Decision 83 07 011 JUL 20 1983

ORIGINAL

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of the Little Lake Water Co. for authority to increase rates and charges for water service in the City of Willits and vicinity in Mendocino County.

Application 82-10-47
(Filed October 19, 1982)

INTERIM OPINION

Statement of Facts

In 1944, as part of an acquisition of a number of Mendocino County electric public utility properties and businesses from California Public Service Company, Pacific Gas and Electric Company (PG&E) also acquired certain water public utility properties and businesses. Because it is a water corporation only incidentally and in most areas does not wish to remain in the water business, PG&E from time to time has sold portions of these water acquisitions. One of these is the Willits water system (the system).

Originally constructed in the 1924-1927 period before the State established water utility standards, the system obtains its water by diversions on its 3,189 acres of timbered watershed lands, feeding this water into Morris Lake where it is stored behind Morris Dam. Released as required, the water is treated in a plant with 2 million gallons per day capacity before being transferred into a gravity flow system for distribution. By 1978 the system was delivering 234.5 million gallons of treated water to approximately 1,840 metered customers. Concluding that the system was not of use in its local electric and gas business, and not producing sufficient revenues to earn what it considered to be reasonable rate of return on the investment, PG&E in 1978 determined to sell the system.

A Redwood City, California investor, business consultant, and former business management professor, Clifford V. Horn (Horn) and his wife[1] became interested, and after making certain investigations, on December 28, 1979 negotiated a purchase contract to acquire the system from PG&E. On July 8, 1980 PG&E and the Horns filed Application (A.) 59792 seeking Commission authorization for the sale and transfer.

The purchase price was to be $2.2 million plus additions and betterments installed by conveyance time.[2] Horn was to pay this purchase price by conveying his and his wife's interest in certain Hawaiian properties estimated to be worth $1.7 million, and by giving PG&E a 25-year first deed of trust (with a variable interest rate) on the system, for the balance.

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[1] Horn owned the public utility Strawberry Heights Water Company at Echo Summit on Highway 50 until it was sold in 1969 to the El Dorado County Irrigation District.

[2] The purchase price was derived from the historical utility plant in service on December 31, 1979, less accrued depreciation, but with additions and betterments as of June 1, 1980. The respective amounts were:

Historical basis of utility plant in service	$3,537,898
Less accrued depreciation	1,054,870
	2,483,028
Additions and betterments	217,325
The net from which the purchase price was derived.	$2,700,353

As matters developed, at conveyance time the Horns' Hawaiian properties were valued at only $1,416,336, and the additions and betterments at $635,722, leaving Horn to be faced with a 25-year note for approximately $1.4 million.[3] After preparation of pro forma tables showing estimated operating results, it was apparent that there would be a substantial negative cash flow, leading staff to recommend changes to the sales agreement as a condition of approval. Horn and PG&E responded, proposing to reduce the amount of Horn's note to $1.1 million by eliminating certain substantial capital expenditures previously proposed for years 1981 and 1982. This also served to reduce the payments on the PG&E note. It was further stated that for a 10-year period PG&E would pay Horn $172,700 annually representing accrued timber revenues to be applied toward meeting all classes of operating expenses and taxes of the system.[4] After analyzing the changes proposed by PG&E and Horn, staff had no objection to their implementation, and agreed to an ex parte order. With these understandings, the Commission by Decision (D.) 92921 dated April 21, 1981 approved the sale and transfer.

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[3] The purchase price at time of conveyance:

Stated purchase price	$2,200,000
Plus additions and betterments at conveyance	635,722
Total purchase price at conveyance	2,835,722
Less value of Horn properties conveyed	1,416,337
Amount to be covered by Horn note	$1,419,385

[4] The Morris Lake watershed area of the system is included in the system's rate base. Every 10 years the timber in the 3,100-acre watershed area is harvested. The 1980-81 harvest yielded a net return of $1,726,496. By D.92192 dated September 3, 1980 in A.58629 PG&E was ordered to amortize these revenues and to include them in the system revenues annually in the amount of $172,650.

Shortly after the Commission approved the sale and transfer, but before consummation with PG&E, Horn asserts that he asked the Administrative Law Judge (ALJ) who had handled both the transfer proceedings and the last general rate proceeding relating to the system, whether the Commission had any interest as to how the timber revenue credits were passed through to the system. Horn states that upon being told in essence "no" and relaying this answer to PG&E, that PG&E questioned that possibly the timber revenues might be used to reduce Horn's note. Horn further states that thereupon he discussed that possibility with the staff, and asserts that he was told by the Financial Section that his note could be reduced by the amount of the timber revenues.[5]

Accordingly, on June 5, 1981 PG&E and Horn entered into an agreement which amended their December 28, 1979 exchange agreement. By the amendment Horn's note to be given as part payment for the system was reduced by the discounted value of the net timber revenues (gross revenues less a 12% expense factor), assuming that the net revenues were paid ratably over a 10-year period. The result was that Horn's note was reduced to $647,560.13 as set forth below:

Total purchase price at conveyance	$2,835,722.32
Less value of Horn's properties conveyed	1,416,336.93
	1,419,385.39
Additional checks from Horn	199.06
	$1,419,186.33
Discounted value of timber revenues	806,217.94
	612,968.39
Materials and supplies advanced	34,591.74
Net amount of Horn's note	$ 647,560.13

[5] Reportedly, however, the staff personnel involved deny that Horn was ever told that he could apply the timber revenues to reduce the amount of the note to PG&E.

On June 5, 1981 the Horns executed a promissory note in favor of PG&E in the amount of $647,560.13, securing this notice with a deed of trust (naming First American Title Insurance Company as trustee) covering the real property owned by the system.[6]

Unfortunately, the utility has not prospered since Horn's takeover of the operation. The water revenues predicted in the last PG&E rate proceeding for the system have not materialized, falling short of expectations by approximately $64,000 annually. The utility has expended considerable sums unsuccessfully seeking to obtain alternative well supplies to alleviate its present complete dependence upon Lake Morris as source of supply. Operating expenses are up substantially, and the utility badly misses the $172,600 annual timber revenues from PG&E. Consequently, on October 19, 1982 the system, now operated as a sole proprietorship by Horn, filed A.82-10-47 requesting authority to raise its rates 269.2% in 1983. Although provided a copy of the Notice of Intent (NOI) procedure for filing an application, Horn instead directly filed this application. As a result the Hydraulic Branch was deprived of the opportunity to review the filing and associated work papers prior to the filing date. The application was deficient in a significant number of instances. These were outlined to the utility and the requested

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[6] No copies of the instruments and agreements pertaining to this alienation of timber revenues were furnished to the Commission at the time they were consummated. Some documents have since been obtained following a specific request made upon PG&E by staff counsel acting upon the direction of the ALJ assigned to this proceeding. However, from the documents furnished to date it is not clear whether the security named in the deed of trust purports to include the water system itself as well as the real property owned by the system, or whether there has been an unauthorized severance (See Public Utilities (PU) Code § 851).

information was furnished over a period of time, enabling the staff to proceed with its field investigation and to prepare a report so that the matter can proceed to hearing. This report was distributed to the utility and interested parties.

However, Horn pleads that he cannot await the outcome of what promises to be protracted formal proceedings, but must have some interim relief if he is to remain afloat. He asserts that he is sustaining substantial operating deficits, forecasting losses of $277,000 in 1983, of which he expects only $66,000 to be depreciation allowance. He states that he cannot continue to sustain this sort of negative cash flow and continue to operate.

Meanwhile, obligations are unpaid, including property taxes, the City of Willits Franchise Tax, and payments on the PG&E note. On March 29, 1983, as a consequence of Horn's failure to make the payment of principal and interest due December 5, 1981 on his PG&E note, a Notice of Default and Election to Sell under terms of the underlying Deed of Trust was recorded by the trustee in Mendocino County. The three-month reinvestment period expired June 29, 1983, and the security property may be sold at public auction if the loan is not reinstated. Further complicating matters, on May 3, 1983 a 20-foot section of the principal main serving the City of Willits ruptured as the probable consequence of ground movement occasioned by the heavy rains, and the system was forced to replace that section on a temporary basis. It lacks funds to make the permanent replacement which must be made.

While matters are undeniably serious, preliminary information from the draft of the staff report indicates that a considerable part of this woeful situation is of Horn's own making. Although Horn expected to be able to operate the utility for less expense than did PG&E, Horn's claimed expenses, particularly in the administrative and general area, are very substantially higher than anything contemplated in the last PG&E rate proceeding, and are not within reasonable limits usually applicable to such expenses within the parameters of the staff's experience with similarly sized water utilities. These claimed expenses will be strongly challenged in the forthcoming hearing on the application. And, of course, compounding the operating expense difficulties is the loss of the offsetting timber revenues diverted to lower Horn's debt to PG&E.

Despite a substantially enhanced rate base, Horn by his application purports to show a 9.7% negative rate of return for 1983.[7] On the other hand, the staff, using a rate base 2.9% less than applicant's, operating expenses its study determined to be appropriate for this utility, and actual water revenues, and by imputing the diverted timber revenues, concludes that the utility would be earning a rate of return of about 4.8%. But, of course, the timber revenues are not available. If the imputed timber revenues are not included in the staff's summary of operations, the utility would show a 1.4% negative rate of return.

There is intense local interest at Willits in this application. Both the city and Little Lake County Water District have expressed to ALJ Weiss their intentions to pursue possible acquisition of the system, and both have had some unfruitful negotiations with Horn. Both these parties as well as the State Department of Health Services plan participation, probably as interveners, in the hearings which are tentatively scheduled to start late in August.

Discussion

The immediate question is whether or not this Commission should grant interim rate relief. Continuity of water service is

[7] Horn inherited PG&E's rate schedules. By D.92192 dated September 3,1980 in A.58629, PG&E had been granted its first rate increase in 26 years, and was authorized a return on rate base of 9.0%.

essential to the 1,800 plus customers in Willits. We should not allow events as they are now cast to run their course, risking a shutdown of the utility or cessation of service.

It is well settled that the Commission may in an emergency grant interim rate relief to a public utility (Pacific Tel. & Tel. Co. (1949) 48 CPUC 487). But such relief is an extraordinary remedy to be employed only when the Commission is persuaded by the evidence before it that the time involved in the usual disposition of the case will cause irreparable financial harm (So. Cal. Edison Co. (1969) 69 CPUC 717), and when the earnings of the utility are so low as to constitute a severe threat to its ability to continue service (Greyhound Line Inc. (1968) 68 CPUC 574).

There is no question but that this utility and its owner face an emergency. Appropriately or not, it has been spending more than it has been earning when we consider the situation relative to the timber revenues. Consider the contrasted results of operations set forth below. If we take the staff figures derived from the June 17, 1983 staff report made following a field investigation, and assume that the staff's estimates of what expenses should be are reasonably correct, and will stand up after testing in hearing (and they are approximately $200,000 less than applicant's), and that staff's estimate of revenues (ex timber revenues) is also reasonably correct (it is approximately $35,000 more than applicant's), applicant is currently losing $39,000 a year, although this includes a $71,800 allowance for depreciation expense. Thus, its rate of return is a negative 1.4%.

Contrasted Results of Operations - 1983
(Without Timber Revenues)
(In thousands)

	Applicant	Staff
Operating Revenues	$321.7	$355.0
Operating Expenses		
Operation & Maintenance	250.6	221.5
Admin. & General	216.0	66.1
Taxes other than Income	66.5	34.3
Depreciation	66.3	71.8
Income Taxes	-	-
Total Expenses	599.4	393.7
Net Operating Revenue	(277.7)	(38.7)
Depreciated Rate Base	2,855.2	2,766.4
Rate of Return	(9.7%)	(1.4%)

(Red Figure)

We will address the issue of whether or not Horn and PG&E required or had authorization under PU Code § 851 to apply the timber revenues to reduce the face amount of Horn's outstanding obligation to PG&E vis-a-vis purchase of the system, with all its ramifications, at the forthcoming hearing. In the interim, both Horn and PG&E are on notice that this Commission does not by this consideration of interim relief signify its approval of that transaction. Apart from the propriety of using revenues specifically directed to be used for the interest of the ratepayers, the magnitude of the interest to be paid on the Horn note after the second year raises questions on the prudence of any such application.[8]

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8 The $647,560.13 promissory note given by the Horns to PG&E provided that the Horns must pay interest after June 5, 1981 on the unpaid balance of the principal at the rate of 11.5% per annum for the first two years, and thereafter at the rate equal to PG&E's "before tax embedded cost of capital." Staff estimates that PG&E's before tax embedded cost of capital in 1983 will be 20.83%.

However, the situation will not permit awaiting the normal disposition of what gives every indication of being a protracted matter. The pending default proceeding, nonpayment of property taxes and city franchise taxes, and failure to pay the accounting firm for services rendered, all pose immediate financial problems that can be alleviated or postponed only by the infusion of money. But Horn's bankers are unwilling to advance loans until he can demonstrate sufficient revenues to generate a positive cash flow. In fact, the situation constitutes a severe threat to the utility's ability to continue service.

The immediate interim answer seems clear. In D.92192, the last general rate increase in 1980, the utility was authorized a rate of return of 9%. Timber revenues were included. As set forth below, if we apply staff's present estimates of 1983 water revenues, impute timber revenues, and add a sufficient interim increase so that we obtain total pro forma revenues which, applying staff's estimated depreciated rate base with staff's estimated operating expenses, would produce the 9% rate of return we authorized in D.92192, we would require an interim increase of $116,500. If we then drop out the imputed timber revenues, this same additional interim increase will still produce a net of $76,700 above operating expenses, for a positive rate of return of 2.8% based on the de facto situation.

Results of Operations

(In thousands)

	1980 D.92192	1983 Application	1983 Staff Estimates Actual	For 9%	Proposed
Operating Revenues					
Water Revenues	$419.3	$321.7	$355.0	$355.0	$355.0
Timber Revenues	172.7	-	172.7	172.7	-
Interim Increase	-	-	-	116.5	116.5
Total Revenues	$592.0	321.7	527.7	644.2	471.5
Operating Expenses					
Oper. & Maint.	183.5	250.6	221.5	221.7	221.7
Admin. & Gen.	72.9*	216.0	66.1	66.1	66.1
Taxes other than Inc.	54.4	66.5	34.3	35.0	35.0
Depreciation	70.2	66.3	71.8	71.8	71.8
Income Taxes	18.0	-	-	.2	.2
Total Expenses	399.0	599.4	393.7	394.8	394.8
Net for Return	193.0	(277.7)	134.0	249.4	76.7
Depreciated Rate Base	2,144.7	2,855.2	2,766.4	2,766.4	2,766.4
Rate of Return	9.0%	(9.7%)	4.8%	9.0%	2.8%

(Red Figure)

*Under PG&E includes Admin. & Gen. 2.3 + Gen. Office Prorated 70.6 = 72.9

By this approach we rectify our 1980 D.92192 overestimation of water revenues, bring expense projections in line with staff's estimate of expenses appropriate for a water utility of this size and circumstance, and still provide that rate of return found appropriate and authorized in the 1980 proceeding, but no more until after hearing. The reasonableness of the 9.0% rate of return for this interim relief is further demonstrated when it is contrasted with the June 17, 1983 staff report which states that the Revenue Requirements Division considers a rate of return of 12.5% as reasonable for this utility.

For the above reasons we determine that an interim partial rate increase to average 32.8% would be appropriate pending our final order in this proceeding. As noted, this average rate increase would produce an approximate $116,500 in additional water revenues annually. This average 32.8% increase is reflected in the new tariff schedule for the system attached to this order as Appendix A. However, some comments relating to the rate design adopted follow.

While the service charge with inverted quantity rate structure adopted in D.92192 in 1980 partially complied with our conservation objectives, representing as it did a change from the former minimum charge with declining quantity rates, the overall rate design still left two deficiencies for correction in subsequent proceedings:

1. The lifeline increase was greater than the system average increase, and
2. The equivalent meter factors were based upon minimum charge ratios rather than upon service charge ratios.

Unfortunately, we cannot in this interim order fully adjust these deficiencies without obtaining an unacceptable rate structure. Therefore, with the objective of eventually arriving at our model rate structure, and attaining the usual 25% lifeline differential desired, the interim rates we authorize by this interim order have incorporated the following revisions:

1. The authorized service charges are based upon the service charge ratios for equivalent meter factors, and
2. The increase to lifeline users is limited to approximately 20%.

A comparison of typical monthly bills at present and authorized rates is shown in the following tabulation for a 5/8 x 3/4 inch meter:

Comparison - Typical Customer Bills

Present and Adopted Rates

5/8 x 3/4 Inch Meter

Usage	Present Bill	Adopted Rates	Amt. Increase	% Increase
0 cu.ft.	$ 4.90	$ 5.90	$ 1.00	20.4
100 cu.ft.	5.40	6.51	1.11	20.6
200 cu.ft.	5.90	7.12	1.22	20.7
300 cu.ft.	6.40	7.73	1.33	20.8
500 cu.ft.	7.66	9.57	1.91	24.9
1,000 cu.ft.	10.80	14.17	3.37	31.2
3,000 cu.ft.	23.36	32.57	9.21	39.4
5,000 cu.ft.	35.92	50.97	15.05	41.9
10,000 cu.ft.	67.32	96.97	29.65	44.0
30,000 cu.ft.	192.92	280.97	88.05	45.6

The percentage increases at large usages for other meter sizes are comparable to the percentages shown on the above tabulation.

Findings of Fact

1. In June 1981 the Horns acquired the system from PG&E under authorization granted by the Commission in D.92921 dated April 21, 1981 in A.59792.

2. The Horns since acquisition have operated the system as a sole proprietorship with Horn providing managerial direction.

3. The last rate increase for the system was authorized by D.92192 dated September 3, 1980 in A.58629. It was the first in 26 years.

4. In D.92192 the Commission determined that a rate of return on depreciated rate base of 9.0% was reasonable for this system.

5. As the apparent consequence of a realization of less water revenues but substantially higher claimed administrative and general expenses than forecast in D.92192, and of the application of certain timber revenues (revenues ordered by D.92192 to be included in revenue) to reduce the Horn's PG&E note, the system is in serious financial difficulties.

6. Asserting that for 1983 the system will sustain losses of approximately $277,000 and incur a 9.7% negative rate of return, in October 1982 Horn filed this application seeking a 269.2% increase in rates.

7. Although provided a copy of the NOI procedure for filing an application, Horn did not comply with that procedure. Consequently, he is not entitled to the benefits of the Commission's Regulatory Lag Plan for Water Utilities in this application.

8. The staff has completed an in-depth field investigation of this utility and has prepared a report including its estimated results of operations for 1983.

9. The staff report, with or without imputation of the timber revenues and after deletion and/or reduction of expenses claimed to levels staff deems reasonable, confirms that the system's rate of return falls short of the 9.0% last authorized. If timber revenues are not imputed, the staff report would show that the system has a negative rate of return, and is in financial difficulties of an emergency nature.

10. For purposes of an interim rate increase, adopting staff's water revenue and expense estimates and rate base, and after imputing timber revenues, staff's estimate of the 1983 results of operations shows that an interim rate increase of 32.8% to yield an approximate $116,500 would not exceed the 9.0% rate of return last found reasonable and applicable to this system in D.92192.

11. An increase in rates and charges averaging 32.8% would be just and reasonable on an interim basis pending our final order in this proceeding, based as it is upon staff's results of operations which are reasonable estimates of 1983 test year operations upon which to rest an interim, partial rate increase, pending our final order. The present rates and charges, insofar as they differ from those prescribed by this decision, are for the future unjust and unreasonable.

Conclusions of Law

1. The evidence shown by the staff report shows that the system is presently in an emergency, and the earnings are so low as to constitute a severe threat to the system's ability to continue service.

2. The staff's estimate of results of operations shows that a rate increase is merited on an interim basis pending our final order in this proceeding.

3. To the extent set forth in the following order a partial rate increase should be granted.

4. The effective date of this order should be the date of signature because of the emergency situation.

INTERIM ORDER

IT IS ORDERED that after the effective date of this order, Little Lake Water Company is authorized to file the revised rate schedules attached to this order as Appendix A. Such filing shall comply with General Order 96-A. The effective date of the revised schedules shall be five days after the date of filing. The revised schedules shall apply only to service rendered on and after the effective date of the revised schedules.

This order is effective today.

Dated JUL 20 1983, at San Francisco, California.

LEONARD M. GRIMES, JR.
President
VICTOR CALVO
PRISCILLA C. GREW
DONALD VIAL
WILLIAM T. BAGLEY
Commissioners

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

Joseph E. Bodovitz

Joseph E. Bodovitz, Executive Director

APPENDIX A

LITTLE LAKE WATER COMPANY

Schedule No. W-1

GENERAL METERED SERVICE (C)

APPLICABILITY

Applicable to all metered water service.

TERRITORY

The incorporated City of Willits, and unincorporated contiguous area as shown on the service area map of the Willits Water System.

RATES

	Per Meter Per Month	
		(D)
		(D)
Service Charge:		
For 5/8 x 3/4-inch meter	$ 5.90	(I)
For 3/4-inch meter	8.00	
For 1-inch meter	11.00	
For 1½-inch meter	15.00	
For 2-inch meter	20.00	
For 3-inch meter	37.00	
For 4-inch meter	50.00	
For 6-inch meter	83.00	
For 8-inch meter	124.00	(I)
Quantity Rates:		
First 300 cu.ft., per 100 cu.ft.	$ .61	(I)
For all over 300 cu.ft., per 100 cu.ft.	.92	(I)

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

SPECIAL CONDITIONS

Customers, whose requirements, in the opinion of the Utility, may overburden its water system, may require unreasonable investment in additional facilities or may interfere with the supply to existing customers, will not be supplied water service under this rate schedule. In such cases a special contract will be required under such terms as the conditions warrant, subject to review by the Public Utilities Commission of the State of California.

(END OF APPENDIX A)