ALJ/nb *

Decision 82 11 054 NOV 17 1982

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of CITIZENS UTILITIES COMPANY of California for authority to increase rates and charges for water service in its Guerneville Water District.	Application 60220 (Filed January 27, 1981)
In the Matter of the Application of JACKSON WATER WORKS, INC. for authority to increase rates charged for water service in the City of Jackson and adjacent territory in Amador County.	Application 60048 (Filed October 31, 1980)
In the Matter of the Application of LARKFIELD WATER COMPANY for authority to increase rates and charges for water service in the unincorporated area of Larkfield Estates and vicinity in Sonoma County.	Application 60328 (Filed March 6, 1981)
In the Matter of the Application of CITIZENS UTILITIES COMPANY of California, for authority to increase rates and charges for water service in its Felton Water District.	Application 60285 (Filed February 23, 1981)
In the Matter of the Application of CITIZENS UTILITIES COMPANY of California for authority to increase rates and charges for water service in its Montara Water District.	Application 60253 (Filed February 10, 1981)

OPINION AFTER REHEARING

Procedure

On July 7, 1982, Decision (D.) 82-07-046 was issued which ordered rehearing of the following decisions: D.82-03-023, March 2, 1982; D.82-04-009, April 16, 1982; D.82-04-017, April 16, 1982; D.82-05-038, May 4, 1982; and D.82-05-076, May 18, 1982. Each decision involved water rate increases for a subsidiary or district of Citizens' Utilities Company (Citizens). The increases were in excess of 50% of previous rates but were limited to only 50% in the first year in order to lessen the immediate impact on customers of justified but unusually precipitous rate increases.

Rehearing was ordered to develop a record by briefs and pleadings of the propriety of our adopting Citizens' rate of return as the measure of compensation to Citizens for the deferred portion of the increases in rates.

Citizens' applications for rehearing were fully considered with staff's brief filed September 7, 1982.

Citizens' Position

Citizens urges that the compensation allowed for deferral of revenues is insufficient because (a) the method used in making the computation is erroneous and (b) an incorrect, inadequate cost rate was used to determine the compensation.

The method is erroneous, according to applicant, because the factor used is not compounded monthly and thus fails to reflect actual monthly, as opposed to annual, loss of revenues.

The cost rate is incorrect or inadequate, according to applicant, because the overall rate of return used, 12.04%, is not the current cost to Citizens of borrowing equivalent amounts of money. That cost should be the current cost of AAA debt of 16%, almost four percentage points higher than the factor we employed.

Staff's Position

Staff argues that the deferred revenues in these cases can be considered as reinvestment and, as such, should be compensated for at the same rate of return found fair and reasonable in the decision, i. e. 12.04%. However, staff makes the additional recommendation that the deferred revenues accrue interest at the authorized rate of return compounded monthly.

Discussion

As framed by the parties, our decision on the matter of appropriate compensation to a utility whose revenues are deferred by our rate policies turns on the view we take of the nature of the deferment. If we consider that our deferral policy constitutes a borrowing from the utility by us on behalf of the ratepayers, we should select a reasonable short-term interest rate to be paid by the ratepayers while they are in possession of the utilities' funds. If, on the other hand, we consider the deferred revenues as reinvestment by the utility in the form of working capital in rate base necessary to implement our rate policies, we should compensate the utility for the use of these dedicated funds by allowing the same rate of return on them as we allow for all other elements of rate base.

Citizens implicitly assumes that the revenue deferral is an enforced loan by it and argues that we should seek the correct interest rate to substitute for the 12.04% we used in the decision. If an annual interest rate is chosen, it should be properly escalated to reflect the annual yield derived by monthly compounding. Citizens suggests that we use 16% as that is the testimony of Citizens in these proceedings for the cost of AAA debt.

Applicant correctly points out that the rate of return allowed does not even purport to be an interest rate. It includes, for example, an embedded cost of debt of only 9.47%. Further, use of a composite cost of capital overlooks the fact that it is the equity holder that is being deprived of the current use of funds. Citizens does not explain why the cost of equity of 13.20%, rather than the 16% cost of long-term bonds, is not the logical conclusion of its argument.

One alternative suggested by staff is balancing account treatment for deferred revenues using a three-month commercial paper rate to be compounded monthly. According to staff, commercial paper, sold at a discount, offers the cheapest short-term borrowing cost, and as such is fair to both the utility and its customers.

However, staff rejects use of the three-month commercial paper rate or any other short-term interest rate in these cases. It perceives balancing account undercollections for those utilities where such treatment is authorized to pose significant short-term cash flow problems requiring the utilities to seek additional short-term financing. A utility's undercollection of expenses, as opposed to revenues, requires additional financing in equivalent amounts, goes the argument, and thus the utility must be compensated by a monthly interest rate.

In contrast, deferred revenues do not represent a cash outlay requiring external financing. In spite of the revenue deferred in the first year, staff asserts that revenues will still exceed expenses. Thus, no cash shortage arises and no borrowing is required.

There are difficulties with this argument. It seems to overlook the evidence summarized in the Sacramento decision (D.82-02-059, February 4, 1982, mimeo. page 10) that Citizens has $30,200,000 of commercial paper outstanding which we valued at 15%. Our deferral of Citizens' revenues obviously will result in the utility's being required to continue to carry the equivalent funds in debt.

Further, it is axiomatic that all sources of receipts and all types of disbursements go into the cash flow mix. We think that the loss of a dollar of revenue is no different than the increase of a dollar in expense in determining net cash balances at month's end. And, of course, those utilities with balancing accounts have the same excess of revenues over operating expenses that staff anticipates will be the case with Citizens.

Staff states that the recommendation of Citizens that we use the current cost of AAA debt of 16% should not be adopted because long-term debt cost is inappropriate to compensate for a 2- or 3-year revenue deferral.

As neither the short-term nor the long-term cost of debt is reasonable, staff suggests we accrue interest on the deferrals at both rates as they exist as components of the rate of return. In order to reflect the economic reality of the time value of money, however, staff recommends that the rate of return on the deferrals should be computed on a monthly, rather than a yearly, basis.

This latter thought does not square with staff's other recommendation that deferred revenues be considered as reinvestment and compensated for at the same rate of return found fair and reasonable in the decision. Compounding the annual rate of return monthly in the manner proposed by Citizens results in a different and higher rate than the 12.04% found fair and reasonable in the decision.

Moreover, it seems to us that the theories advanced by the applicant and staff are valid only under limited circumstances. When short-term interest rates are below the authorized rate of return, the revenues deferred as a result of our policy could be considered a reinvestment since this would be the rational response of profit-maximizing shareholders. However, when interest rates rise above the rate of return, the deferred revenues are more like a forced loan since the rational response of shareholders would be to invest their money elsewhere.

The incongruities discussed above point out the problem in adopting either theory. Nonetheless, we believe that the basic recommendation reached by the staff is the correct one. Revenues deferred as a result of our policy limiting first-year rate increases to 50% should earn the annual rate authorized for all rate base elements. The rate of return should be computed on a yearly basis. Because of the volatility of short-term interest rates, we believe this is the most feasible method of measuring compensation to Citizens for deferred revenues.

This return strikes a fair balance between the interests of shareholders and ratepayers. When short-term interest rates are below the authorized rate of return, shareholders will benefit. When short-term rates are above the rate of return, ratepayers will benefit.

Findings of Fact

1. On July 7, 1982, D.82-07-046 was issued which ordered rehearing of the following decisions: D.82-03-023, March 2, 1982; D.82-04-009, April 16, 1982; D.82-04-017, April 16, 1982; D.82-05-038, May 4, 1982; and D.82-05-076, May 18, 1982.

2. Each of the decisions involved water rate increases for a subsidiary or district of Citizens. The increases were in excess of 50% of previous rates, but were limited to only 50% in the first year in order to lessen the immediate impact on customers of justified but unusually precipitous rate increases.

3. Rehearing was ordered to develop a record by briefs and pleadings of the propriety of our adoption of the rate of return for Citizens as the measure of compensation to Citizens for our ordered deferral of a portion of the increases in rates.

4. Citizens' applications for rehearing were fully considered with staff's brief filed September 7, 1982.

5. The proper compensation for the deferral of revenues is the rate of return found reasonable for Citizens in these proceedings.

Conclusion of Law

The decisions ordered reheard should be affirmed.

ORDER AFTER REHEARING

IT IS ORDERED that D.82-03-023, D.82-04-009, D.82-04-017, D.82-05-038, and D.82-05-076 are affirmed with respect to the method of compensation shown in Appendix E of each decision.

This order becomes effective 30 days from today.

Dated NOV 17 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

Joseph E. Bodovitz, Executive Director