

ORIGINAL

Decision 82 05 011 MAY - 4 1982

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application for transfer of assets)
and liabilities from THE DESCANSO)
PARK WATER CO. to THE SWEET WATER)
WORKS, INC.)

Application 60882
(Filed September 8, 1981)

Lorenzo W. Milan, for Sweet Water Works; and Wendel S. Skinner and LeRoy J. LaFrentz, for Descanso Park Water Co.; applicants.
Courton & Associates, by Lawrence Buxton, for Merigan Ranch; and George M. Ream and Peter G. Bradley, for customers of Descanso Park Water Co.; protestants.
Jasjit S. Sekhon, for the Commission staff.

O P I N I O N

By this application, Descanso Park Water Co. (DPWC), a California corporation, seeks authority to transfer its assets, liabilities, and certificate of public convenience and necessity to The Sweet Water Works, Inc. (buyer). DPWC's sole stockholder is LeRoy J. LaFrentz, who has operated DPWC for over three decades. LaFrentz is 77 years of age and wants to retire. Buyer is a newly formed California corporation. Its principal stockholder, Lorenzo W. Milan, is an investor/entrepreneur.

DPWC's customers are concerned over what the effects of the proposed transfer, if consummated, might be on water supply, rates, and service. Peter G. Bradley and George M. Ream appeared as protestants on behalf of many of DPWC's customers at the public hearing in this matter held before Administrative Law Judge Main on March 16 and 17, 1982 at Descanso.

DPWC's service area is located near the unincorporated community of Descanso in San Diego County. The service area varies in elevation from approximately 3,400 feet to approximately 3,600 feet. The source of water supply is the local groundwater table. DPWC serves nearly 300 metered customers.

The State Department of Health Services prepared a report dated November 10, 1981 listing various deficiencies in DPWC's water system and operating practices. Some of the deficiencies are: improperly vented wells, incomplete water sampling, and an incomplete distribution system map. The deficient operating practices have since been corrected and the system deficiencies cited are being worked on. The State Department of Health Services is satisfied, according to our staff, with DPWC's efforts in correcting the deficiencies.

Proposed Purchase

The price for the purchase of the utility is \$361,517.

According to the Letter of Intent, which is attached to the application, and Exhibit 6, the staff report, (1) purchase price is apportioned:

a. Water Utility	\$300,000
b. Water Utility Land	24,607
c. Realty Owned by LaFrentz	36,910

and (2) purchase is to be accomplished by buyer's:

a. Assuming existing encumbrances:

Small Business Administration (SBA) Loans	\$50,000
Bank of America Loan for 1976 Case Tractor	6,000
Getchell Contract Balance	17,770
Outstanding Main Extension Advances	<u>5,747</u>
Total	\$79,517

b. Making \$25,000 cash down payment
upon close of escrow

c. Issuing the following:

Note Due LaFrentz 9 Months After Close of Escrow, Interest Rate of 12½%	\$ 20,000
Note Due LaFrentz 18 Months After Close of Escrow, Interest Rate of 12½%	15,000
Note Due LaFrentz in Monthly Installments of \$2,186.13 for 15 Years, Interest Rate of 8½%	222,000

Price Exceeds Rate Base

From DPWC's 1980 annual report to the Commission, staff developed, as shown in Exhibit 6, a rate base of \$97,040. Although some or most of the plant funded from the above-tabulated SBA loans may not have been built until 1981, it can be gathered from the 1980 vintage rate base and the amount of those loans that the purchase price of \$361,517 exceeds rate base by at least \$200,000.

In a statement dated August 20, 1981 appended to the application, an increase in rate base was requested: "...the buyers and sellers jointly petition the PUC, as part of their application, to increase the rate base of Descanso Park Water Co./Sweet Water Works to \$300,000 to reflect the value of the assets (minus land) as paid by the buyers." In regard to this request John D. Reader, chief hydraulic engineer of the Commission, wrote to buyer on September 18, 1981 in part as follows:

"Justification for reappraising a public utility water system would have to be supported in detail on a day-to-day basis from records of time spent with verification that Mr. LaFrentz actually did this work and was not adequately compensated.

"Another more costly approach would be to hire an engineer to prepare an original cost appraisal and depreciation reserve study. Either approach should be discussed with the Finance Section of the Revenue Requirements Division.

"The Commission would have to approve the restatement of the utility's books. This has never been done to my knowledge in a transfer proceeding. In any event, it would require detailed studies by the utility or its consultant, checking by the staff and if acceptable by the staff, presentation to the Commission for its approval.

"We must advise the buyers that the Commission is unlikely to consider the joint request to increase the rate base in this proceeding.

"The Commission will want a statement from the buyers that they are aware that the rate base is only about \$104,300 and that they could not expect to earn a return on the purchase price."

We set rates based on historical or net cost rate base. Rate base is not adjusted either up or down when a utility is transferred. Customers should not be subjected to rate changes due to the purchase price for utility property. This ensures

Continuity of rate base irrespective of sales price when assets or control changes hands. The buyer and seller should not hold a false expectation that for rate setting purposes rate base will be adjusted after the sale; it would only be adjusted if seller could show the net historical cost was not accurately booked.

By letter dated October 1, 1981, LaFrentz and Milam responded in part as follows:

"In letter received by us, dated 18 September 1981, Mr. John Reader of the PUC indicated that our application for change of rate base was inappropriate in the transfer application.

"For that reason, in this letter, we are requesting that the PUC delete our request for increase in rate base, but continue to process our application for transfer of the Descanso Park Water Company.

"Purchaser hereby acknowledges that the rate base as of the present moment is \$104,300 --- and agree that with that rate base, Sweet Water Works could not expect an early return on purchase price.

"Purchaser, however, stipulates that this does not preclude the Sweet Water Works from requesting rate base change at a later date based on adequate information to be supplied by the applicant."

Limitation on Debt

In Exhibit 6 our staff recommends that upon its sale or transfer, if approved, the water utility should not carry long-term debt in excess of 50% of rate base to avoid burdensome debt service requirements. The statement in Reader's letter of "not expecting to earn a return on the purchase price" is thus only part of what is required in staff's view to make the transaction acceptable. It is also necessary (1) to limit long-term debt to 50% of rate base and (2) presumably to segregate for accounting and ratemaking purposes the difference between the purchase price of utility plant, on the one hand, and its original cost less depreciation, on the other hand.

Further, through its tie to rate base, it is implicit that staff's recommendation applies to used and useful utility plant, including land belonging to DPWC. It does not apply to real property owned by LaFrentz which is not used by the public utility. The latter property should not have been included in the application in the first place, since its transfer or sale does not require Commission approval.

Bottled Water Venture

In his testimony, on behalf of buyer, Milam stressed that the Descanso ratepayers eventually will bear the brunt of more costly water service regardless of what entity, including a district, serves the area. Even so, he does not expect the public utility operation itself, if acquired by buyer, to be profitable. He seems to believe that there will be profits, however. In his view the profits could come from the land being acquired, from a bottled water business, or from some other as yet unidentified but associated venture.

Although it is apparent from his testimony that these nonpublic utility ventures not only are highly conjectural but have not been planned properly or even thought through, the customers of DPWC are nonetheless deeply concerned that a bottled water business might jeopardize their water supply. Many of the approximately 50 letters received by the Commission from the water company's customers have expressed this concern. In Exhibit 6 staff addressed this matter as follows:

"The Hydraulic Branch Engineer has reviewed the utility's water supply and is of the opinion that the utility has enough water to serve its present customers. However, buyers have expressed an intention to use the utility water for bottling operation and sell it in health food stores. During the field investigation, the buyers informed the Hydraulic Branch Engineer that since the planning for the bottling operation was in preliminary stages, no information relating to the amount of water required for such operation was available. Some of the 21 customers who wrote to the Commission were concerned that the excessive bottling operation could adversely affect the local ground water table. Prior to commencing a large scale bottling operation, the buyers should prepare a detailed ground water basin study showing total annual recharge and extractions."

In Exhibit 5 Milan, for buyer, responded as follows to the foregoing staff assessment:

". . . It is our stand that (1) the water utility is --- at present --- operating at a less than break-even level; (2) any such requirements --- for engineering studies or financing different than the one proposed --- will increase, drastically, the cost of operating the utility; thus (3) Sweet Water Works will consent to such onerous conditions only if the new utility is permitted to bill the customers of Descanso for the additional costs, and in the billing, cite Public Utility Commission requirements as the reason for rate hikes. We feel strongly about this because such engineering studies and changes in financing mean that the PUC is substituting its judgement for those of the investors in Sweet Water Works, and we are sure that such requirements will radically undercut our plans to operate an efficient utility with any ancillary businesses we may deem necessary to increase the cash flow of The Sweet Water Works."

Concerning this matter Ream, for DPWC customers, stated:

"...we believe no attempt to export water out of this basin will be tolerated by citizens in this valley until a complete and precise basin groundwater study has been completed. Such an analysis must, among other things, determine overall future basin needs; minimum safe yield under assumed 30 year drought conditions; the actual groundwater profiles; movements and agreement on long term minimum recharge rates. I am told by experts such a study could well exceed a minimum estimate of \$50,000 with a \$100,000 price tag a more likely sum. . . ."

Formation of a District

Buyer's proposed purchase of the water system and speculative bottled water venture have spurred DPWC's customers into action. On March 1, 1982 an application was tendered for filing with the San Diego County Local Agency Formation Commission (LAFCO) to establish a publicly owned community water district for Descanso under Government Code Sections 61000-61934. Exhibit 3 is a copy of that application, together with a petition signed by over 60% of the registered voters within the proposed district.

By notice dated March 10, 1982 (Exhibit 4) LAFCO advised that the application was incomplete in that (1) metes and bounds description of the perimeter of the proposed district and (2) proposed district budget, which are required before the application can be processed, were not provided.

Certain DPWC customers have obtained the services of S. M. Schmidt, a former executive officer of LAFCO, as a consultant. Schmidt testified that it would probably take about three years before a district could acquire the water system in Descanso (i.e., it would take approximately three years to obtain both the necessary approvals for the district's formation and the necessary financing). He further testified that unless the owners of the water company would agree to its sale to the new district, LAFCO may not approve the formation of the district.

As support for a district, Ream asserts there are the following advantages:

1. The ability to obtain a variety of funding sources to finance needed long-term improvements, including federal and state grants, low-interest loans, general obligation bonds, hookup fees, and service availability charges.
2. The ability to guarantee long-term local control and management of limited ground-water resources.
3. The ability to keep rates lower since the district is a nonprofit-making entity.

Ream also referred to our Resolution M-4708 dated August 28, 1979 which, among other things, states that the Commission will "support and promote the conversion of unviable or marginal water utilities to public ownership or their mergers with more viable entities when opportunities arise and customer service is more likely to improve through such change than without it." Bradley and Ream urge, on behalf of many of DPWC's customers, that the application before us be denied.

Staff's conclusions and recommendations, as set forth in Exhibit 6, are: (1) LaFrentz "is in excellent health and has the necessary experience, knowledge and background to efficiently manage a small water utility"; (2) buyer has "no prior experience in operating a small water utility"; and (3) if the request for the sale and transfer of the water system is granted, the long-term debt of the utility should not exceed 50% of rate base.

Discussion

As enunciated in Resolution M-4708, supra, it is Commission policy to encourage public ownership of small water companies. And the record in this proceeding clearly shows that community efforts toward forming a district are now underway. Equally clear, however, is that the three-year time frame required to make a district effective is too long for LaFrentz to have to wait for his retirement.

In its present form the proposed transaction for the sale and transfer of the public utility is unacceptable in the following respects:

1. DPWC's properties and those of LaFrentz are commingled. To the extent LaFrentz's property is not a part of used and useful utility plant of the water system, it should be excluded from the sale and transfer of the water system.
2. The purchase price greatly exceeds rate base. The public utility's capital structure, after the sale and transfer, should closely approximate rate base and be predominantly equity or if unavoidable, evenly divided between debt and equity.

3. There is a lack of definitive plans on the part of buyer for the management and operation of the public utility.
4. There must be a clear understanding on the part of buyer that no venture is to be undertaken that would jeopardize an adequate and reliable water supply to the water utility's customers.

It is up to DPWC and buyer to determine whether they are willing to and, if so, how they can restructure the proposed sale and transfer to make it acceptable. Clearly, the application, as it now stands, should be denied.

Findings of Fact

1. LaFrentz and Milam have signed a Letter of Intent dated June 5, 1981 regarding the purchase of DPWC.
2. The purchase covers both the public utility water system and real property owned by LaFrentz; the price is \$361,517 which is to be paid with a \$60,000 down payment spread over 18 months, assumption of approximately \$80,000 in existing debts and outstanding main extension balances, and payout of the balance of approximately \$222,000 over 15 years at an 8½% interest rate.
3. At year-end 1980, DPWC's rate base was approximately \$100,000.
4. Buyer, a newly formed California corporation, does not have definitive plans for the management and operation of a public utility. ✓
5. On March 1, 1982 an application was tendered for filing with LAFCO to establish a publicly owned community water district for Descanso under Government Code Sections 61000-61934. Approximately three years are required to form the district and obtain necessary financing.

6. To promote financial soundness, the public interest requires the total capital structure of the public utility, upon consummation of its sale and transfer, to closely approximate rate base and be predominantly equity or, if unavoidable, evenly divided between debt and equity.

Conclusions of Law

1. In its present form the proposed transaction for sale and transfer of the public utility is unacceptable.
2. The application should be denied without prejudice.

O R D E R

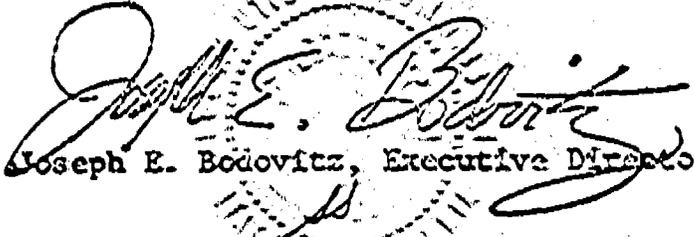
IT IS ORDERED that Application 60882 is denied without prejudice.

This order becomes effective 30 days from today.

Dated MAY 4 1982, at San Francisco, California.

JOHN E. BRYSON
President
RICHARD D. GRAVELLE
LEONARD M. GRIMES, JR.
VICTOR CALVO
PRISCILLA C. GREW
Commissioners

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


Joseph E. Bodovitz, Executive Director

3. There is a lack of definitive plans on the part of buyer for the management and operation of the public utility.
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2. The purchase covers both the public utility water system and real property owned by LaFrentz; the price is \$361,517 which is to be paid with a \$60,000 down payment spread over 18 months, assumption of approximately \$80,000 in existing debts and outstanding main extension balances, and payout of the balance of approximately \$222,000 over 15 years at an 8 $\frac{1}{2}$ % interest rate.
3. At year-end 1980, DPWC's rate base was approximately \$100,000.
4. Buyer, a newly formed California corporation, does not have definitive plans for the management and operation of public utility. SS
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