Phase I issues, can be closed at this time.

Findings of Fact

1. The Commission adopted Resolution G-2736 on October 28, 1987, initiating a comprehensive management audit of SoCalGas in two phases.

2. Phase I of the management audit examined SoCalGas' operational and financial processes as well as its management performance and is the subject of this investigation, I.89-04-051.

same tariffs would cover both the NORMCO and the Matterhorn service areas.

Water Branch requests that the Commission order Alco to keep a separate set of books, and file separate tariffs for Matterhorn. Water Branch believes this would allow for a more accurate audit of Matterhorn's operations, which could be difficult if only one set of books is used.

Alco responds that a separate set of books for 11 customers is unnecessary and costly. Alco proposes to separately record Matterhorn entries so that Water Branch can readily identify those items in its audit. Alco also argues that separate tariffs are unnecessary and costly.

We agree with Alco that separate books and tariffs are not justified for Matterhorn. We will require Alco to keep separate entries for Matterhorn so that Water Branch may readily audit the books.

Comments

Comments on the proposed decision of the Administrative Law Judge were filed by Water Branch. The comments were carefully considered, but no changes have been made to the proposed decision.

Findings of Fact

1. Alco is an established public utility serving water in Monterey County.
2. Matterhorn was a mutual water corporation serving customers in Matterhorn Estates.
3. Water Branch opposes the application.
4. Matterhorn desired to sell the water system because of the difficulty of operating it and the high cost of insurance.
5. There are no public utility water companies in the vicinity of Matterhorn Estates with which the system is likely to compete.
6. Alco entered into an agreement to acquire Matterhorn's water system for \$3,000 on June 16, 1988.
7. Matterhorn's system is in good condition.
8. Matterhorn is in violation of GO 103 because it has only one source of water.

9. Alco installed a sand separator at a cost of \$4,500 to eliminate the sand and pressure problems on the Matterhorn system.

10. Alco proposes to record the acquisition of Matterhorn based on the original cost of the water system.

11. Alco and Water Branch agree that the original cost of the water system, depreciated through December 31, 1988, is \$38,558.

12. The water system was dedicated to public use by Matterhorn.

13. Alco requests that rates currently in effect for its NORMCO district be adopted for the Matterhorn system.

14. The Matterhorn system will nearly break even at proposed rates.

15. Alco may incur an income tax liability as a result of acquiring Matterhorn.

16. A separate set of accounting records, and separate tariffs are not justified for the 11 customer Matterhorn system.

#### Conclusions of Law

1. The sale and transfer of Matterhorn's water system to Alco should be authorized.

2. Alco should be authorized to record the actual purchase price, plus improvements and working cash, in rate base.

3. Alco should be authorized to charge Matterhorn customers the same rates that are presently being charged to NORMCO customers.

4. At this time Alco should not be authorized to recover any income tax liability that it may incur from the purchase of Matterhorn's water system.

#### ORDER

##### IT IS ORDERED that:

1. Alisal Water Corporation (Alisal) is authorized to acquire and to operate Matterhorn Estates Mutual Water Company's



(Matterhorn) water system, the service area as shown in Attachment A to the application.

2. Alisal shall keep its books and records in accordance with the Uniform System of Accounts for Water Utilities prescribed by the Commission, and with separate entries for Matterhorn.

3. Alisal shall record the purchase of Matterhorn's water system at a December 31, 1988 net rate base of \$7,740, as discussed in this decision.

4. Alisal is authorized to file, after the effective date of this order, and in compliance with GO 96-A, tariffs applicable to the service authorized containing rates, charges, and rules applicable to its water system. The rates shall be as proposed for service in Attachment B to the application.

5. Alisal shall use its existing Corporate Identification No. U-206-W in connection with the certificate or authority issued in this proceeding. The number shall appear in the caption of all original pleadings and in the title of pleadings filed in existing cases before this Commission.

This application is granted as set forth above.

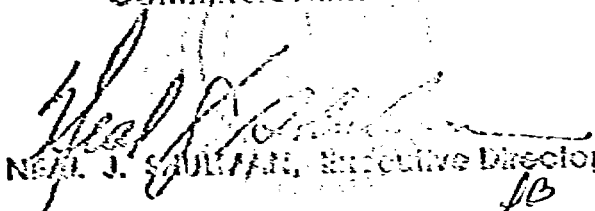
This order is effective today.

Dated SEP 12 1990, at San Francisco, California.

G. MITCHELL WILK  
President  
FREDERICK R. DUDA  
STANLEY W. HULETT  
PATRICIA H. ECKERT  
Commissioners

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

Commissioner John B. Ohanian,  
being necessarily absent, did  
not participate.

  
NEAL J. SULLIVAN, Executive Director 16 -  
JB

APPENDIX A

SCHEDULE NO. 1-NMC

METERED SERVICE

NORTH MONTEREY COUNTY AREA

APPLICABILITY

Applicable to all metered water service. (N)

TERRITORY

Prunedale and vicinity, North Monterey County (N)

RATES

Per Meter  
Per Month

Quantity Rates:

First 300 cu. ft., or less .....	\$ 0.83	(N)
Over 300 cu. ft., per 100 cu. ft. ....	1.04	(N)

Service Charge:

For 5/8 x 3/4-inch meter	10.00	(N)
For 3/4-inch meter	11.00	:
For 1-inch meter	15.00	:
For 1-1/2-inch meter	20.00	:
For 2-inch meter	27.00	(N)

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