Decision **DRAFT DECISION OF ALJ BUSHEY (Mailed 6/10/2003)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Application of Point Arena Water Works, Inc. for an order authorizing a rate increase in rates subject to refund producing additional annual revenues of $70,137 or 56.9% for the test year 2002.	Application 02-11-057 (Filed November 25, 2002)

INTERIM OPINION RETAINING ACCOUNTING AND RATEMAKING TREATMENT OF 1995 TAX REFUND

Summary

This decision holds that the Commission retain the accounting and ratemaking of income tax refunds received by Point Arena Water Works (PAWW) over a several-year period ending in 1995.

Background

In Resolution W-4356, October 24, 2002, the Commission granted PAWW a $70,137 or 56.9% rate increase, subject to refund. About a year earlier, the Commission had also granted PAWW a $47,677 or 62.3% rate increase, also subject to refund, based on a finding that such an increase was necessary to provide sufficient funds to meet PAWW's cash operating expenses with no depreciation or rate of return on rate base. The Commission noted that PAWW's last rate case was in 1991, and that PAWW operated at a loss of $56,687 in 2000. As part of its review leading up to Res. W-4356, the staff conducted two public

meetings in Point Arena and prepared an extensive staff report with accompanying audit of the utility's 2000 books of account.

The City of Point Arena (City) objected to the rate increases requested by PAWW and disagreed with staff's review. At the staff's recommendation, the Commission converted this advice letter rate case to a formal proceeding in Resolution W-4356.

Among its other issues, the City differed with PAWW and staff regarding the proper ratemaking treatment of an income tax refund to PAWW from the 1990s. The staff auditor concluded from PAWW's records, that (1) the tax refund had been obtained by PAWW at its own expense, and (2) the money had been used to meet operating and maintenance expenses that utility revenue failed to cover. Accordingly, the auditor recommended the tax refund not be used to lower prospective rates. The City disagreed. In Res. W-4356, the Commission noted that "This difference of opinion can be addressed in the formal proceeding…."

On March 20, 2003, the assigned Administrative Law Judge (ALJ) convened a prehearing conference (PHC). The tax refund was among the matters discussed at the PHC, and the ALJ set a briefing schedule on the question of "whether or not this issue should be in this proceeding." The ALJ also set a procedural schedule for the remainder of this proceeding. As noted above, the rate increase proposals at issue here have been through an extensive informal review process with our staff, including an audit and a staff report. PAWW and our staff indicated at the PHC that they would rely extensively on these previously prepared analyses to make the required showing.

The tax refund has great significance for revenue requirement, with the potential of completely offsetting current rate base. Consequently, resolution of

this issue is key to the scope of the subsequent portions of this proceeding. The parties have filed extensive opening and reply briefs, with accompanying documentation.

In its initial brief, PAWW provided documents (including copies of cancelled checks) showing that the net state and federal tax refund was $184,954 and that it had been received by 1995. PAWW also showed that customers did not pay any of the costs of obtaining this refund. PAWW explained that in 1993 AT&T Communications, Inc. (AT&T) agreed to fund a new water main that would enable PAWW to provide fire protection to Point Arena City Hall and High School. AT&T entered into such an agreement to promote good will with the community due to a series of construction failures, with resulting environmental degradation, when crossing streams with its fiber optic cable system. AT&T paid $660,236.79 to PAWW for the costs of the water main. At the time, AT&T and PAWW believed that federal tax law would characterize such a payment as a contribution in aid of construction, and that the payment would be taxable income to PAWW. Consequently, AT&T and PAWW agreed that AT&T would pay to PAWW the amount of the expected tax in addition to actual construction costs. PAWW then remitted the tax amount to the state and federal taxing authorities. PAWW subsequently came to believe that changes in the tax laws had resulted in this type of construction payment being no longer considered income. PAWW decided to seek a refund, and AT&T declined to participate in the effort or to share in any amounts recovered. PAWW successfully obtained state and federal refunds.

In its initial brief, the City contended that AT&T's total payment, including the amount for taxes, to PAWW should be included in PAWW's contributions in aid of construction account. For ratemaking purposes, contributions in aid of

construction are an offset to ratebase, so the City's proposal would have the effect of reducing ratebase by the amount of refund. The City calculated the total refund to be about $519,000. The City also argued that the alleged misuse and disappearance of this amount from PAWW's accounts has a significant and continuing impact on the financial capability of the company to provide safe and efficient service.

In its reply brief, PAWW vigorously contested the City's calculation of the amount at issue and referred to the documents attached to its opening brief. PAWW also contended that the City's proposal to use the tax refunds as an offset to rate base would effectively deny PAWW an opportunity to earn a rate of return and would violate the rule against retroactive ratemaking.

The City, in its reply brief, alleged that PAWW had illegally removed the tax refund amount from the contributions in aid of construction account and paid it to the shareholder and affiliated businesses, and that restoring it to the account would correct this error.

Discussion

Pursuant to Pub. Util. Code § 451, all rates charged by a public utility must be just and reasonable. The Commission has determined that such rates must be based on the reasonable cost of providing service to customers. Specifically, the Commission uses projections of future costs - a "future test year" – to evaluate whether the revenue to be collected from customers under proposed rates would cover the utility's costs.

For large water utilities, the Commission has set a three-year schedule for each utility to present a general rate case to the Commission. In this way, the Commission can monitor revenue and cost levels to ensure that the utility is

neither over nor under earning. (See Re Schedule for Processing Rate Case Applications by Water Utilities, 37 CPUC2d 175 (D.90-08-045).)

For small water utilities, such as PAWW, the cost of presenting a formal rate case to the Commission is a significant expense.[1] The Commission, therefore, has established a simplified procedure for rate case review, which enables small water utilities to obtain rate review and any needed modifications more economically. The Commission has not imposed a specific time schedule on small water utilities to file general rate cases. Despite the flexibility the Commission has allowed small water utilities, the Commission has not wavered from its commitment to small water utilities charging cost-based rates.

Resolution W-4356 describes the staff's investigation and audit that led it to conclude that PAWW had allowed its rates to diverge substantially from its costs, and that it had been losing money since 1994. In 2000, our auditors found that the divergence resulted in operating expenses exceeding operating revenues, which justified an immediate 62% rate increase just to meet cash operating expenses, with no depreciation or return on rate base. Thus, PAWW's 2000 rates bore little relation to PAWW's 2000 costs. Failure to synchronize costs and rates is at odds with our fundamental commitment to cost-based rates.

PAWW sought to correct this imbalance in 2002 with its request to triple its rates. Although the Commission allowed only a bit more than doubling the rates, customers were understandably distressed by the size of this increase. Such an outcome, however, is directly attributable to PAWW's decisions not to seek rate review for over a decade.

---

[1] We note that PAWW has reported that expenses for this case to date exceed $80,000.

Another likely outcome of postponing rate review for so long was that in the intervening decade PAWW would make management decisions that were inconsistent with Commission policy. PAWW's use of income tax refunds for operating and maintenance expenses was such a decision. When a public utility receives substantial and unexpected revenue, the Commission's strong preference is to evaluate prospectively options for allocating the revenue. Here, however, PAWW's long absence from Commission review has precluded prospective allocation.

The City has presented us with a sound argument for one possible allocation methodology, namely, treating the tax refund as a contribution in aid of construction. The California Constitution and the Public Utilities Code grant us sufficient ratemaking authority over PAWW to allow us to implement this option, and others, if we were to determine that such an outcome was appropriate in the circumstances. For the reasons set out below, however, we decline to do so.

PAWW's shareholders have incurred substantial out-of-pocket losses in the last several years. Our auditor documented a net operating loss of $56,687 in 2000, and the recently filed 2002 annual report showed a $28,636 loss, despite the rate increase authorized in October 2002. Losses of nearly $90,000 in just two years would suggest that over the last several years PAWW's losses have exceeded the net tax refund. More importantly, we are compelled to note the practical difficulties inherent in allocating funds that are no longer available. While the Commission can and does impute improperly used funds regardless of the actual availability of the funds, such ratemaking fictions are of little use to a small system, such as PAWW's, which requires actual cash to meet expenses. Accordingly, persuasive facts would be needed to justify setting aside these

practical issues. In this case, the offers of proof included in the parties' briefs do not rise to that level.

PAWW management, with the assistance of counsel, sought and obtained the refund on its own initiative and did not seek reimbursement in rates for its legal costs. Moreover, our auditor found that PAWW used the tax refund for operating and maintenance expenses, which kept customer rates lower than a revenue requirement analysis would have supported. In Res. W-4356, we granted an interim increase that more than doubled rates, based on our determination that customer revenue had not been adequate to meet costs. Regardless of the outcome of the remaining, non-tax refund issues, it is clear that the lengthy rate case hiatus, which enabled this issue to remain dormant for so long, has benefited customers in the form of lower rates and has resulted in substantial losses for shareholders.

The City's proposed treatment of the tax refund as a contribution in aid of construction is but one of many allocation methodologies that we might use to address this issue. In its briefs, the City cites extensively to the Uniform System of Accounts for the proposition that the tax refund should be returned to the contributions in aid of construction account and used as a deduction to rate base. Simply crediting the amount to that account, however, does not resolve the ratemaking question. It is a well-settled proposition that accounting rules do not control ratemaking. (See, e.g., Decision No. 42068, (September 21, 1948) 48 CPUC 253, 257.)

The Commission has previously changed accounting and ratemaking treatment after the fact, rejecting assertions that to do so would violate the rule against retroactive ratemaking. In Re California Water Service Company, (1994) 56 CPUC2d 4 (D.94-09-032), the Commission ordered Cal Water to change its

accounting and ratemaking for sale proceeds from 26 real estate parcels from giving all proceeds to shareholders to dividing the proceeds 50/50 between shareholders and ratepayers.[2] The Commission found that: "[Its] ratemaking authority is not constrained by the Uniform System of Accounts" and that such changes to a utility's accounting and ratemaking treatment do not constitute retroactive ratemaking. (Id. at 18.)

Here, as in the Cal Water decision, the Commission has the discretion to order changes in the accounting and ratemaking for this capital account. The Commission reached its decision in Cal Water by "weighing the equities and consideration of the ongoing needs of the utility." Consideration of similar factors in this case leads to today's decision declining to change PAWW's accounting and ratemaking treatment. Also as we did in Cal Water, we direct PAWW in the future to comply fully with the Uniform System of Accounts and to seek staff guidance when needed.

If the Commission had been presented with this issue in a timely manner, the Commission would have used its broad discretion in an orderly manner to allocate this extraordinary revenue pursuant to a wide range of potential allocation methodologies. However, retrospective allocation of the funds after the passage of many years adds substantial complexities including the potential for significant accounting adjustments to PAWW's books. While such adjustments are within the Commission's authority, such extraordinary actions

[2] The Commission concluded that the changes in accounting and ratemaking would not be retroactive ratemaking because the changes would not result in any adjustment to previously collected rates.

must be taken in response to compelling circumstances, which we do not find here.

In sum, we are displeased with the circumstances surrounding the tax refunds and this long overdue rate case. After careful consideration of the argument and offers of proof presented by the City, we are not persuaded, however, that these circumstances have resulted in or will result in unjust or unreasonable rates, or that the public interest otherwise justifies further consideration of this nearly decade-old issue. Therefore, based on the unique circumstances of this case, we decline to change the ratemaking and accounting treatment of the income tax refunds.

To ensure that similar issues do not arise in the future, we will order PAWW to file an informal general rate case no less frequently than once every three calendar years.

Comments on Draft Decision

The draft decision of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.7 of the Rules of Practice and Procedure. The City filed comments on June 26, 2003, and PAWW filed reply comments.

PAWW stated that the City's comments violated Rule 77.3 of the Commission's Rules of Practice and Procedure (Rules) because the comments were merely reassertions of arguments that were rejected by the Draft Decision. PAWW included a point-by-point review of each of the City's alleged errors in the Draft Decision and concluded that the comments were either restatements of arguments or rhetorical statements, all of which are not within the proper scope of comments on Draft Decisions. PAWW concluded that, as specified in Rule 77.3, the City's comments should be accorded no weight.

Although we find that PAWW's contentions have merit, we observe that contrary to the City's position, the Commission in Res. W-4356 did not offer a guarantee that evidentiary hearings would be held on the tax refund issue.[3] Rather, the only statement on that topic was in the Comments section: "This difference of opinion can be addressed in the formal proceeding recommended above" (i.e., Application 02-11-057). Likewise, neither the assigned ALJ in her direction to the parties at the PHC, nor the Assigned Commissioner in his scoping ruling, offered such a guarantee. The assigned ALJ made clear that she was setting "a briefing schedule for whether or not this issue should be in this proceeding," and the Assigned Commissioner's scoping ruling noted that the ALJ had required those briefs and that a draft decision (this interim decision) was then being prepared on the issue.

As we explained above, we consider allocation of extraordinary revenue on a case-by-case basis. Here, our auditor has found that PAWW has incurred substantial financial losses, and that the tax refund has been used to pay expenses otherwise properly allocated to ratepayers. Given these findings, as well as the passage of time and practical issues discussed above, we conclude that the public interest is best served by retaining the existing ratemaking and accounting treatment of the funds. The facts the City offers to prove in evidentiary hearings do not overcome this conclusion. We have, however, made changes to the text of today's decision to clarify the basis for our decision.

---

[3] Due process does not require a formal, evidentiary hearing. See D.00-03-020, mimeo. at pages 6-11 and cases cited therein.

Assignment of Proceeding

Carl W. Wood is the Assigned Commissioner and Maribeth A. Bushey is the assigned Administrative Law Judge in this proceeding.

Findings of Fact

1. PAWW's last general rate case was in 1991.

2. Since some time after 1991, PAWW's rates have failed to generate sufficient revenue to meet reasonable expenses.

3. PAWW received extraordinary revenue in the form of income tax refunds over a several-year period ending in 1995.

4. PAWW did not seek Commission direction as to the disposition of the income tax refunds.

5. The staff auditor concluded that the tax refunds had been obtained by PAWW at its own expense, and the money had been used to meet operation and maintenance expenses that utility revenue failed to cover.

6. The argument and offers of proof presented by the City do not justify litigating this issue.

7. The balance of the equities and the on-going needs by the utility support retaining the ratemaking and accounting treatment for the tax refunds.

Conclusions of Law

1. The Commission's ratemaking authority is sufficient to order changes to the accounting and ratemaking treatment of the tax refunds.

2. The Commission should exercise its ratemaking discretion to retain the existing ratemaking and accounting treatment of the income tax refunds due to the losses incurred by PAWW and complexities caused by the passage of time.

3. No hearings are required.

4. PAWW should file an informal general rate case no less frequently than once every three calendar years.

INTERIM ORDER

IT IS ORDERED that the Commission shall not change the ratemaking and accounting treatment for income tax refunds received by Point Arena Water Works (PAWW) over a several year period ending in 1995 and that PAWW shall file an informal general rate cases no less frequently than once every three calendar years.

This order is effective today.

Dated _____, at San Francisco, California.