

Decision 91 10 017 OCT 11 1991

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of California Utilities)
Services, Inc. (U-418-S) for an)
order authorizing it to increase)
rates charged for sewer service,)
and to record a historical)
cost appraisal and accumulated)
depreciation requirement study.)

Application 90-10-017
(Filed October 11, 1990)

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O P I N I O N

1. Summary

This decision grants an increase in monthly flat rates from the current \$11.94 to \$22.50, an 88.4% increase, to California Utilities Services, Inc. (applicant or CUS), a waste disposal utility near Salinas. In February, the utility was authorized on an interim basis to increase rates 41% from \$8.47 monthly. The utility had requested an interim increase in rates to \$22.62, or 167%, and a permanent increase to \$33.78, or 299%. The sewer system was in a state of disrepair when it was taken over in 1986, and operating costs associated with a new sewage treatment plant have caused the utility to incur heavy losses. The order also requires the utility to give public notice before embarking on further plant improvement that would increase rate base by 25% or more in the course of a year.

2. Background

CUS¹ provides sewer service to about 1,000 ratepayers in the Toro area, about four miles southwest of Salinas. The service area lies in a valley between the Salinas-Monterey Highway and the Fort Ord Military Reservation.

Applicant took over this system in March 1986. The acquisition was authorized by Decision (D.) 87-05-033.² Before CUS stepped in, the system had been effectively abandoned by its previous owners and was in a state of disrepair. It operated under

1 The shareholders of CUS are Robert T. Adcock and N. Patricia Adcock. The Adcocks also are principal shareholders of Alisal Water Corporation and Toro Water Service, Inc.

2 The decision also authorized CUS to amend its tariffs to provide for a \$4,000 inclusion fee per residence for real estate developers and builders. (D.87-05-033, at 10-11.) This inclusion fee has financed much of the utility's rebuilding program.

restrictions imposed by the Central Coast Regional Water Quality Control Board, requiring substantial improvements before new customers could be served. CUS began a rebuilding and expansion program which has brought the system up to contemporary standards.

At the time CUS acquired the system, a monthly flat rate of \$7.50 per connection was in effect, authorized by Resolution W-2515 on June 1, 1979. In that resolution, the Commission found that the rate was sufficient to cover the utility's expenses with no return on investment. On September 14, 1988, the Commission in Resolution W-3410 authorized an offset increase to \$8.47 per connection to cover increased expenses, again with no return on investment.

The rebuilding program initiated by applicant includes a new waste water treatment plant, located on the south bank of the Salinas River. Called a Sequencing Batch Reactor system (SBR), it includes two large SBR tanks and a chlorine contact chamber designed to process an average dry weather flow of 300,000 gallons daily. After treatment, the disinfected wastewater is piped through an irrigation pumping system to newly expanded sprayfields. While much of the capital cost of these improvements was contributed by developers (in order to permit the system to serve new customers), the additional facilities resulted in a near doubling of CUS operating costs. At hearing, the utility estimated that it was losing \$450 a day.

To meet these costs and to provide for a return on investment, applicant on October 11, 1990, filed its application seeking an interim increase in 1991 revenue to \$163,178, or a 167% increase, and a permanent increase in annual revenue to \$291,875, or a 299% increase. The company proposed increasing the \$8.47 monthly rate to \$22.62 on an interim basis and to \$33.78 on a permanent basis.

A prehearing conference was held on December 19, 1990, and a public participation hearing--attended by some 200 persons--was held in Salinas on January 15, 1991. In D.91-02-035, issued on February 21, 1991, the Commission authorized CUS to implement an interim rate increase of 41%, increasing the monthly flat rate from \$8.47 to \$11.94, in order to increase revenues from \$92,900 annually to \$131,000. The increase was made subject to refund pending the outcome of hearings on the merits of the application.

Five days of hearing were conducted from April 22 through April 26, 1991, in San Francisco and Salinas, and a sixth day of hearing was held on May 13, 1991. Parties include the utility, the Water Utilities Branch of the Commission Advisory and Compliance Division (Branch) and the representative of seven homeowners' associations (Homeowners). The Commission heard testimony from 11 witnesses. Approximately 50 exhibits were received into evidence. The case was submitted on June 17, 1991, with the filing of reply briefs.

3. The Rate Base

The principal issue in this proceeding is the establishment of a rate base for CUS. Rate base recognizes the utility's investment in utility plant, materials and supplies and working cash (if any), less depreciation and contributions.³ The Commission has never adopted a rate base for CUS or for its

³ Rate base is multiplied by rate of return to determine the operating income necessary for a utility to have the opportunity to earn a reasonable return on investment. A utility's "rate of return," which is expressed as a percentage, reflects the utility's weighted cost of capital. It is found by multiplying capital structure components by the costs associated with the various forms of financing. It includes interest on borrowed funds, plus dividends on preferred stock and a reasonable allowance for a return on equity (common stock).

predecessor, Salinas Utility Services.⁴ In D.87-05-033, which authorized CUS to acquire Salinas, the Commission deferred adoption of a rate base to the next rate proceeding. The reason for the deferral was that the original cost appraisal and depreciation reserve study submitted by the utility did not determine the amounts of contributions and advances in constructing the original plant. (D.87-05-033, at 5-6.)

Rate base determination is complicated because the sewer system came under the Commission's jurisdiction in 1972, long after original construction. The system was built in the mid-1960s by Western Pacific Sanitation Company, using funds advanced by developers and funds obtained by sale of notes to The Mutual Life Insurance Company of New York (MONY). Western Pacific used these and other funds to construct water and sewer systems in California and New Mexico. Salinas Utility Services acquired Western Pacific's Monterey County operations in 1971.

There is no public record setting forth the original cost of the utility's plant. While CUS has financial records of its plant investments since 1985, it does not have records of pre-1985 transactions.

Branch and CUS agree on rate base data for the period 1985-1991. They disagree on how to calculate plant cost for the period prior to 1985. The utility seeks authority to record an historical cost appraisal and accumulated depreciation requirement study as of December 31, 1985. Branch takes alternative positions. First, it proposes that the Commission adopt \$5,000 as the appropriate cost of plant as of 1985. Alternatively, it proposes a

⁴ Salinas Utility Services first came under Commission jurisdiction on July 1, 1972, when Public Utilities (PU) Code §§ 216, 230.5, 230.6, and 1001 were amended to include regulation of sewer corporations.

staff reconstruction of plant cost based on data analyzed by a Commission accountant in 1973.

3.1 CUS Rate Base Proposal

The utility submits as Exhibit G of its application an historical cost appraisal and accumulated depreciation requirement study conducted by consulting engineers Creegan & D'Angelo. Engineer Rene Fuog, who designed and helped supervise construction of the new CUS sewage treatment plant, was the author of the appraisal.

Fuog explained that he did an inventory of existing plant as of December 31, 1985, prepared a present-day cost estimate for constructing that facility, and then reduced that cost to 1964-1965 cost levels by means of a standard index. The result was an appraised gross value of plant as of the end of 1985 of \$860,349. Plant depreciation for the same period was calculated at \$389,329, for a net value of \$471,020.

Branch objects to the appraisal. It states that although the information may provide a reasonable estimate of the reproduction cost of plant in terms of 1965 dollars, it lacks the element of separating the total into what the original owner (Western Pacific) invested and what developers contributed. Fuog acknowledged this in his testimony, stating:

"The manner in which plant is financed cannot be estimated from an inspection of the physical properties or through a determination of their original costs. Our cost appraisal reflected a cash value. We have no information on the financing of the facilities and cannot comment on this item." (Ex. 12, Prepared Testimony, at 2.)

CUS argues that historical cost appraisal has in the past been accepted for ratemaking purposes where original records are inadequate to determine original cost. (Ramona Water Co. (1973) 75 CPUC 44, 51.) It points to a number of cases in which the Commission has held that utility property that has been sold or

transferred to another utility should be recorded at original cost less depreciation for ratemaking purposes.⁵

The difficulty we have with the utility's historical cost appraisal is the same that faced us when CUS sought approval of a cost appraisal in 1987.

"(T)he appraisal did not make a determination of the amounts of contributed and advanced plant. Since plant, depreciation reserve, contributions, and advances are only important in determining rate base, it is reasonable to defer granting authority to record these items until the next rate proceeding where they can be appropriately examined." (D.87-05-033, at 6.)

In an attempt to cure this defect, CUS through its staff accountant introduced an updated rate base calculation (Exhibit 14, Schedule F Updated) in which it estimates contributions in aid of construction on the appraised properties of \$317,491. However, there is little or no explanation of how the utility calculated this amount. At best, it appears to be a good-faith estimate intended to account for the fact that much of the original plant was built through contributions and unpaid debt that ultimately became contribution.

The utility has not persuaded us that these estimates of original cost, as offset by contributions and advances, reflect a fair and reasonable amount upon which to establish rate base.

3.2 Branch's Purchase Price Proposal

Branch argues that use of a historical cost appraisal is not appropriate when a utility's purchase price is known to be less than the utility's historical cost. In that instance, it argues, purchase price is the appropriate rate base component. It notes

⁵ See Suburban Water Systems (1972) 73 CPUC 343, 344; Re City of Fresno (1986) 20 CPUC 2d 502, 523; Application of Kitchen (1985) 18 CPUC 2d 259.

the Commission's explanation of this principle in Mira Monte Water Co. (1980) 3 CPUC 2d 263, 267:

"This policy [applicable to a mutual water company when purchased by a private individual or entity and thereby becoming a public utility] is no more than application of a generally applicable ratemaking principle which has long been 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."

The Commission reemphasized this policy in two recent decisions involving applications of Alisal Water Corporation:

"By allowing the purchaser[s] the opportunity to earn a return only on [their] own investment, we are simply following the basic regulatory principle that utilities are entitled to a fair return on their investment (not on someone else's investment)." (Alisal Water Co. (1990) 37 CPUC 2d 72, 78-79.)

Similarly, in D.90-09-044, another decision involving Alisal, the Commission stated:

"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 [paid] for by the customers of the mutual water company being acquired, by customer donations, or by any other means.^{1/}"

* * *

^{1/} 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." (D.90-09-044, at 11.)

Branch makes this argument in support of its position that the actual purchase price of the Salinas system was \$5,000, the acknowledged amount spent by the Adcocks in acquiring the MONY note and lien and otherwise dealing with ownership documents.⁶ As we found in D.87-05-033, the existence of the MONY note "effectively destroyed all incentive to improve the sewer system, as any one investing funds faced the possibility of foreclosure once the system had been rehabilitated and turned into a profitable operation." (D.87-05-033, at 5.)

Adcock testified that he and his wife spent three days in New York negotiating with MONY. They persuaded the insurance company that the note, although nominally worth some \$230,000, was actually worthless, since the sewer system could not make payments and no one would improve or acquire the system under threat of a \$230,000 lien. After lengthy negotiations, Adcock said,

"we convinced them to sell [the note] to us for a thousand dollars because we needed to protect the future investment in the facility. Otherwise, the alternative was for them to wait another 20 years for something to happen, because they didn't have any buyer.... They called in three other officers, and they debated it with us for quite some time. And

⁶ The utility argues that original cost less depreciation has been consistently relied upon from early Commission decisions, and that a change to a policy of considering the lesser of purchase price or original cost is prohibited by PU Code § 1708 without notice and opportunity to be heard by all affected parties. While we acknowledge that prior decisions can be cited to support both an original cost and a purchase price theory of ratemaking, we believe that the objective of permitting investors a return on their investment, rather than the investments of others, is a consistent one in these decisions. (Mira Monte Water Co. (1980) 3 CPUC 2d 263.) In any event, CUS can hardly argue lack of notice as to the Alisal decisions, since the owners of CUS also are the majority owners of Alisal and since CUS counsel represented Alisal in D.90-07-057.

finally one of the officers said, 'What the hell. Let's go (with it).' " (Tr. at 531.)

The Adcocks spent an additional \$4,000 in fees and expenses in tracking down and obtaining title documents from representatives of Salinas Utility Services and Western Utilities Service. The Adcocks then invested \$10,000 in CUS, which acquired title to the sewer system. Adcock testified that in acquiring the system, CUS assumed Salinas liabilities, including unpaid bills of \$27,372, past-due property taxes of \$38,489, and an existing \$231,305 liability on Salinas Utility Services' books representing unpaid principal and interest on the MONY note. The Adcocks later cancelled the MONY liability.

We cannot agree with Branch that \$5,000 represents the purchase price of the Salinas utility. These were costs incurred by the Adcocks in order to acquire the system. Had they chosen to do so, the Adcocks could simply have retained the MONY note and not acquired the utility, hoping to profit on the \$230,000 lien from some future owner of the sewer system.

If we were to adopt these costs as an appropriate rate base calculation, it would be necessary to account for acquired liabilities, which CUS places at \$297,166 (unpaid bills, property taxes, and the MONY obligation). (See Del Oro Water Co., Inc. (1990) D.90-07-036, at 5.) Branch suggests that we ignore the \$230,000 MONY lien as a fictional one that disappeared when the Adcocks acquired the note. Branch implies that cancellation of the note was a quid pro quo in the Commission's approval of the acquisition in D.87-05-033. We do not read the decision as requiring the Adcocks to cancel the MONY debt as a condition to acquiring the Salinas system.

On the other hand, we agree with Branch that factoring into rate base a \$230,000 debt that does not exist would reward the Adcocks for their bargaining skills but would not provide an appropriate yardstick for return on owners' investment.

3.3 Branch's Alternative Proposal

As an alternative, Branch has developed original cost data from Commission records that we deem reliable. Branch relies on Salinas Utility Services data at the time the utility came under Commission regulation in 1972. The source is Application (A.) 53991, filed in 1973, in which Salinas Utility Services requested a general rate increase.

Although the utility did not seek return on investment in that application, the Commission's staff accountant included balance sheet items in the report that became Exhibit 2 in the Commission record. Staff at that time reviewed the financial records of all of the utilities that made up Western Pacific Sanitation Company. These included Ventura Utility Services, Lompoc Utility Services, Ontario Utility Services, Mission Hills Water Company, and Salinas Utility Services. For Salinas Utility Services, the accountant's report shows as of September 30, 1973, the following:

Utility plant in service	\$ 376,113
Accumulated depreciation	50,294
Advances for construction	218,758
Connection fees	34,300

The staff accountant stated that, since no refunds were made, the advances should be considered contributions. Similarly, staff concluded that connection fees should be considered as contributions. Based on this analysis, Branch concludes that rate base was \$79,129 in 1974. Through accumulated depreciation, rate base declined to \$48,226 in 1989. Although the utility added plant to the system during this period, the additions were contributed and had no effect on rate base. Not until 1990, when CUS used investor funds to complete its treatment plant, did the rate base increase. Branch's analysis, combined with evidence of \$2.1 million in contributions, produces a rate base of \$419,492 for test year 1991. (See Appendix A.)

While the utility produced a former Commission staff member who contested the applicability of this analysis, his testimony did not challenge the reliability of the information. Homeowners commented:

"The historical cost figures available from a 1973 staff report in Application Nos. 53989, 53990 and 53991 provide the most reliable basis for the Commission to consider. In 1973, the staff was 18 years closer to the early 1960s construction period and must have had a reliable basis for including plant, depreciation reserve and contribution data for six utility systems in its report." (Brief of Coalition of Homeowners Association, at 5.)

Balancing consumer and company interests is the basic objective in selecting rate base. Within the principles discussed above, that analysis is driven by the facts of each case. As we stated in D.90-07-057, at 5, we make such determinations on a case-by-case basis. We agree with Homeowners that Branch's alternative rate base calculation is the most reliable on this record. We adopt it.

4. Summary of Earnings

Appendix A shows test year 1991 estimates of earnings by applicant and by Branch, and adopted revenues, expenses, and rate base, utilizing an 11% rate of return. Homeowners developed estimates that generally parallel those of Branch. Homeowners' recommended rate increase is slightly below that recommended by Branch. ✓

4.1 Customer Base

We adopt 1,020 as the customer base for test year 1991. (Exhibit 14, Schedule D Updated.)

4.2 Rate Design

The utility assesses a flat rate on all connections. A country club served by the utility is charged a rate equal to 8 connections, and a school is charged a rate equal to 14 connections, based on usage estimates apparently agreed to by those

institutions. Branch does not oppose that practice, but it recommends that tariffs in this case reflect these multiple billing charges for large users. The utility agrees. The proposed tariffs in Appendix B reflect this billing practice.

5. Operating Expenses

Table A compares expense estimates of the utility and Branch for test year 1991 and shows adopted amounts. Significant differences are discussed below.

Table A

Operating Expenses (Test Year 1991)

<u>Items</u>	<u>Utility</u>	<u>Branch</u>	<u>Adopted</u>
Purchased Power	\$29,454	\$27,713	\$27,713
Employee Labor	58,819	48,005	53,412
Materials	24,677	17,433	21,055
Contract Work	10,537	7,547	7,547
Transportation	14,540	10,183	10,896
Office Salaries	16,973	9,124	16,973
Management Salaries	18,000	12,315	12,315
Employee Benefits	8,446	9,712	8,446
Office Services & Rentals	5,256	3,391	4,578
Office Supplies	6,688	2,716	5,500
Professional Services	3,283	1,800	1,800
Insurance	2,676	2,676	2,676
Rate Case Expense	5,000	3,000	5,000
General Expense	1,392	516	516
	<hr/>	<hr/>	<hr/>
Total	\$205,741	\$156,131	\$178,427

5.1 Purchased Power

Branch's estimate of energy use is based on actual use for the period May 1990 through February 1991, adjusted at hearing to incorporate more recent data. The utility's estimate is based on what it believes will be higher required monthly use in the year ahead, but its evidence supporting this is unpersuasive. Branch's estimate is the more credible, and it is adopted.

5.2 Employee Labor

The utility's new treatment plant requires a full-time certified operator. Another full-time employee maintains the sprayfields. The utility seeks \$10,814 for part-time labor, generally Alco employees, to relieve the two full-time employees. Based upon the utility's testimony, the sprayfield operator is available from two-thirds to one half of his time to back up the plant operator during absences. Branch has disallowed all labor costs for part-time labor on the theory that occasional work (enlarging the sprayfields) can be capitalized and recovered in rate base, and that two employees are sufficient to operate the plant and sprayfields. The utility has shown that some part-time labor is required to cover the full-time employees during periods of vacation or other absence, but the utility has not rebutted Branch's showing that at least one-half of this need can be met with existing resources. Accordingly, we allow for part-time labor, but we have reduced by one-half the utility's estimate of this cost.

5.3 Materials

Branch adopted the utility's first estimate for chemicals, and it adjusted 1989 parts costs by a standard inflation formula. At hearing, the utility increased its chemical cost estimate to reflect the judgment of its new treatment plant operator that prior estimates had been misstated because of inaccurate meter interpretation. (Exhibit 21.) The utility did not produce a witness who could testify knowledgeably about the estimate. Therefore, the data could not be verified by Branch through independent analysis or cross-examination. For these reasons, our adopted rate includes some but not all of the utility's new estimate.

5.4 Contract Work

This account includes laboratory charges for tests required by the Department of Health Services and the Regional

Water Quality Control Board. Branch bases its estimate on the tests that actually are required for test year 1991, and its estimate of other contract work is based on recorded 1990 expenses adjusted for inflation. The utility's estimate averages previous contract work, at least some of which is now done by the two full-time employees. We adopt Branch's estimate.

5.5 Construction Rate Adjustment

Northshore Construction Company, owned by a relative of Adcock, did excavation work for the new treatment plant at a cost of about \$65,000. Branch recommends disallowance of \$13,665, or 50% of the relative's \$30 hourly supervision rate, on grounds that the practice presents an appearance of impropriety. Adcock acknowledges that the practice presents "obvious opportunities for abuse," and he states that the practice has been discontinued. (Ex. 39, at 2.) The evidence shows that the Northshore work was done at or below prevailing cost, and there is no showing of impropriety. We will not at this time impose a disallowance.

5.6 Transportation

Branch and the utility agree on heavy equipment rental costs for the test year, but they disagree on costs of two pickup trucks leased from G&L Leasing, an Adcock-owned subsidiary. Branch proposes that the mileage rates for the leased trucks be 26 cents per mile, the Internal Revenue Service vehicle rate. The utility testified that the two pickup trucks are leased at actual cost (35 cents per mile) to CUS, and that this rate includes all fuel and maintenance for the vehicles. The evidence supports the utility's justification for the cost of the vehicles, but the utility has not in our judgment rebutted Branch's evidence of required mileage. We allow the utility's 35-cent rate, but we have adjusted mileage to reflect Branch's estimate.

5.7 Office Salaries, Equipment, and Supplies

Branch for the most part accepts the utility's estimates for office salaries, equipment, and supplies allocated to the sewer

utility. However, Branch recommends that billing be done quarterly in advance rather than monthly in advance. If the Commission directs the utility to make this change in billing frequency, Branch estimates that many of the office costs would be reduced by two-thirds, since the billing function would be performed once every three months instead of monthly.

On cross-examination, Branch's witness acknowledged that the idea for quarterly billing came from isolated comments at the public participation hearing. Branch has not interviewed customers on their billing preference, nor has it considered what costs, if any, are involved in a billing system changeover. Branch estimates that quarterly billing would save more than \$12,000 annually, but direct savings (postage, billing forms, envelopes) would be approximately \$3,000. The other \$9,000 would involve reallocation of shared personnel costs from the sewer utility to other Adcock-managed utilities. Homeowners had this comment:

"The Homeowners question the staff assumption that many customers would prefer quarterly billing. At the public participation hearing we only recall that one customer indicated that other sewer districts in Monterey County bill on a quarterly basis. Quarterly billing when rates are being substantially increased could be a burden to many customers." (Brief of the Coalition of Homeowners Associations, at 6.)

The utility states that it does not oppose quarterly billing in principle, but it is reluctant to make such a change without surveying customers and analyzing actual cost impact. We agree that, speaking generally, responsible management can best decide such matters as billing frequency. Absent compelling

circumstances, the Commission avoids micromanagement.⁷ Branch has not presented sufficient evidence to justify quarterly billing, although it has shown that some adjustments are warranted in the office services and supplies account. We adopt the utility's estimates in office personnel, service and supplies, with minor adjustments, based on the current monthly billing practice.

5.8 Management Salaries

The utility requests a management salary of \$18,000 annually as compensation for the services of both Mr. and Mrs. Adcock. Branch recommends \$12,315, basing this on the total 1990 management salaries paid to the Adcocks as apportioned by number of customers served by each of the Adcock companies. The utility argues that at least one sewer utility pays its manager more than \$18,000⁸ and that the Adcocks, as managers, obviously deserve a salary of more than \$12,315. The question, however, is not the value of the managers' compensation with respect to this utility. The question is what salary draw is reasonable from CUS operations for the owner-managers of CUS and other utilities. Branch's computation, based on total salary draw divided by number of customers for each utility managed by the Adcocks, is a reasonable one. The utility's computation, based on value of the services of the individuals involved, provides no guidance, since any such valuation is subjective. We adopt Branch's recommendation.

5.9 Employee Benefits

Since we have rejected Branch's proposal for quarterly billing, we adopt the utility's allocation of group insurance,

⁷ See, e.g., Re Southern California Edison Company (1990) 37 CPUC 2d 488, 569 ("This Commission is mindful of actions which appear to substitute Commission decision-making for the judgment of utility management....").

⁸ See Watertek, Inc., Resolution W-3547, issued March 13, 1991.

pension, and worker compensation costs for employees for the test year.

5.10 Professional Services

Branch's estimate for legal and engineering fees is lower than the utility's estimate because the utility included fees for sprayfield condemnation and surveying as operating expenses. These charges have been accounted for in plant additions. Branch's estimate is adopted.

5.11 Rate Case Expense

Branch accepts the utility's estimate of \$15,000 for costs incurred in connection with rate cases. It argues, however, that the expense should be amortized over 5 years, instead of 3, since the utility is likely to file advice letters rather than initiate another rate case in 3 years. The \$15,000 estimate reflects costs of this proceeding. We see no reason to depart from a standard three-year amortization period,⁹ and we adopt the utility's recommendation.

5.12 General Expense

Branch excluded bank charges from the general expense account, reasoning that such charges are part of working cash allowance when warranted. We agree.

6. Other Matters

6.1 Working Cash Allowance

The utility requests a working cash allowance of \$16,885. The Commission's practice is to grant a working cash allowance if customers are billed in arrears, and to deny a working cash allowance if customers are billed in advance. (See, Standard Practice U-16, Determination of Working Cash Allowance.) The utility bills its customers at a flat rate 30 days in advance. No

⁹ California-American Water Co. (1983) 12 CPUC 2d 389.

showing has been made justifying a departure from Commission practice. The working cash allowance is disallowed.

6.2 Depreciation, Expense, Taxes

Both Branch and the utility use a depreciation rate of 3.927% for test year 1991. The differences are due to the rate base recommendations of the parties, and to the adjustment for work by Northshore Construction. Differences in the franchise tax, property tax, and income tax recommendations are the result of the parties' different calculations of gross revenues, rate base, and taxable income. The depreciation and tax estimates based on our findings on these issues are set forth in Appendix A.

7. Rate of Return

Compensation of the investor is expressed in terms of a percentage rate of return that, when multiplied by the dollar rate base, produces a dollar return. In order for a utility to provide proper service and to maintain financial integrity, its return must be adequate to service existing debt and to permit the investor to earn a reasonable return.

CUS proposes a 12.64% rate of return based on the following cost of capital elements as of December 31, 1990:

<u>Description</u>	<u>Amount</u>	<u>Ratio</u>	<u>Cost</u>	<u>Weighted Cost</u>
Long-term Debt	\$390,764	41.19%	12.12%	4.99%
Common Stock Equity	<u>558,015</u>	<u>58.81</u>	<u>13.0</u>	<u>7.65</u>
Totals	\$948,779	100.0%		12.64%

Branch's investigation, however, revealed that the utility's long-term debt represented personal borrowing by Adcock, and the utility had neither sought nor obtained Commission approval to incur this debt, as required by PU Code § 823. As a result, Branch regards the utility as 100% equity financed, and it

recommends a rate of return of 10.75%. That rate of return is the midpoint of the standard rate of return (from 10.50% to 11%) recommended by the Commission Advisory and Compliance Division (CACD) as of April 20, 1989.¹⁰

The utility's accounting witness testified initially that the failure to obtain Commission approval for borrowing had been an oversight. Later, the utility argued that it had not had time to seek approval of the loans because of the requirements of this rate proceeding. On brief, the utility argued that the loans were intended initially to be short-term borrowing (for which Commission approval is not required), and it is only now, when the loans are to be rolled over as long-term debt, that it is required to seek approval under Section 823.

A fair rate of return should fall somewhere between inadequate earnings and excessive earnings, and its determination weighs several factors, including ability to attract capital, economic risk, quality of service provided, and cost of capital. (Hope Natural Gas Company (1942) 320 U.S. 591.) As to service, Branch notes that CUS has no outstanding compliance requirements ordered by the Commission. In the past three years, the utility has had no informal complaints filed with the Commission's Consumer Affairs Branch. At the public participation hearing, the only service complaints raised were that the utility had failed to bill a number of customers because of poor recordkeeping, a situation that the utility states it has now remedied.

We find unpersuasive the utility's defense of its failure to obtain Commission approval of its debt. On the other hand, we recognize the reality that debt exists, and we note that the Commission contemplated borrowing to finance required improvements

¹⁰ See Memorandum, April 20, 1989, "Fair and Reasonable Rate of Return for Small Water Utilities."

in D.87-05-033.¹¹ Assuming CUS seeks and obtains approval for incurring long-term debt, it may at a later time file for a different rate of return.¹²

We agree with Branch that, on this record, we must regard the utility as 100% equity financed and, therefore, subject to applicable Commission guidelines for rate of return. However, the record is clear that CUS has rescued a failing sewer utility and restored quality service to ratepayers. For that reason, we adopt an 11% rate of return as fair and equitable on this record.

8. Excess Gross-up Revenue and Audit

Capital improvements to the utility's sewer system have been financed primarily by contributions from developers in order that the system could serve additional homes. Since 1987, pursuant to this Commission's decision in Re Tax Reform Act of 1986 (1987) 25 CPUC 2d 299, the utility has, in addition to contributions, received gross-up amounts to cover anticipated federal taxes on the contributions. However, because the utility has operated at a loss since the CUS takeover, the utility apparently has incurred no income tax liability during at least the years 1987 and 1989.

Homeowners, through their representative and witness John D. Reader, introduced evidence showing that the utility has collected for the years 1987 through 1989 more than \$200,000 in gross-up dollars that it has not had to pay in federal taxes. Reader testified that, based on his understanding of the Tax Reform

11 See D.87-05-033, Finding of Fact 12: "The \$400,000 shortage [required for improvements] is expected to be reduced by about \$250,000 when one of the developers deposits his contribution. CUS can borrow the remaining \$150,000."

12 See CACD Memorandum, supra, at 2: "To determine a fair and reasonable rate of return for utilities having capital structures comprised of debt and equity, we maintain our previous recommendation that advice letter filings be reviewed on an individual basis."

Act decision, the utility either should have refunded that amount to developers or, preferably in his judgment, included it in contributions or deducted that amount from operating expenses. If the tax gross-ups are credited to contributions in aid of construction, they serve to reduce the rate base.

Branch did not examine the gross-up revenue issue in its investigation. However, it supports the recommendation of Homeowners. At hearing, all parties appeared to agree that \$214,000 in tax gross-ups should be added to contributions in aid of construction, thus reducing rate base. The \$214,000 was derived from the calculations of the utility's expert, John J. Gibbons. We will adopt \$214,000 as part of contribution in aid of construction.

We do not reach in this proceeding the question of whether CUS is required to refund to developers tax gross-ups collected for periods in which no tax liability occurred. The utility's income tax status is not clear on this record, nor has the utility filed a tariff change dealing with refund of tax gross-ups as contemplated by the ordering paragraphs of the Tax Reform Act decision. (25 CPUC 2d at 337.) Moreover, the evidence suggests that all contributions received from developers, including gross-up amounts, have been applied to the utility's construction program and other costs.

9. Current Tax Liability

The utility's regulatory expert Gibbons testified that CUS erroneously had failed to book certain contributions as income in 1988 and that this error, in his judgment, means that CUS has a current federal tax liability of \$81,035. He testified that an amended tax return will have to be filed, and that the final liability may change depending on adjustments. The utility's liability, if any, for past taxes has little or no bearing on setting rates for the future. Appendix A makes no adjustment for this potential liability.

10. Response to Motions

On the final day of hearing, the utility moved that the Commission accept for filing, as part of this proceeding, a modified advice letter dealing with sewer main extension rules. The original advice letter filing had been rejected by Branch because, in Branch's view, it did not comply with notice requirements of General Order 96-A. Although an objection to the modified filing was sustained at hearing, both the utility and Branch have made motions in their briefs to have the Commission rule in this proceeding on the sewer main extension filing. We believe that the matter is properly the subject of an advice letter filing or, if the utility continues to disagree with Branch's response, a separate application.¹³ The motions related to the sewer main extension rules are denied.

Following hearing, Branch in its briefs moved that the Commission make its decision in this case an interim one, subject to refund, pending an audit of all Adcock-managed companies and additional hearings on the results of the audit. Branch would have us direct a second phase of this proceeding to deal with audit results. The utility states that it has no objection to the audit, but it argues that its books have been examined by Branch for several months as part of this proceeding, and it objects to a

¹³ The advice letter filing has been the subject of extensive correspondence between the utility and Branch. The utility argues that it should not have to send a copy of a 14-page tariff filing to all 1,000 of its customers when, it alleges, only developers are affected. Branch's position is that the subject may be of wider concern than the utility states, and that the utility need only prepare a Branch-approved description of the change for circulation to ratepayers. We gather that Branch contemplates a bill insert that can be accomplished at little or no additional cost to the utility. While that would appear to be a reasonable resolution of the dispute, the utility if it disagrees may proceed by way of application.

delay in final resolution of this rate proceeding. Branch's motion to require a second phase in this proceeding is denied.¹⁴

11. Future Plant Expansion

The interim rate increase granted in this proceeding (from \$8.47 to \$11.94 monthly) was a 41% increase for ratepayers. The final rate increase (from \$11.94 to \$22.40) represents another 88% increase. The increase from \$8.47 to \$22.40 constitutes a 164% increase for ratepayers. While this compares favorably, from a ratepayer's point of view, with the 299% increase sought by the utility, the magnitude of the increase is troubling. The record in this proceeding shows that ratepayers have enjoyed an artificially low rate for some years. Additionally, however, the record shows that owner investment and operating costs for the sophisticated new waste water treatment plant are greater than the utility had estimated.

With the steady growth in customer base that the utility has experienced, additional plant may be required within a few years. Branch proposes, and we agree, that our order should require that any further plant improvement be the subject of notice and customer comment if rate base is affected significantly. Accordingly, our order provides that if total annual plant improvement by CUS will increase rate base by 25% or more, CUS must first provide notice to ratepayers and to Branch. The notice should identify the intended improvements, estimate costs and effect on rates, and state effects on service and any alternatives

¹⁴ Branch states that its audit was ordered, pursuant to PU Code § 314, in early June. CUS is a relatively small utility, and any significant audit result affecting the decision in this case presumably could be filed by either party during the decision review period and prior to the Commission's final order. Alternatively, either party may move to modify or seek another proceeding should the audit disclose material discrepancies that cannot be dealt with by agreed adjustments.

the utility considered. The utility should provide 20 days for the customers to respond. At the end of that time CUS should forward all customer comments to the Water Branch.

If customer response to such notice is significant, the utility and Branch should conduct a public meeting to further explain the improvements. After the meeting, Branch should recommend whether the utility should proceed by way of application for Commission authorization for any or all of the disputed improvements.

12. Comments: Administrative
Law Judge's Proposed Decision

In accordance with PU Code § 311 and Rule 77.1 of the Rules of Practice and Procedure, the draft decision prepared by the administrative law judge was mailed to parties on August 28, 1991. No party has filed comments. Apart from minor corrections, therefore, the text of the draft decision is unchanged.

Findings of Fact

1. CUS, a California sewer utility, provides service to approximately 1,000 ratepayers in the Toro area, four miles southwest of Salinas.

2. Principal shareholders of CUS are Robert T. (Tom) Adcock and N. Patricia Adcock. The Adcocks also are principal shareholders of Alisal Water Corporation and Toro Water Service, Inc.

3. CUS acquired the sewer system in March 1986 under authorization granted by the Commission in D.87-05-033.

4. Before the acquisition, the sewer system had been effectively abandoned by its previous owners and was in a state of disrepair.

5. CUS has conducted an expansion and rebuilding program that has brought the system up to contemporary standards.

6. The rebuilding program includes a new SBR waste treatment plant, expanded sprayfields and related equipment.

7. The additional sewer system facilities have nearly doubled CUS's operating costs.

8. Branch's reconstruction of original cost, less depreciation, based on Commission records developed soon after the utility was dedicated to public service, provides the most reliable and equitable basis for establishing rate base.

9. The utility's estimate of customer base for test year 1991 and its rate design are uncontested on this record.

10. Branch's estimate of energy use, based on records of actual use, is more credible than the utility's evidence of estimated future use.

11. Some part-time labor is required to back up two full-time employees in operating the new waste water treatment plant and sprayfields, but the utility has not rebutted Branch's showing that use of part-time labor can be minimized.

12. The evidence supports the utility's proof of some, but not all, of its material cost estimates for test year 1991.

13. The utility has not rebutted Branch's showing of contract work costs based on actual testing requirements and recorded expenses adjusted for inflation.

14. Branch has not presented evidence of impropriety in excavation work performed by a relative of the utility's owners, and Branch's recommendation for a disallowance is rejected.

15. The utility has established that 35 cents per mile is an actual and reasonable cost of leased trucks, but it has not rebutted Branch's estimate of reasonably necessary mileage.

16. Branch has failed to show that a change to quarterly billing, instead of monthly billing, should be required.

17. The utility has not established a reasonable basis for its recommendation of manager salary.

18. The utility has not rebutted Branch's showing of reasonable professional service fees.

19. Branch has failed to justify its recommendation that rate case costs be amortized over 5 years instead of 3.

20. The utility has failed to justify a working cash allowance when its practice is to bill in advance rather than in arrears.

21. The utility has failed to rebut Branch's showing of 100% equity ownership, but the utility has shown that its quality service to ratepayers justifies an 11% rate of return.

22. Homeowners have established that gross-up payments by developers may equitably be deemed contributions in aid of construction, thus reducing rate base.

23. Neither the utility nor Branch has presented evidence showing that the utility's sewer main extension rule should be decided in this proceeding rather than through an advice letter filing or separate application.

24. Branch has failed to meet its burden in proposing that this proceeding should remain open pending an audit of Adcock-managed utilities.

25. Branch has persuasively shown that further plant improvements that will increase rate base by 25% or more should be subject to public notice and, in the event of significant opposition, to approval by the Commission.

26. The increase in rates authorized by this decision is expected to provide annual revenues of \$275,450. ✓

Conclusions of Law

1. The application should be granted as set forth in the opinion and CUS should be authorized to increase its rates as set forth in Appendix B, the adopted rates being just, reasonable, and nondiscriminatory.

2. Because of the immediate need for additional revenues, the following order should be effective on the date of signature, and revised tariff schedules should be effective five days after filing.

3. The adopted rate base is reasonably estimated by Branch at \$419,492. The rate base is calculated from historical cost data contained in A.53991, filed in 1973, by Salinas Utility Services, a CUS predecessor, and from CUS plant costs for the period 1974-1991.

4. The adopted Summary of Earnings for test year 1991 (Appendix A) sets forth reasonable estimates of the levels of revenues and expenses.

5. A rate of return of 11% on the adopted rate base is reasonable.

6. The utility should be permitted to continue its service-connection rate multiple for service to a school and to a country club.

7. The utility should give notice of any future plant improvement expected to increase rate base by 25% or more within a one-year period, consistent with this decision.

ORDER

IT IS ORDERED that:

1. California Utilities Services, Inc. (CUS) is authorized to file the revised tariff schedule attached to this decision as Appendix B and to concurrently cancel its present schedule for such service. The filing shall comply with General Order Series 96. The effective date of the revised schedule shall be 5 days after the date of filing. The revised schedule shall apply only to service rendered on and after its effective date.

2. Any further plant improvement that would increase rate base by more than 25% in a 1-year period shall not be implemented without notice to the Commission and to ratepayers and opportunity to comment, as described in this decision.

3. Motions by the parties related to a main extension rule filing and to a proposed second phase of this proceeding are denied.

4. This proceeding is closed.

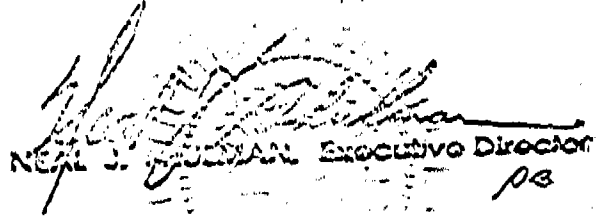
This order is effective today.

Dated OCT 11 1991, at San Francisco, California.

JOHN B. OHANIAN
DANIEL Wm. FESSLER
NORMAN D. SHUMWAY
Commissioners

Commissioner Patricia M. Eckert,
being necessarily absent, did not
participate.

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


NEAL J. JORDAN, Executive Director
PB

APPENDIX A

CALIFORNIA UTILITIES SERVICES, INC.
SUMMARY OF EARNINGS
Test Year 1991

Item	Utility Estimated		Branch Estimated		Adopte
	Present	Requested	Present	Requested	
	Rates	Rates	Rates	Rates	Rates
Operating Revenue					
Gross-up Excess	\$ 0	\$ 0	\$ 16,207	\$ 16,207	\$
Flat Rate	97,676	408,045	97,676	408,045	275,45
Total Revenue	97,676	408,045	113,883	424,252	275,45
Operating Expenses					
Power	29,454	29,454	27,713	27,713	27,71
Other Vol. Related Expn.	0	0	0	0	
Employee Labor	58,819	58,819	48,005	48,005	53,41
Materials	24,677	24,677	17,433	17,433	21,05
Contract Work	10,537	10,537	7,547	7,547	7,54
Transportation Expense	14,540	14,540	10,183	10,183	10,89
Other Plant Maintenance	0	0	0	0	
Office Salaries	16,973	16,973	9,124	9,124	16,97
Management Salaries	18,000	18,000	12,315	12,315	12,31
Employee Benefits	8,446	8,446	9,712	9,712	8,44
Uncollectibles	0	0	0	0	
Office Services & Rental	5,256	5,256	3,391	3,391	4,57
Office Supplies	6,688	6,688	2,716	2,716	5,50
Professional Services	3,283	3,283	1,800	1,800	1,80
Insurance	2,676	2,676	2,676	2,676	2,67
Regulatory Expense	5,000	5,000	3,000	3,000	5,00
General Expense	1,392	1,392	516	516	51
Subtotal	205,741	205,741	156,131	156,131	178,42
Depreciation Expense	36,704	36,704	30,080	30,080	20,99
Franchise Tax	8,173	8,173	5,998	5,998	5,50
Property Taxes	8,050	8,050	6,409	6,409	4,19
Payroll Taxes	5,096	5,096	5,825	5,825	5,82
Income Taxes	800	30,865	800	26,562	14,34
Total Deductions	264,564	294,629	205,243	231,005	229,29
Net Revenue	(166,888)	113,416	(91,360)	193,247	46,15
Average Plant	3,391,395	3,391,395	2,562,600	2,562,600	2,931,46
Avg. Accum. Depreciatn.	529,077	529,077	167,922	167,922	307,53
Net Plant	2,862,318	2,862,318	2,394,677	2,394,677	2,623,92
Less: Advances	0	0	0	0	
Contributions	1,888,431	1,888,431	1,660,270	1,660,270	2,110,94
Defer. Income Tax	93,496	93,496	93,496	93,496	93,49
Plus: Working Cash	16,885	16,885	0	0	
Mat'l & Supplies	0	0	0	0	
Rate Base	897,276	897,276	640,911	640,911	419,49
Rate of Return	(loss)	12.64%	(loss)	30.15	11.0

(END OF APPENDIX A)

APPENDIX B

CALIFORNIA UTILITIES SERVICES, INC.

Schedule No. 1

GENERAL FLAT RATE SERVICE

(T)

APPLICABILITY

Applicable to all sewer service.

(T)

TERRITORY

An area midway between the cities of Salinas and Monterey in the vicinity of and along State Highway 68, Monterey County.

RATES

	<u>Per Month</u>	
All service connections, except as follows	\$ 22.50	(I)
Toro Park School	315.00	(I)
Corral de Tierra Country Club	180.00	(I)

SPECIAL CONDITIONS

(N)

1. All bills are subject to the reimbursement fee set forth in Schedule No. UF.
2. Bills will be rendered in advance of the period for which service will be provided.
3. The above rates for individual-named customers are based upon an equivalent number of single-family residential service connections. Customers so classified may appeal the classification to the Commission under the provisions of Rule No. 10, Disputed Bills.

(I)
(I)
(I)
(I)
(I)
(I)
(I)
(I)
(I)
(I)
(N)

(END OF APPENDIX B)

APPENDIX C
 CALIFORNIA UTILITIES SERVICES, INC.
COMPARISON OF RATES

A comparison of the present and adopted rates is shown below:

General Flat Rate Service:

Interim Rate Increase granted by Decision 91-02-035:

	<u>Per Service Connection Per Month:</u>		
	<u>1990</u>	<u>Present</u>	<u>Percent</u>
	<u>Rate</u>	<u>Rate</u>	<u>Increase</u>
Individual service Connections	\$ 8.47	\$ 11.94	41.0%

Adopted Rate Increase:

	<u>Per Service Connection Per Month:</u>		
	<u>Present</u>	<u>Adopted</u>	<u>Percent</u>
	<u>Rate</u>	<u>Rate</u>	<u>Increase</u>
Individual service Connections	\$ 11.94	\$ 22.50	88.4%

* * *

(END OF APPENDIX C)

APPENDIX D

Page 1

CALIFORNIA UTILITIES SERVICES, INC.

ADOPTED QUANTITIES

Test Year 1991

Expenses:

1. Power, Pacific Gas and Electric Company

Rate Schedule No. AG-1 (Effective date, January 1, 1991):

kWh used	10,550	
Rate, per kWh	\$ 0.13690	
Amount		\$ 1,444
Customer Charge:		
Number of meters	1	
Rate, per meter per month	\$ 10.00	
Amount		\$ 120
Demand Charge:		
Number of Horsepower	5	
Rate, per Horsepower per mo.	\$ 2.10	
Amount		\$ 126
Subtotal, Schedule AG-1	\$ 1,690	

Rate Schedule No. A-10 (Effective date, May 10, 1991):

Winter:

kWh used	128,170	
Rate, per kWh	\$ 0.07497	
Amount		\$ 9,609

Summer:

kWh used	128,170	
Rate, per kWh	\$ 0.09673	
Amount		\$ 12,398

Customer Charge:

Number of meters	1	
Rate, per meter per month	\$ 63.00	
Amount		\$ 756

Demand Charge:

Number of kW per year	815	
Rate, per per kW	\$ 4.00	
Amount		\$ 3,260

Subtotal, Schedule A-10 \$ 26,023

Total Power \$ 27,713

APPENDIX D
Page 2

ADOPTED QUANTITIES
(continued)

2.	Purchased Water	None
3.	Payroll and Employee Benefits:	
	Employee Labor	\$ 53,412
	Office Salaries	16,973
	Management Salaries	<u>12,315</u>
	Total	\$ 82,700
	Payroll Taxes	\$ 5,825
4.	Ad Valorem Tax:	
	Tax Rate	1.00%
	Assessed Valuation	\$ 419,492
	Tax	\$ 4,195
5.	Laboratory Expense (in Contract Work)	\$ 6,371
6.	Number of Services:	
	General Flat Rate Service	1,020

INCOME TAX CALCULATIONS
Test Year 1991

: Line :	:	State	Federal
: No. :	Item	Tax	Tax
1	Operating Revenue	\$ 275,450	\$ 275,450
2	Expenses	178,427	178,427
3	Taxes Other than Income	15,497	15,497
4	Depreciation	20,994	20,994
5	Interest	0	0
6	Taxable Income for State Tax	60,500	
7	State Tax @ 9.3% (\$800 min.)	5,627	
8	Taxable Income for Federal Tax		54,874
9	Federal Tax @ 15% of 1st \$50,000		7,500
10	Federal Tax @ 25% of next \$25,000		1,218
11	Total Income Taxes	\$ 14,345	

(END OF APPENDIX D)