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Decision 83 04 069 APR 20 1983

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of the SOUTHERN CALIFORNIA WATER COMPANY for an order authorizing it to increase water rates for water service in its Los Osos District.	Application 82-08-22 (Filed August 10, 1982)

O'Melveny & Myers, by Guido R. Henry, Jr., Attorney at Law, for applicant.
Javier Plasencia, Attorney at Law, and Mehdi Radpour, for the Commission staff.

O P I N I O N

Applicant Southern California Water Company seeks authority to increase rates for water service in its Los Osos District. The rate increases proposed by applicant are in steps designed to increase annual revenues in test year 1983 by $308,000, or 94.68%, over the revenues produced by rates in effect on June 1, 1982; in test year 1984 by $82,500, or 12.96%, over revenues from rates proposed for 1983; and in test year 1985 by $49,800, or 6.92%, over revenues from rates proposed for 1984.

The hearing in this matter was preceded by an informal public meeting held during the evening on September 23, 1982 in Los Osos. The meeting was sponsored by applicant and the Commission staff to provide customers an opportunity to express their views and to give applicant an opportunity to explain or respond in an informal setting. Twelve customers attended the meeting.

After due notice, public hearing was held in this matter before Administrative Law Judge Main on a consolidated record with Application (A.) 82-08-26 (Simi Valley District) in Los Angeles on December 13, 14, and 15, 1982. A.82-08-26 will be decided in a separate order. This proceeding was submitted upon the filing of concurrent briefs due on or before January 18, 1983.

General Information

Applicant owns and operates water systems in 18 districts and an electric system in Big Bear Lake, California. Each district is a separate unit for operational, accounting, and ratemaking purposes. The districts are grouped into five divisions. The headquarters and general office are located in Los Angeles. Customers' bills for all districts are prepared at the Los Angeles general office. Overall functions such as accounting, engineering, data processing, and purchasing are also centralized there.

As of December 31, 1981, statewide applicant was serving 236,137 customers and had 375 employees and an investment in utility plant of $156,416,000. Gross operating revenue for the 12-month period ended December 31, 1981 was $42,804,600. Applicant's approximately 2,000,000 shares of common stock are owned by more than 5,000 individual and institutional shareholders. Its preferred stock (198,000 shares in four series) is held by institutional investors.

Los Osos District

The Los Osos District, which is located in the unincorporated territory of San Luis Obispo County, is comprised of three water systems: the Los Osos system, the Rolling Hills system, and the Country Club system. The area is mostly residential. Of the 2,289 customers served as of December 31, 1981, 99.5% were in the commercial classification which consists of residential and business customers. The water supply is obtained from 10 wells. As of December 31, 1981, there were 147,825 feet of distribution mains ranging in size up to 14 inches in diameter and eight steel tanks with a total storage capacity of 964,000 gallons. The historical cost of utility plant in service in the Los Osos District at December 31, 1981 was $1,786,200, and the depreciation reserve was $343,500, yielding a net depreciated cost of $1,442,700.

Present and Proposed Rates

Applicant provides water service in the Los Osos District under Schedule LO-1, General Metered Service. In addition, service is rendered under companywide Schedules AA-4, Private Fire Protection Service; AA-5, Public Fire Protection Service; AA-9, Construction and Temporary Service; and AA-10, Service to Company Employees.

Applicant proposes to increase the rates for general metered service. A tabular comparison of present and authorized rates for general metered service is included in Appendix B to this decision.

Need For Rate Relief

In its application, applicant stated that its depressed earnings for this district are "mainly caused by increases in the costs of purchased power, labor, postage, payroll taxes, income taxes, liability insurance, depreciation, increased rate base and increased cost-of-capital since these costs were last considered by the Commission in setting rates."

Rate of Return

Applicant and staff agree on the types and amounts of senior securities to be issued in years 1983, 1984, and 1985, on the coupon rate or dividend level of those issues, and on the percentages of long-term debt and preferred stock in the capital structure. They also agree on the projected costs of total long-term debt and of total preferred stock with one exception. Applicant contends the cost projection on new issues should include an allowance of 25 to 50 basis points to cover the cost of issuance, which is a cost that has not been allowed for by staff.

While the cost of issuance is included in the computation of the embedded cost of debt, we must keep in mind that the estimated interest costs associated with new issues are at best only estimates. We would be remiss to add a further estimate to a cost that in itself is an estimate and therefore, we will adopt the estimated interest rates and dividend rates projected by staff.

Applicant and staff disagree on the rate of return on common equity with applicant advocating 17% and staff a 14.50-15.00% range. Applicant and staff also disagree on the common equity ratio with applicant stressing that the ratio should not be allowed to fall below 37%, which was the level used by the Commission in setting rates in the most recent proceeding involving applicant, and staff deriving 36% based in part upon its estimates of additions to

retained earnings. Applicant contends that it finds itself in a downward cycle: In one proceeding rates are set on an estimated equity ratio; earnings resulting from these rates, however, are insufficient to maintain that ratio so in the next proceeding staff assumes a lower ratio.

The pivotal issue, which is the return on common equity, will now be addressed.

Applicant's Witness

William V. Caveney, president and chief executive officer of applicant, appeared as its expert on the cost of money to applicant. He presented a study prepared under his direction entitled "Financial Statistics Years 1972 through 1981 Recorded and Cost of Money Years 1982 through 1985 Estimated" (Exhibit 6) which reflects in its Table 9 a 17% rate of return on common equity at a common equity ratio of 37%.

In reviewing the data compiled in Exhibit 6, Caveney emphasized that sale of common stock accounted for about half of the approximately $10 million increase in applicant's common stock equity from 1979 to 1981. The major sale of common stock occurred in 1980 and was necessary because the restrictive covenants in applicant's first mortgage bond indenture prohibited the issuance of additional debt. The sale of common stock in 1980 could only be made at a discount from book value which resulted in a significant book value dilution to existing shareholders and made necessary that almost 90% of applicant's earnings be paid out in order to maintain a reasonable dividend per share on the increased number of shares outstanding.

Throughout his testimony Caveney stressed that applicant must receive a higher authorized rate of return on its common equity than that proposed by staff so that applicant will be able to sell common shares in the future at prices that do not significantly dilute book value and require an excessively high dividend payment ratio. It is his opinion that in the future rather than sell common stock at a significant discount, applicant should reduce its construction program. Should that occur, it could jeopardize service.

Caveney also presented Exhibit 9 setting forth a Discounted Cash Flow (DCF) analysis. He testified that there are two schools of thought about how growth expectations are estimated for use in a DCF formula. One approach uses dividend growth; the other uses earnings growth. If dividend growth is used, his calculations indicated a cost of common stock of 16.4 to 16.9%. The other approach hinges in large part on an assumed growth rate which itself rests on assumptions as to the ratio of earnings retained and the rate of return to be earned on the earnings retained. Caveney did not calculate a DCF return using earnings growth rate because he believed that recent retention rates and historic returns on common equity were so low as to distort calculated averages to the point that a DCF calculation based on earnings growth was unfair. However, he estimated that a DCF calculation based on earnings growth would yield a cost of common stock capital of 17 to 19% if the earnings growth factor were based on a reasonable retention rate and on a return on equity equal to the one included in its most recent water rate decision of the Commission.

It is Caveney's view that prior to 1977 the authorized return on common equity for applicant was above or close to those authorized for the major energy utilities and that since 1977, the Commission has authorized returns for applicant that have been well below those for energy utilities. It is his position that an assessment of some of the risk elements of water utilities and energy utilities has been brought before the Commission before by applicant and more recently by California Water Service Company, but little specific response from either the Commission staff in exhibits or testimony or by the Commission in its decision has been made. He requests that the Commission treat the comparative risks of energy utilities and water utilities as a material issue in this proceeding.

As part of his testimony, Caveney presented a Report on Risk (Exhibit 7) in which the risks faced by energy utilities were compared and contrasted with the risks faced by water utilities, especially applicant. Applicant's Report on Risk and Caveney's pertinent testimony may be summarized as follows:

1. Regulatory Procedures Affecting Risk.

   Water utilities are on a three-year rate cycle while energy utilities are on a two-year cycle. This means that the errors inherent in the projection process of ratemaking must be lived with for a 50% longer period by water utilities. This extended rate period risk makes multi-district utilities especially vulnerable to changes in rates of return in the capital markets and other unforeseen factors. Moreover, the specific multi-district rate-setting practices increase applicant's risk as compared to major energy utilities. Under these practices only a portion of applicant's total utility investment is in a general rate proceeding in any one year. In implementing

step rates the Commission does not allow averaging of the rates of return of several districts or permit the full step if the rate of return for the individual district is above that authorized. Accordingly, the weighted average rate of return realized in all step rate districts will be below that authorized by the Commission.

For the supply cost offsets of balancing accounts the procedures used tend to reduce the risks for energy utilities more than for water utilities. Energy utilities are allowed to charge interest and recover undercollections over a four-month period. Water utilities are allowed to recover undercollections over a one-year period and not allowed to charge interest. Applicant had in excess of $1,000,000 outstanding in amounts undercollected from customers in each of the last three years.

2. Sales Volatility and Rate Design.

Variations in temperature and rainfall in applicant's service areas produce greater usage fluctuations than experienced by an electric utility serving some of the same areas. Even though applicant's sales are more volatile, the electric utility has available to it balancing account techniques to protect against sales fluctuations while those techniques are not available to applicant as a water utility. In addition, the Commission has mandated water rate designs that fail to minimize the fluctuations in return on equity as a function of fluctuations in sales.

3. Increasing System Standards.

In recent years the Commission has encouraged energy utilities to reduce the rate of growth of system demand while requiring water utilities to increase system demand capabilities to provice increased fire-flow and system pressure.

4. Product Quality Risks.

Water is the only commodity distributed by a public utility which is ingested by the human body. This exposes water utilities to unpredictable changes in quality standards relating to changes in health standards. The changes in health standards typically relate to expansion of medical and health knowledge which occurs unpredictably. In recent years such changes in standards have resulted in material expenditures at unexpected times. These expenses are not always fully recoverable from ratepayers.

5. Tax Risks.

The U.S. Internal Revenue Service is challenging applicant's treatment for tax purposes of main extensions and other advances in aid of construction. This appears to be part of a broader tax challenge to all California water utilities giving their future tax treatment a significantly riskier framework than that faced by energy utilities.

6. Financial Risks.

Applicant's business is more capital-intensive than energy utilities in that applicant must invest more capital dollars in order to produce a dollar of revenue. The relatively higher depreciation rates of energy utilities mean that invested capital is at risk for a shorter period of time and the significantly larger size of energy utilities makes them generally less risky.

7. Cost Volatility and Supply Availability.

Applicant has faced in the past and expects to face in the future rising costs of purchased water and volatile costs of power for pumping. Applicant also faces risks of availability of supply.

8. Stock and Bond Ratings.

The Standard & Poors' rankings of the common stocks of representative California energy utilities is higher than the ranking for applicant and the Moody's bond ratings for these energy utilities are also higher than the rating that would be expected to be obtainable for applicant's debt. These rankings and ratings indicate that the investment community views applicant's stocks and bonds as more risky for investment purposes than those of the California energy utilities reviewed.

9. Need and Ability to Raise Capital.

In the ten years 1973 through 1982, applicant raised 63% ($48.4 million) of its required capital through external financing and generated 37% ($28.3 million) internally. Of the external financing, $30 million was long-term debt, $9 million was preferred stock, and $6.7 million common stock. Because of the relatively small sizes of applicant's debt offerings, it was precluded from the public debt market and had to rely on the private placement market where interest rates are generally higher. Applicant provided a compilation of the ratios of market value to book value of the common stock for certain major energy utilities and for applicant. It was believed that the upturn in the ratio for the energy utilities represented a market reaction to the higher rates of return authorized for them in recent years. Unlike the energy utilities, applicant is limited in its ability to sell common stock or securities convertible into common stock by its low market-to-book ratio and in 1980, when required to raise a significant amount of additional common stock equity, was forced to sell common stock at a price which was 21% below its book value per share.

Staff Witness

Christopher J. Blunt, a financial examiner with the Revenue Requirements Division of the Commission, appeared as an expert witness on behalf of staff. Blunt based his return on equity recommendations on an analysis of many factors both tangible and intangible which he claims affect the cost of equity capital to applicant. Blunt testified that one cannot base estimates solely on definitive formulas or precise mathematical calculations, that, of necessity, determination of return on equity capital is a judgment determination. In arriving at his recommendation he was guided by the standards set forth by the U.S. Supreme Court decisions and prior decisions of this Commission. They are as follows:

1. The return to the equity holder should be commensurate with the returns on investments in enterprises having similar risks.
2. The return should be sufficient to enable the utility to attract capital of reasonable rates and to assure confidence in the utility's financial integrity.
3. The return should balance the interests of both the investors and the customers of the utility.

Blunt believes that his recommended return on common equity of 14.5% to 15.0% will provide an adequate risk premium over long-term debt during the period the water rates will be in effect. As a confirmation of his judgment recommendation, Blunt compared the results he obtained upon performing a DCF analysis of applicant. He listed the following factors which he contends make a water utility less risky than an energy utility:

1. Water utilities are not as capital-intensive. Construction programs are much smaller and are financed to a large degree by advances for construction and contributions in aid of construction.
2. Water utilities do not capitalize interest on construction projects. Construction work in progress is included in rate base which results in a better quality of earnings and better cash flow.
3. Water utilities are allowed offset increases in costs such as purchased water and power by advice letter filings concurrently with such increases. Energy companies, however, face a lag between the time fuel cost increases are experienced and offsetting rates are authorized.
4. Water utilities are not faced with risks such as fuel costs, source of supply, nuclear generation, technological changes, competition, etc.
5. Water utilities do not have to raise large amounts of equity capital in order to maintain balanced capital structures because of better cash flows and lesser capital requirements for construction. For example, during the six-year period 1976-1981, there were only five authorizations to issue common stock by water utilities for a total of $8.8 million, whereas during the four-year period 1978-1981, for the energy companies alone, there were 33 authorizations to issue common stock for a total of $2.2 billion.

Some of the additional factors which Blunt considered in arriving at his recommendation were:

1. Applicant is a regulated public utility engaged in a business which affects the public interest.

2. This commission must, by law, try to assure utility customers of adequate, reliable service at the lowest reasonable rates.
3. Fair and reasonable rates must balance the interest of both the ratepayers as well as the investors.
4. Interest coverage requirements.
5. Capital requirements.
6. Applicant's capital structure, capital costs, and financial history.
7. Economic conditions - the effects of inflation and increases in embedded costs of capital.

Blunt believes that his recommendation will provide applicant an opportunity to pay suitable dividends as well as make moderate additions to retained earnings.

Discussion

In arriving at a capital structure which includes 36% common equity, Blunt reviewed applicant's financing scheduled for years 1983 through 1985 and projected retained earnings for those years. However, his actual computations yielded results closer to 35% (i.e., average common equity ratios of 35.35% for 1983, 35.27% for 1984, and 35.41% for 1985). It is applicant's position that the common equity portion of its capital structure should not fall below 37%, which in itself is on the thin side. We see substantial merit in that position.

Blunt's DCF analysis was used to test the reasonableness of his 14.5 to 15.0% return on common equity recommendation. As structured by Blunt, the DCF calculation arrives at a future return based on the perceived investor expectation which in turn is based in large part on historic returns.

Over the past decade, applicant has internally generated only 37% of its capital requirements while being required to rely on the capital markets for 63%. In raising capital externally, it has had to compete for the investor dollar against larger and more highly rated utilities, both based within and without California. Applicant contends that the return on equity actually earned by it puts it at a competitive disadvantage in raising funds. Because of the low market price of its common stock, applicant's management relied on debt financings and deferred sales of common stock until applicant's bond trust indenture restrictions prohibited further debt financings.

By May 1980, management had no choice but to issue a substantial amount of common stock at the then prevailing market price which was substantially below the book value per share of the outstanding common stock. In order to protect the annual dividend per common share, applicant increased the proportion of earnings paid out in dividends. This higher percentage payout resulted in a lower rate of internal generation of funds which will inevitably add to the dependence on the capital markets for future capital.

Apart from the retention of tax benefits by applicant as a result of the Economic Recovery Tax Act of 1981 (ERTA) which presumably has been reflected in Blunt's projection of equity ratios, the only apparent ways of increasing the amount of internally generated funds are to decrease the dividend payout or obtain an increase in the authorized return on common equity.

A different alternative would be for applicant to reduce its requirement for funds by curtailing its construction program. If the construction budget of applicant were to be significantly cut, it would jeopardize applicant's ability to continue to provide an acceptably high standard of service.

The arguments for a higher return on equity center upon the fact that SoCal's percentage of internally generated funds has been only 37% as compared to higher levels realized by other water utilities. Applicant alleges that this situation has resulted in a dependence on the capital markets for future capital and necessitated a common stock offering in 1980 which caused a significant book value dilution to existing shareholders.

We agree that a low level of internal generation does impact the financial flexibility of SoCal and a market-to-book ratio below one is a reasonable concern. In setting our return on common equity, we must not only consider SoCal's current financial condition, but also review its historical financing activity along with the projected financing through the 1983 through 1985 test period. SoCal's 1980 common stock financing, however, was the first of such financing over the 1972 through 1981 period and it does not plan to issue common stock through 1985. We cannot set a return on equity that will guarantee a certain level of internal generation and furthermore, it is not possible to develop a return that will guarantee a market-to-book ratio of one. We believe our order today will provide SoCal with sufficient financial flexibility to meet its ongoing capital requirements and provide an opportunity to attain a market-to-book ratio of one.

SoCal's concern regarding the regulatory procedures for multidistrict water utilities does deserve consideration. In SoCal's view multidistrict utilities are especially vulnerable to changes in rates of return in the capital markets in that only a portion of its total utility investment is in a general rate proceeding in any one year. Accordingly, the weighted average rate of return for all districts will be below that authorized by the Commission in the most recent decision in which the rate of return was set. Underlying SoCal's argument is the assumption that over time the rates of return in the capital markets will increase. Equally likely, however, is that rates of return may decline so that the weighted average rate of return will be higher than authorized by the Commission in its most recent decision. In fact, we have seen recent declines in interest and inflation rates from levels achieved last summer which would be reflected by lower rates of return than those authorized last summer. We therefore are not persuaded that SoCal is disadvantaged under current procedures.

SoCal next argues that water utilities are riskier than energy utilities for several reasons. It asserts that the major rating agencies have ranked the stocks and bonds of energy utilities higher than those of SoCal Water. Hence, the investment community regards SoCal as riskier than energy utilities.

We have difficulty comparing risk differentials between water and energy utilities measured by stock rankings and bond ratings. With regard to bonds, we point out that neither Standard & Poor's nor Moody's, the major rating agencies, rates the bonds of

SoCal. The reason is that the volumes of debt issued by major water utilities are so insignificant compared to debt issued by major energy utilities. Moreover, debt issued by water utilities is done through private placement rather than through the public market and we find no evidence to support SoCal's claim that private placement of debt financing is more expensive than financing in the public market. We therefore do not find SoCal's comparisons to be relevant.

We have further difficulty comparing the risk differentials between water and energy utilities on the basis of stock rankings. Again, the amount of stock issued by water utilities is very small and is issued very infrequently when compared to energy utilities. We also have no evidence before us to indicate how the ranking of utility stocks by agencies reflects the specific risks of a particular utility.

SoCal next contends that its business is more capital-intensive than energy utilities. Because energy utilities have relatively higher depreciation rates, their invested capital is at risk for a shorter period of time. SoCal also asserts that the significantly larger size of energy utilities makes them less risky.

We are not persuaded by these arguments. As our staff points out, water utility construction programs are much smaller than those of energy utilities, and are financed largely by advances and contributions in aid of construction. In addition, unlike energy utilities, water utilities are allowed to include construction work in progress in rate base which results in a better cash flow and quality of earnings.

SoCal maintains that water utilities are exposed to unpredictable changes in water quality and health standards that result in material expenditures at unexpected times which are not always fully recoverable from ratepayers.

Again, we are not persuaded that this circumstance justifies higher rates of return for water utilities than for energy utilities. Any extraordinary expense which is reasonably incurred is generally recoverable from ratepayers. We further note that water utilities do not face the considerable costs associated with nuclear generation which the major California energy utilities face.

Lastly, unlike energy utilities, water utilities can offset increased purchased power and water costs by filing advice letters either in anticipation of such costs or immediately after Commission approval of such costs. Energy utilities, however, experience a lag between the time fuel costs increase and offsetting rates are authorized.

After weighing all of the evidence in this proceeding and taking cognizance of the improvement in current and projected market conditions, we are of the opinion that a 14.5% return on equity is reasonable for applicant and strikes a balance between the consumers' short-term concern of obtaining the lowest possible rates while maintaining good water service over the long run. The resultant overall rates of return for the test years are developed as follows:

TEST PERIOD - 1983, 1984, and 1985

Component	Capitalization Ratios	Cost	Weighted Cost
1983			
Long-Term Debt	49.00%	9.53%	4.67%
Bank Loans	1.00	13.50	.14
Preferred Stock	13.00	8.55	1.11
Common Stock	37.00	14.50	5.37
	100.00%		11.29
1984			
Long-Term Debt	49.00%	9.96	4.88
Bank Loans	1.00	13.00	.13
Preferred Stock	13.00	9.06	1.18
Common Stock	37.00	14.50	5.37
	100.00%		11.56
1985			
Long-Term Debt	49.00%	10.34	5.07
Bank Loans	1.00	13.00	.13
Preferred Stock	13.00	9.30	1.21
Common Stock	37.00	14.50	5.37
	100.00%		11.78

Results of Operations

To evaluate the need for a rate increase, witnesses for applicant and the Commission staff have analyzed and estimated for test years 1983 and 1984 applicant's operating revenues, operating expenses, and rate base for this district. Staff's study of operating results (Exhibit 18A) was based, in part, on later information than that available in June 1982 when applicant finalized its study (Exhibit 11). The staff's estimates, supplemented as shown in Exhibit 21 to reflect the January 1, 1983 rate increase authorized by Resolution W-3059, in conformity with ERTA, were accepted by applicant. We adopt the staff estimates as supplemented.

Table 1, which follows, sets forth the adopted operating results for test years 1983 and 1984 at rates effective January 1, 1983 and at the rates authorized by this decision.

Table 1

SOUTHERN CALIFORNIA WATER COMPANY
Los Osos District

Adopted Summary of Earnings
Test Year 1983
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Item	Rates Effective January 1, 1983	Authorized Rates
	(Dollars in Thousands)	
Operating Revenues	$ 487.0	$ 540.9
Operating Expenses		
Oper. & Maint.	202.7	202.9
Admin. & Gen.	29.9	29.9
Gen. Office Allocation	17.4	17.4
Subtotal	250.0	250.2
Depreciation Expense	43.8	43.8
Taxes Other Than Inc.	21.1	21.1
Income Taxes	46.6	74.1
Total Expenses	361.5	389.2
Net Revenues	125.5	151.7
Rate Base	1,343.8	1,343.8
Rate of Return	9.34%	11.29%

Table 1

SOUTHERN CALIFORNIA WATER COMPANY
Los Osos District

Adopted Summary of Earnings
Test Year 1984
Page 2

Item	Rates Effective January 1, 1983	Authorized Rates
	(Dollars in Thousands)	
Operating Revenues	$ 501.8	$ 590.5
Operating Expenses		
Oper. & Maint.	212.7	213.1
Admin. & Gen.	31.9	31.9
Gen. Office Allocation	18.6	18.6
Subtotal	263.2	263.6
Depreciation Expense	47.4	47.4
Taxes Other Than Inc.	22.4	22.4
Income Taxes	32.1	77.3
Total Expenses	365.1	410.7
Net Revenues	136.7	179.8
Rate Base	1,555.2	1,555.2
Rate of Return	8.79%	11.56%

Authorized Revenue Increases

By comparing the entries for operating revenues in Table 1, it can be seen that the rates to be authorized for test year 1983 yield additional gross revenues of $53,900 which represent a 11.1% increase over revenues at present rates. The rates to be authorized for test year 1984 yield additional gross revenues of $33,200 which represent a 6.0% increase over revenues at 1983 increased rates. In addition, a third set of rates will be authorized to allow for attrition in rate of return after test year 1984. This is in keeping with our intention that the districts of Class A water utilities will not file a general rate increase application more often than once in three years.

The attrition to be allowed for after 1984 has an operational component and a financial component. Its operational component is 0.77% as indicated by the 1983 rate of return of 11.29% declining to 10.52% for 1984 at the rates authorized for the remainder of 1983. Its financial component is the adopted estimate of financial attrition in rate of return between years 1984 and 1985 of 0.22% (i.e., the difference between the rates of return of 11.78% and 11.56% for years 1985 and 1984, respectively).

To offset the 0.99% combined financial-operational attrition rate, we may authorize a step increase for 1985 of up to $31,700. Applicant will be required to file an advice letter with supporting work papers on or after November 15, 1984 to justify such an increase. Fixing rates in this way results in a better matching of the consumers' interests than setting a high initial rate which would yield the adopted rate of return for a three-year average. The required supplemental filings will permit review of achieved rates of return before the final step increase is granted.

Rate Design

In Exhibit 18 staff made the following observations and recommendations on rate design:

> "13.3 The authorized increase should be allocated to service charges, quantity rates and flat rates and be proportional to the gross revenues derived from each category, and based on rates in effect when the decision in this proceeding is signed.
>
> "13.4 The staff recommendation of an equal percentage increase in service and commodity charges is based on Commission policy to create an incentive for conservation.
>
> "13.5 The utility proposes to increase rates for General Metered Service (Schedule LO-1). Staff agrees and also recommends that rate for Private Fire Protection Service (Schedule AA-4) be increased from $3.00 to $4.00 per month for each inch of diameter of service connection and Schedule AA-4 be revised to accommodate the rate."

Applicant did not oppose the above staff recommendations.

We adopt staff's recommendations on rate design. In addition, the rate increases authorized by this decision will incorporate the present public fire protection surcharge which was authorized by Resolution L-213 referenced above. No refunds from the surcharge revenues are warranted.

Conservation and Pump Efficiency

Applicant has an established program to promote water conservation. Currently, its efforts are directed primarily toward providing conservation reminders through inserts mailed with customers' bills.

Applicant also has an established program to maintain pump efficiencies. Our staff reports that "the majority of pumps and boosters in the Los Osos District are within and above the average-fair range." The utility has indicated that it will repair the one pump and two boosters, which are below average-fair range, in 1983 and 1984.

Service

In Exhibit 18 staff commented on service as follows:

"12.2 Customers service complaints for the year 1981 and the nine months of the year 1982 are summarized as follows:

	Year 1981	9-Month 1982
Water Quality	44	23
Pressure	30	26
Leaks	9	17
Misc.	3	7
Total	86	73

"12.3 The record indicates that the complaints were investigated and resolved by the utility within a reasonable period of time after notification.

"12.4 An inspection of the utility's facilities revealed that their procedures for handling customer service in this district was satisfactory.

"12.5 An informal public meeting was held in the City of Los Osos on September 23, 1982. Twelve customers attended the meeting. The customers in Bayview Heights area complained of lack of water pressure whenever electric power interruption occurs."

The Bayview Heights area referred to in the staff comments is served by the Los Osos system. Water is boosted to approximately 430 customers in the upper Bayview gradient by four electric boosters at the Bayview Reservoir. This zone is subjected to water outages whenever electricity supplying the boosters is interrupted. There have been four power outages since 1980; the longest was five hours. During these outages, a portable gasoline engine-driven booster at the site provides service to this upper zone.

Applicant submitted to staff a detailed study of the need for a new reservoir for the Bayview Heights area. It would not only provide water in the event of power outages but will provide required storage needed in this system since the current storage will only meet the system demands until 1984. Approximately 90% of the customer growth is occurring in this area which, according to staff estimates, is about 60 customers per test year. The reservoir will also provide needed fire-flow protection in the area.

Applicant has selected three possible sites at the 470-foot elevation level. Before purchasing the land applicant plans to obtain the approval required from the San Luis Obispo County Planning Commission and the California Coastal Commission in order to construct the reservoir. Staff has estimated that the land will be purchased in early 1984 and construction of the reservoir will start in April 1984.

Findings of Fact

1.a. Applicant's service, conservation program, and pump efficiency program overall are satisfactory.

b. Service to the upper Bayview Heights area will become less vulnerable to power outages upon the installation of the new reservoir in 1984.

2. The adopted estimates of operating revenues, operating expenses, and rate base for the test years 1983 and 1984, together with an additional revenue requirement of $31,700 for 1985 due to attrition, reasonably indicate the results of applicant's future operations.

3. The compilation of the adopted quantities and the adopted tax calculation are contained in Appendix C to this decision.

4. The risk differentials between water and energy utilities as measured by stock rankings and bond ratings are not comparable and therefore should not be used in evaluating whether water utilities are more or less risky than energy utilities.

5. A reasonable common stock equity ratio to use for applicant in this proceeding is 37%.

6. Rates of return of 11.29%, 11.56%, and 11.78%, respectively, on applicant's rate base for 1983, 1984, and 1985 are reasonable. The related return on common equity is a constant 14.50%. This will require an increase of $53,900, or 11.1%, in annual revenues for 1983; a further increase of $33,200 or 6.0%, for 1984; and a further increase of $31,700 or 5.4%, for 1985.

7. The revenues authorized, under the provisions of Commission Resolution L-213, incorporate the present public fire protection surcharges offsetting loss of fire hydrant revenues. No refund is necessary.

8. The adopted rate design is reasonable.

9. The increases in rates and charges authorized by this decision are justified, and are just and reasonable.

10. The further increases authorized in Appendix A should be appropriately modified in the event the rate of return on rate base, adjusted to reflect the rates then in effect and normal ratemaking adjustments for the 12 months ended September 30, 1983 and/or September 30, 1984, exceeds the lower of (a) the rate of return found reasonable by the Commission for applicant during the corresponding period in the most recent rate decision, or (b) 11.29% for 1983 and 11.56% for 1984.

Conclusions of Law

1. The adopted rates are just, reasonable, and nondiscriminatory.

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

3. Because of the immediate need for additional revenue, the following order should be effective today.

O R D E R

IT IS ORDERED that:

1. Applicant Southern California Water Company is authorized to file for its Los Osos District, effective today, the revised rate schedules for 1983 in Appendix A. The filing shall comply with General Order Series 96. The effective date of the revised schedules shall be the date of filing. The revised schedules shall apply only to service rendered on and after their effective date.

2. On or after November 15, 1983 applicant is authorized to file an advice letter, with appropriate work papers, requesting the step rate increases for 1984 shown in Appendix A, or to file a lesser increase which includes a uniform cents per 100 cubic feet of water adjustment from Appendix A in the event that the Los Osos District rate of return on rate base, adjusted to reflect the rates then in effect and normal ratemaking adjustments for the 12 months ending September 30, 1983, exceeds the lower of (a) the rate of return found reasonable by the Commission for applicant during the corresponding period in the then most recent rate decision, or (b) 11.29 %. This filing shall comply with General Order Series 96. The requested step rates shall be reviewed by staff to determine their conformity with this order and shall go into effect upon staff's determination of conformity. Staff shall inform the Commission if it finds that the proposed step rates are not in accord with this decision, and the Commission may then modify the increase. The effective date of the revised schedules shall be no earlier than January 1, 1984, or 30 days after the filing of the step rates, whichever is later. The revised schedules shall apply only to service rendered on and after their effective date.

3. On or after November 14, 1984 applicant is authorized to file an advice letter, with appropriate work papers, requesting the step rate increases for 1985 shown in Appendix A, or to file a lesser increase which includes a uniform cents per 100 cubic feet of water adjustment from Appendix A in the event that the Los Osos District rate of return on rate base, adjusted to reflect the rates then in effect and normal ratemaking adjustments for the 12 months ending September 30, 1984, exceeds the lower of (a) the rate of return found reasonable by the Commission for

applicant during the corresponding period in the then most recent rate decision, or (b) 11.56%. This filing shall comply with General Order Series 96. The requested step rates shall be reviewed by staff to determine their conformity with this order and shall go into effect upon staff's determination of conformity. Staff shall inform the Commission if it finds that the proposed step rates are not in accord with this decision, and the Commission may then modify the increase. The effective date of the revised schedules shall be no earlier than January 1, 1985, or 30 days after the filing of the step rates, whichever is later. The revised schedules shall apply only to service rendered on and after their effective date.

This order is effective today.

Dated APR 20 1983, at San Francisco, California.

(Appendixes A and B to be prepared by Revenue Requirements Division.)

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
DONALD VIAL
Commissioners

Commissioner Priscilla C. Grew, being necessarily absent, did not participate in the disposition of this proceeding.

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

Joseph E. Bodovitz, Executive Director

APPENDIX A
Page 1

Schedule No. LO-1

Los Osos and Edna Road Tariff Areas

GENERAL METERED SERVICE

APPLICABILITY

Applicable to all metered water service.

TERRITORY

Unincorporated areas in the vicinity of Los Osos and unincorporated areas south of the City of San Luis Obispo, San Luis Obispo County.

RATES

	Per Meter Per Month
Service Charge:	
For 5/8 x 3/4-inch meter	$ 6.60
For 3/4-inch meter	7.40
For 1-inch meter	10.40
For 1½-inch meter	14.90
For 2-inch meter	19.00
For 3-inch meter	33.00
For 4-inch meter	45.00
For 6-inch meter	77.00
For 8-inch meter	89.00
For 10-inch meter	106.00
Quantity Rates:	
For First 300 cu. ft., per 100 cu. ft.	0.726
For all over 300 cu. ft., per 100 cu. ft.	0.763

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

APPENDIX A
Page 2

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

METERED RATES

	Effective Dates	
	1-1-84	1-1-85
Service Charge		
	Per Meter Per Month	
For 5/8 x 3/4-inch meter	$ 0.65	0.40
For 3/4-inch meter	0.60	0.50
For 1-inch meter	1.00	0.60
For 1½-inch meter	1.30	0.80
For 2-inch meter	2.00	1.00
For 3-inch meter	3.00	2.00
For 4-inch meter	5.00	3.00
For 6-inch meter	6.00	4.00
For 8-inch meter	9.00	5.00
For 10-inch meter	10.00	6.00
Quantity Rates:		
For the first 300 cu. ft., per 100 cu. ft...	0.031	0.40
For all over 300 cu. ft., per 100 cu. ft....	0.032	0.42

(END OF APPENDIX A)

APPENDIX B

Comparison of typical bills for residential metered customers of various usage level and average usage level at present and authorized rates for the year 1983.

General Metered Service (5/8 x 3/4) inch Meters

Monthly Usage	At Present Rates	At Authorized Rates	Percent Increase
(Cubic Feet)			
300	$ 8.01	$ 8.78	9.60%
500	9.38	10.30	9.81
1,000	12.78	14.12	10.49
1,505 (Average)	16.22	17.97	10.79
2,000	19.59	21.75	11.02
3,000	26.40	29.38	11.28
5,000	40.02	44.64	11.54
10,000	74.07	82.79	11.77

(END OF APPENDIX B)

APPENDIC C
Page 1

ADOPTED QUANTITIES

Name of Company: Southern California Water Company

District: Los Osos

1. Net-to-Gross Multiplier: 2.057
2. Federal Tax Rate: 46%
3. State Tax Rate: 9.6%
4. Local Franchise Tax Rate: 0.00%
5. Uncollectibles Rate: 0.404%

Offset Items	Test Years 1983	1984
6. Purchased Power		
A. Ccf/kWh - Pumps	0.588	0.588
Boosters	3.537	3.537

ADOPTED QUANTITIES

Offset Items (Cont'd)	Test Years 1983	1984
B. kWh (Total)	960,500	987,500
C. Average Cost/kWh	$0.07888	$0.07888
Cost of Power	75,900	78,000
7. Ad Valorem Taxes	$ 14,300	$ 15,000
Effective Tax Rate	0.894%	0.894%

8. Number of Services:

	No. of Services 1983	No. of Services 1984	Usage - KCcf 1983	Usage - KCcf 1984	Avg. Usage-Ccf/Yr. 1983	Avg. Usage-Ccf/Yr. 1984
Commercial	2,382	2,451	430.4	442.8	180.7	180.7
Public Authority	5	5	12.4	12.4	2,480.7	2,480.7
Other	1	1	0.3	0.3	275.0	275.0
Subtotal	2,388	2,457	443.1	455.5		
Private Fire Prot.	3	3				
Total	2,391	2,460				
Water Losses			41.1	42.4		
Total Wtr. Prod.			484.2	497.9		

ADOPTED SERVICE BY METER SIZE

9. Adopted Service by Meter Size

Meter Size	1983	1984
5/8" x 3/4"	1,893	1,962
3/4"	298	298
1"	164	164
1½"	9	9
2"	22	22
3"	1	1
4"	-	-
6"	1	1
8"	-	-
10"	-	-
	2,388	2,457

10. Metered Water Sales Used to Design Rates

Range - Ccf	Usage - Ccf 1983	1984
0-3	79,582	81,887
>3	363,518	373,713
	443,100	455,600

APPENDIX C
Page 4

INCOME TAX CALCULATION

1983

Line No.	Item	Present Rates CCFT (A)	Present Rates FIT (B)	Adopted Rates CCFT (C)	Adopted Rates FIT (D)
		(Thousands of Dollars)			
1	Operating Revenues	$487.0	$487.0	$540.9	$540.9
2	O&M Expenses	250.0		250.2	250.2
3	Taxes Other Than Income	21.1		21.1	21.1
4	CCFT	-	7.6	.0	12.7
5	Subtotal	271.1	278.7	271.3	284.0
6	Deductions From Taxable Income				
7	Tax Depreciation	68.7	54.5	68.7	54.5
8	Capitalized Overhead	5.6	5.6	5.6	5.6
9	Interest	62.9	62.9	62.9	62.9
10	Preferred Stock Div. Credit	.0	.1	.0	.1
11	Subtotal Deductions	137.2	123.1	137.2	123.1
12	Net Taxable Income for CCFT	78.7		132.4	
13	CCFT	7.6		12.7	
14	Total CCFT			12.7	
15	Net Taxable Income for FIT		85.2		133.8
16	Federal Income Tax		39.2		61.5
17	Graduated Tax Adjustment		-.2		-.2
18	Fed Income Tax Before Adj.		39.0		61.4
19	Investment Tax Credit		.0		.0
20	Total FIT		39.0		61.4

APPENDIX C
Page 5

INCOME TAX CALCULATION

1984

No.	Item	Present Rates CCFT (A)	Present Rates FIT (B)	Adopted Rates CCFT (C)	Adopted Rates FIT (D)
		(Thousands of Dollars)			
1	Operating Revenues	$501.8	$501.8	590.5	590.5
2	O&M Expenses	263.2	263.2	263.6	263.6
3	Taxes Other Than Income	22.4	22.4	22.4	22.4
4	CCFT	.0	3.8	.0	12.3
5	Subtotal	285.6	289.4	286.0	298.3
6	Deductions From Taxable Income				
7	Tax Depreciation	81.6	55.6	81.6	55.6
8	Capitalized Overhead	18.4	18.4	18.4	18.4
9	Interest	76.4	76.4	76.4	76.4
10	Preferred Stock Div. Credit	.0	.1	.0	.1
11	Subtotal Deductions	176.4	150.5	176.4	150.5
12	Net Taxable Income for CCFT	39.8		128.1	
13	CCFT	-2.2		12.30	
14	Total CCFT	3.8		12.30	
15	Net Taxable Income for FIT		61.9		141.7
16	Federal Income Tax		28.5		65.2
17	Graduated Tax Adjustment		-.2		-.2
18	Fed Income Tax Before Adj.		28.3		65.0
19	Investment Tax Credit		.0		.0
20	Total FIT		28.3		65.0

(END OF APPENDIX C)

A different alternative would be for applicant to reduce its requirement for funds by curtailing its construction program. If the construction budget of applicant were to be significantly cut, it would jeopardize applicant's ability to continue to provide an acceptably high standard of service.

The arguments for a higher return on equity center upon the fact that SoCal's percentage of internally generated funds has been only 37% as compared to higher levels realized by other water utilities. Applicant alleges that this situation has resulted in a dependence on the capital markets for future capital and necessitated a common stock offering in 1980 which caused a significant book value dilution to existing shareholders. 55

We agree that a low level of internal generation does impact the financial flexibility of SoCal and a market-to-book ratio below one is a reasonable concern. In setting our return on common equity, we must not only consider SoCal's current financial condition, but also review its historical financing activity along with the projected financing through the 1983 through 1985 test period. SoCal's 1980 common stock financing, however, was the first of such financing over the 1972 through 1981 period and it does not plan to issue common stock through 1985. We cannot set a return on equity that will guarantee a certain level of internal generation and furthermore, it is not possible to develop a return that will guarantee a market-to-book ratio of one. We believe our order today will provide SoCal with sufficient financial flexibility to meet its ongoing capital requirements and provide an opportunity to attain a market-to-book ratio of one.