

ORIGINAL

Decision No. 88875 MAY 31 1978

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of California-American Water Company, a corporation, for authority to raise rates in its San Marino District.	)	Application No. 57087
	)	(Filed February 15, 1977;
	)	amended December 9, 1977)

Eugene L. Freeland, Attorney at Law,
for applicant.
William C. Bricca, Attorney at Law,
for the Commission staff.

O P I N I O N

Applicant California-American Water Company seeks authority to increase rates for water service in its San Marino District to produce an additional \$223,600 annually in gross revenues, which is a 13.15 percent increase. Public hearing was held before Administrative Law Judge Main in San Marino on December 21, 1977. Notice of hearing was published, mailed to customers, and posted in accordance with this Commission's Rules of Practice and Procedure. The matter was submitted on January 20, 1978 upon the receipt of late-filed Exhibit 15.

Testimony on behalf of applicant was presented by its vice president. Several customers testified, urging the introduction of lifeline rates. The Commission staff presentation was made through accountants and engineers.

Applicant, a California corporation, is a wholly owned subsidiary of the American Water Works Company, Inc. (AWWC) of Wilmington, Delaware, and operates public utility water systems in portions of the counties of San Diego, Los Angeles, Ventura, and Monterey. Applicant's San Marino District provides public

utility water service to about 13,000 customers and consists of two physically separated systems designated as "Upper" and "Lower". The Upper System serves the city of San Marino and a portion of the city of San Gabriel and vicinity. The Lower System serves the cities of Rosemead, Temple City, and El Monte, and certain unincorporated territory of Los Angeles County.

Rates

Applicant proposes to change from its present block-rate type structure to a service charge plus uniform commodity charge type for its general metered service, to increase rates for that service, and to increase rates for construction and other temporary water service (Schedule SM-9). Present rates for general metered service are as follows:

Item	Per Meter Per Month	
	Lower System	Upper System

Quantity Rates

First 800 cu.ft. or less	\$ 3.10	\$ 3.10
Next 1,700 cu.ft., per 100 cu.ft. ....	.303	.340
Next 7,500 cu.ft., per 100 cu.ft. ....	.263	.298
Over 10,000 cu.ft., per 100 cu.ft. ....	.222	.236

Minimum Charge

For 5/8 x 3/4-inch meter	\$ 3.10	\$ 3.10
For 3/4-inch meter	4.00	4.00
For 1-inch meter	6.20	6.20
For 1 1/2-inch meter	11.00	11.00
For 2-inch meter	16.00	16.00
For 3-inch meter	32.00	32.00
For 4-inch meter	49.00	49.00
For 6-inch meter	88.00	88.00
For 8-inch meter	135.00	135.00
For 10-inch meter	175.00	175.00
For 12-inch meter	236.00	236.00

The Minimum Charge will entitle the customer to the quantity of water which that minimum charge will purchase at the Quantity Rates.

Rate of Return

A public utility is constitutionally entitled to an opportunity to earn a reasonable return on its investment which is lawfully devoted to the public use. It is a percentage expression of the cost of capital utilized in providing service. Within this context, a fair and reasonable rate of return applied to an appropriately derived rate base quantifies the earnings opportunity available to the enterprise after recovery of operating expenses, depreciation allowances and taxes.

Ultimately, the rate of return determination in this proceeding must represent the exercise of informed and impartial judgment by the Commission, which must necessarily give equal weight to consumer and investor interests in deciding what constitutes a fair and reasonable rate of return. Such balancing of interests is directed toward providing water consumers with the lowest rates practicable, consistent with the protection of the utility's capacity to function and progress in furnishing the public with satisfactory, efficient service and to maintain its financial integrity, attract capital on reasonable terms and compensate its stockholders appropriately for the use of their money.

Applicant contends that the fair rate of return for it is 10.08 percent, which is based on its capital structure, as of December 31, 1976, consisting of 60.66 percent debt and 39.34 percent adjusted common equity, its embedded cost of debt of 8.84 percent, and an allowance for return on equity of 12 percent. To support the 12 percent return on common equity, applicant points to recent decisions by the Commission involving California Cities Water Company, San Gabriel Valley Water Company, California Water Service, and Southern California Water Company in which authorized rates of return result in computed returns on common equity ranging from 12.00 to 12.78 percent.

The Commission staff contends that 9 to 9.3 percent is a reasonable range in rate of return to be applied to applicant's rate base. In reaching its recommended range the staff used the consolidated capital structure and debt costs of AWWC, applicant's parent company, and its subsidiaries. The staff stresses that such use is consistent with our holdings in the prior decisions on this utility, that the recommended range brackets the 9.2 percent found reasonable for applicant in its last general rate proceeding (D.86249 dated August 17, 1976), and that there has been no material change in either the consolidated capital ratios or costs of senior securities of AWWC and its subsidiaries since that determination.

In D.86249 the following reasons were listed for the staff's using the consolidated capital structure and debt cost of AWWC and its subsidiaries:

- "1. That capital structure and debt cost was adopted in recent rate increase proceedings involving applicant's Village, Baldwin Hills, Coronado, and Sweetwater Districts.
- "2. Secondary leverage will cause American's yield on common equity to be greater than applicant's yield on common equity.
- "3. The use of American's capital structure negates the downward adjustment of Cal-Am's interest rate on original long-term debt (which resulted from refinancing the original short-term debt of applicant) adopted by the Commission rate increase applications prior to the Village proceeding."

Despite the above quoted reasons, using the consolidated capital structure of AWWC and its subsidiaries is, nonetheless, unwieldy because that structure is so highly leveraged. The common equity ratio is in the 20 percent range which makes the

very difficult task of setting the reasonable return on common equity more difficult. Also, its use is worrisome in that the embedded cost of debt to the operating company and the relative importance of that debt in its own capital structure are not visible.

With regard to the benefit to the parent company from secondary leverage it would appear that effect is mitigated by a plant acquisition adjustment. That is an adjustment which precludes the inclusion in rate base and therefore earnings on the amount by which the purchase price of water systems exceeds the net book value of the properties. As of August 31, 1977 applicant's unamortized plant acquisition adjustment was \$4,929,934 (Exhibit 12, Attachment 3).

With regard to the interest rate on applicant's original long-term debt (\$20,000,000, 8-3/4 percent, first mortgage bonds, 1969 issue, due 1995), we made in D.76279 (1969) 70 CPUC 243 the following findings:

"3.a. . . .

- "b. When applicant was organized to acquire the Water Department of CW&TC, AWWC borrowed \$45,000,000 from six banks, two on the West Coast and four in the East, of which \$20,000,000 was loaned to applicant on a 3-year note bearing interest at 5-1/4 percent. Said note expired on March 31, 1969, and applicant has been required to refinance said note with notes bearing interest at 7-1/2 percent from March 31, 1969 to June 9, 1969 and at 8-1/2 percent from said latter date to December 31, 1969, and has sought authority to issue long-term debt at 8-3/4 percent.
- "c. Applicant's parents, and their bankers and investment counsellors, failed to refinance AWWC's short-term notes at lower interest rates before it was too late and the prime rate had risen, radically. They were laggard

in their efforts to obtain for applicant, and its customers, the benefits of low-cost financing. The public interest would be adversely affected if applicant's and its parents' laggardness were permitted to flow through to the customers in the form of higher rates for water service.

- "d. Applicant's predecessor, CW&TC, had a long financial history with capabilities of borrowing large sums of money at low interest rates.

This original long-term debt was incurred for applicant's six original districts. The properties of one of the largest of those districts, the Sweetwater District, have been taken by a public entity. As a result of that condemnation, applicant's capital structure is undergoing substantial change.

In Decision No. 86807 dated January 15, 1977 in Case No. 9530, we discussed extensively the results of the staff's investigation into the finances of AWWC and Cal-Am. Among other things, we observed that AWWC had not made any cash investments in Cal-Am's securities subsequent to acquiring the water properties in 1965. Moreover, we pointed out that Cal-Am's continued maintenance of a higher dividend payout ratio than the ratio of AWWC's dividend to its consolidated net income resulted in Cal-Am sending up-stream funds which were then invested in AWWC's other subsidiaries or were used to retire the holding company's stock and debt.

A prohibition on payment of dividends by Cal-Am imposed in said Decision No. 86807 was later rescinded by Decision No. 87710 dated August 16, 1977 in Case No. 9530, which further ordered that part of any funds derived from the then anticipated condemnation of the Sweetwater District be reinvested in Cal-Am's other districts.

Cal-Am's intent to conform with this order is evident in Exhibit 13 which indicates that a portion of the Sweetwater condemnation proceeds is being used "to retire its two most expensive debt issues, those being its \$5,005,000 of 9-7/8 percent debentures and \$1 million of 9-1/4 percent first mortgage bonds. In light of the present and near-term future capital requirements of its...operating districts, and because the interest rate on its 8-3/4 percent first mortgage bonds is very favorable in today's market, the company decided against calling any of the 8-3/4 percent bonds. Instead, the company's stockholders will invest the \$7.2 million of unallocated cash available from the Sweetwater condemnation in new Cal-Am water plant facilities..."

From Exhibits 1 and 13 it is apparent that applicant's capital ratios by early 1978 should approach 50 percent long-term debt and 50 percent adjusted common equity (i.e., after deducting the unamortized balance of the utility plant acquisition adjustment) and that the cost factor for its remaining long-term debt should approximate 8.60 percent.

After careful consideration of the entire record, we reach a judgmental determination of 9.6 percent as the fair rate of return for applicant. It yields a computed return on

common equity of 10.60 percent, using a capital structure of 50 percent debt and 50 percent common equity and a cost factor of 8.60 percent for debt. A 10.60 percent return on common equity comports with applicant's equity ratio being higher than that of other major water utilities under our jurisdiction and with the existing parent/applicant relationship.

If the rates for water service in each of applicant's districts are brought into balance with the fair rate of return of 9.6 percent, a computed before-tax interest coverage of 3.40 times will pertain in relation to a weighted debt cost of 4.30 percent. This will counteract a serious erosion in coverage which has been exacerbated by the removal of the earnings potential of the Sweetwater District. In Exhibit 6 applicant depicted this erosion:

Estimated Coverages 1977
(Before Income Taxes)

Forecast Basis	Earnings Available For Coverage	Interest on Long-term Debt	Coverage
12 Months Estimated	\$3,515,000	\$2,459,500	1.43 times
8 Months Recorded & 4 Months Estimated	1,875,200	2,430,900	0.77 times
10 Months Recorded & 2 Months Estimated	1,558,100	2,446,000	0.64 times

Results of Operation

Witnesses for applicant and the Commission staff have analyzed and estimated applicant's operational results for this district. Summarized in the following Table I are the estimated results of operation, taken from applicant's Exhibit 3 and the staff's Exhibit 10, for test year 1977 under present water rates. For comparison, this table also shows the results of operation at rates authorized herein.

Table I
Estimated Results of Operation
(Test Year 1977)

Item	Present Rates		Authorized Rates
	Applicant	Staff	Adopted Results
(Dollars in Thousands)			
Operating Revenues	\$1,700.0	\$1,700.0	\$1,923.6
<u>Operating Expenses</u>			
Oper. & Maintenance	846.2	846.2	846.5
Admin. & General	220.9	220.9	220.9
Depreciation	137.9	137.9	137.9
Taxes, Except Income	164.0	164.0	156.3
Income Taxes	54.6	79.4	192.6
Total Expenses	1,423.6	1,448.4	1,564.2
Net Operating Revenue	276.4	251.6	359.4
Average Rate Base	3,779.3	3,779.3	3,779.3
Rate of Return	7.31%	6.66%	9.51%

Applicant's estimates in Exhibit 3 supersede its earlier estimates set forth in Exhibit 2. The updated estimates are consistent with the staff estimates in Exhibit 10 and reflect a conservation effect. They also reflect various cost changes recently experienced including those in electric power, payroll, and payroll-related costs.

When applicant prepared its Exhibit 2 estimates of water use (322.2 Ccf per residential, 502.7 Ccf per commercial, and 991.4 Ccf per public authority customer), neither the 1976 recorded consumption was available nor was the fact that water consumption for the eleven months ended November 30, 1977 was 18.2 percent below the same period in 1976. In contrast, as set out by the staff in Exhibit 10 "Ehe estimated consumption per residential, commercial, and Public Authority metered customer by staff is 301.87 Ccf, 531.22 Ccf and 935.55 Ccf respectively for test year 1977. The staff's estimate reflects a 3.0% reduction in sales to residential and commercial customers due to a change in future use patterns resulting from applicant's water conservation program including the distribution of water conservation devices."

Our adopted operating results shown in the last column of Table I, at the rates authorized herein, reflect this staff showing modified to accommodate cost changes, including income taxes, associated with changes in revenues. One further modification increased the interest deduction used by the staff in computing taxable income from \$154,000 to \$160,200, consistent with the debt ratio of 50 percent and the debt cost factor of 8.60 percent associated with the fair rate of return determination made hereinabove. It can be seen by comparing the entries for operating revenues in Table I that the rates to be authorized yield additional annual operating revenues of \$223,600 representing a 13.15 percent increase.

Authorized Rates

Exhibit "D" appended to the amendment to the application filed December 9, 1977 foreshadowed Exhibit 3. It contained the operating results upon which applicant is basing its \$1,923,600 revenue requirement for this district (i.e., operating expenses of \$1,542,600 and net operating revenues of \$381,000, with the latter figure representing a 10.08 percent rate of return on a

\$3,779,300 rate base). On December 12, 1977 the following notice of the amended application was mailed to each customer in the San Marino District:

"NOTICE

"On February 15, 1977, California-American Water Company filed Application No. 57087 with the California Public Utilities Commission for authority to raise rates charged to the customer in its San Marino District.

"On December 9, 1977, California-American Water Company filed an amendment to Application No. 57087 with the California Public Utilities Commission requesting that the Commission recognize various changes which have occurred since filing of the original application, which consist primarily of anticipated lower revenues due to water conservation and increased costs for water assessments, electric power and payroll, experienced subsequent to the filing of the original application.

"The original application requested authority to increase rates by 9.46% for general metered and metered construction service, which was estimated would produce an additional \$159,000 annually in gross revenues. The amended application requests authority to increase rates by 13.15% for general metered and metered construction service, which is estimated will produce an additional \$223,600 annually in gross revenues.

"Inquiries relative to the proposed increase may be directed to the California Public Utilities Commission at either 455 Golden Gate Avenue, San Francisco, California 94102 or 107 South Broadway, Los Angeles, California 90012, making reference therein to Application No. 57087.

"A copy of the amended application and related exhibits may be examined at the offices of the California Public Utilities Commission at 455 Golden Gate Avenue in San Francisco and at 107 South Broadway in Los Angeles, and in the office of California-American Water Company at 2020 Huntington Drive, San Marino, California.

"The Commission has set this matter for public hearings commencing on December 21, 1977 at 10:00 AM in the City Hall, Council Chambers, 2200 Huntington Drive, San Marino, California at which time and place applicant and all interested parties may appear and be heard.

California-American Water Company"

However, because of an error in rate design, the rates as proposed by applicant yield additional annual gross revenues of \$175,000 which fall \$48,600 short of the revenue requirement of \$1,923,600 contended for by the applicant. A revenue requirement of \$1,875,000 equates to an 8.82 percent rate of return.

Although the staff supports applicant's proposed conversion from a minimum charge rate schedule to a service charge rate schedule for general metered service, it opposes applicant's proposed rate structure in other respects. That rate structure provides for a uniform quantity rate and results in a reduction in charges to certain users. In Exhibits 10 and 15 the staff recommended that a 300-cubic-foot lifeline block be established in a two-quantity-block structure with inverted rates and service charges be formulated in such manner as "to eliminate or minimize any reduction in customer's monthly bills, particularly with the high quantity users." The staff recommendation on lifeline rates comports with current Commission policy.

For comparison, tabulated on the following page are applicant's proposed rates, staff rate designs taken from Exhibit 15, and the rates authorized herein. The authorized rates are designed to yield additional annual gross revenues of \$223,600 requested by applicant and achieve a 9.51 percent rate of return on a 1977 test year basis.

Item	Per Meter Per Month			Authorized Rates Herein
	Applicant Staff Rate Designs	Proposed 8.82% Rate	10.08% Rate of Return	

Service Charge:

For 5/8 x 3/4-inch meter	\$ 2.60	\$ 2.60	\$ 2.75	\$ 2.70
For 3/4-inch meter	2.90	3.10	3.30	3.20
For 1-inch meter	3.90	4.70	5.00	4.80
For 1 1/2-inch meter	5.50	7.30	7.70	7.50
For 2-inch meter	7.00	10.40	11.00	10.70
For 3-inch meter	13.00	20.00	21.00	20.50
For 4-inch meter	17.80	29.40	31.00	30.20
For 6-inch meter	29.50	52.00	55.00	53.30
For 8-inch meter	44.00	79.00	83.00	81.00
For 10-inch meter	54.50	101.00	107.00	103.60

Quantity Rates:

Lower System

Per 100 cu.ft.	\$ 0.236	\$ -	\$ -	\$ -
First 300 cu.ft., per 100 cu.ft..	-	0.172	0.181	0.177
Over 300 cu.ft., per 100 cu.ft..	-	0.233	0.246	0.239

Upper System

Per 100 cu.ft.	\$ 0.275	\$ -	\$ -	\$ -
First 300 cu.ft., per 100 cu.ft..	-	0.192	0.202	0.197
First 300 cu.ft., per 100 cu.ft..	-	0.260	0.274	0.267

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.

Investment Tax Credit Reporting

In Decision No. 87838 dated September 13, 1977 in Application No. 53587, et al, concerning the Pacific and General telephone companies we made the following finding:

"4. For ITC we shall make an adjustment prior to the end of each calendar year (or as soon thereafter as possible) for the rates to be set beginning January 1 of the next calendar year taking into account at that time the growth in the amount of ITC estimated for the next immediate future calendar year as compared to the last test year (or last preceding year), and recomputing federal tax expense and gross revenue requirements based on that new estimate for each year between rate cases. This method complies with the requirements of ratable (service life) flow-through selected by the utilities under IRC Section 46."

Based on this quoted finding, the staff recommended that applicant California-American Water Company "submit to the Commission sometime prior to the end of each calendar year beginning with the test year, their estimated Investment Tax Credit for the next calendar year relating to the 6% ratable flow-through to income. Applicant should also show the effect on rates to be effective beginning January 1 of the next calendar year, taking into account at that time the growth in the amount of Investment Tax Credit estimated for the next immediate future calendar year as compared to the last test year (or last preceding year), recomputing the federal tax expense and gross revenue requirements based on the new estimate for Investment Tax Credit for each year between rate cases...."

Applicant's response to the staff recommendation is contained in late-filed Exhibit 12 in the Village District rate proceeding (A.56966). That exhibit has been incorporated into this record by reference.

Applicant opposes putting into effect at this time the annual adjustment which is indicated by the staff proposal, contending that the issue of whether it will result in a denial of the investment tax credit is controversial and unresolved. Holding the staff's proposal in abeyance will, it asserted, allow a meaningful review of the issues involved before any irreparable harm results. If this is done, applicant argued, the need for it to become involved in this controversial and many-faceted issue will be eliminated and in time when the issues are finally resolved, the Commission can apply to applicant the results of the litigation.

Applicant also pointed out that pertinent projections for the ensuing year are not available in November, its capital budget for any given year being given final approval in February of that year. Any projection prior to that date would, according to applicant, be highly speculative and clearly unreliable because it would not reflect management's consideration of current business conditions (e.g., strikes or shortages of building materials).

From our standpoint, the staff recommendation appears premature in that Decision No. 87838, supra, has been stayed pending the appeal to the California Supreme Court. Nonetheless, to assist the staff in monitoring for informational purposes changing revenue requirements with changes in income taxes ascribable to ratable flow-through of the investment tax credit, applicant will be directed to furnish the data sought by the staff but to do so with a three-month lag. That lag is in keeping with applicant's timetable for its capital budget (i.e., the due date is moved from the end of the calendar year to the end of March of the ensuing year).

Findings

1. Applicant's water quality, conservation program, and service are satisfactory.
 2. The adopted estimates, previously discussed herein, of operating revenues, operating expenses, and rate base for the test year 1977 reasonably indicate the probable results of applicant's operations for the near future.
 3. Applicant's request for an increase in gross operating revenues of \$223,600 for this district equates to a 9.51 percent rate of return on rate base in our adopted operating results. This is slightly less than the fair rate of return for applicant, which rate of return is 9.6 percent. Such increase is just and reasonable.
 4. The rates authorized herein for general metered service are based on the staff recommended rate design. That design is appropriate and proper.
 5. The proposed rates for construction and other temporary service (Schedule SM-9) are reasonable.
 6. The increases in rates and charges authorized herein are justified; the rates and charges authorized herein are reasonable; and the present rates and charges, insofar as they differ from those prescribed herein, are for the future unjust and unreasonable.
- The Commission concludes that the application should be granted to the extent provided by the following order and that applicant should be required to furnish for informational purposes certain data concerning the investment tax credit.

O R D E R

IT IS ORDERED that:

1. After the effective date of this order, applicant California-American Water Company is authorized to file for its San Marino District the revised rate schedules attached to this order as Appendix A. Such filing shall comply with General Order No. 96-A.

The effective date of each revised schedule shall be four days after the date of filing. The revised schedule shall apply only to service rendered on and after the effective date thereof.

2. Applicant shall furnish the staff with data by district substantially as described in this decision under investment tax credit reporting and in paragraph 31 of Exhibit 10. The data for year 1978 shall be tendered to the staff on or before June 30, 1978. Thereafter, for three more years, such information shall be provided each year on or before March 31 of the year to which the estimates apply.

The effective date of this order shall be thirty days after the date hereof.

Dated at San Francisco, California, this 31st day of MAY, 1978.

Rolent Bateman
President

Vergard L. Steggen
Richard D. Thiele

Commissioners

I concur in part &
dissent in part.
William Synovs, Jr

Commissioner Claire T. Dedrick, being necessarily absent, did not participate in the disposition of this proceeding.

APPENDIX A
Page 1 of 2

Schedule No. SM-1

San Marino District Tariff Area

GENERAL METERED SERVICE

APPLICABILITY

Applicable to all metered water service.

TERRITORY

San Marino, Rosemead, portions of San Gabriel, Temple City, and vicinity, Los Angeles County.

RATES

	<u>Per Meter Per Month</u>		
	<u>Lower System</u>	<u>Upper System</u>	
Service Charge:			(c)
For 5/8 x 3/4-inch meter	\$ 2.70	\$ 2.70	(c)(I)
For 3/4-inch meter	3.20	3.20	|
For 1-inch meter	4.80	4.80	|
For 1 1/2-inch meter	7.50	7.50	|
For 2-inch meter	10.70	10.70	|
For 3-inch meter	20.50	20.50	|
For 4-inch meter	30.20	30.20	|
For 6-inch meter	53.30	53.30	|
For 8-inch meter	81.00	81.00	|
For 10-inch meter	103.60	103.60	(c)(I)

Quantity Rates:

First 0-300 cu.ft., per 100 cu.ft. ..	\$ 0.177	\$ 0.197	(c)(I)
Over 300 cu.ft., per 100 cu.ft. ..	0.239	.267	(c)(I)

The Service Charge is applicable to all metered service. It is a readiness-to-service charge to which is added the charge, computed at the Quantity Rates, for water used during the month.

(c)
|
(c)

APPENDIX A
Page 2 of 2

Schedule No. SM-9

San Marino District Tariff AreaCONSTRUCTION AND OTHER TEMPORARY SERVICEAPPLICABILITY

Applicable to temporary water service provided on a flat rate basis for street paving, curb and sidewalk construction, and for water delivered to tank wagons or trucks from fire hydrants or other outlets provided for such purposes.

TERRITORY

The cities of San Marino and Rosemead and portions of the cities of San Gabriel, El Monte, Temple City, and certain contiguous unincorporated areas in Los Angeles County.

RATES

For Flooding Ditches:

0 to 4' deep	\$.016	Per Lineal Foot (I)
Over 4' to 6' deep .....	.022	"
Over 6' to 8' deep .....	.027	"
Over 8' to 10' deep .....	.033	"
Over 10' to 12' deep .....	.044	"
Over 12' deep .....	.077	"

For Water Delivered in Tank Wagons \$.077 Per 100 Gallons (I)

SPECIAL CONDITIONS

1. For other temporary uses the quantity of water used shall be estimated or metered by the utility. Charges for such water shall be at the quantity rate for General Metered Service.

2. Applicant for temporary service shall be required to pay the utility in advance the net cost of installing and removing any facilities necessary in connection with furnishing such service by the utility.

3. Applicant for temporary service may be required to deposit with the utility a sum of money equal to the estimated amount of the utility's bill for such service.