

DWA/RSK/ SMW/jrb

**PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

**DIVISION OF WATER & AUDITS**  
**Utility Audit, Finance and Compliance Branch**

**RESOLUTION NO. W-4753**  
**March 26, 2009**

**R E S O L U T I O N**

**(RES. W-4753), ARROYO CENTER WATER COMPANY (Arroyo)  
ORDER AUTHORIZING A GENERAL RATE INCREASE  
PRODUCING ADDITIONAL ANNUAL REVENUE OF \$19,310 OR  
54.5% IN TEST YEAR 2008.**

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**SUMMARY**

On December 4, 2007, Arroyo filed a draft advice letter with the California Public Utilities Commission (Commission), Division of Water and Audits (DWA), requesting an increase in its rates for test year 2008. This resolution grants a rate increase in gross annual revenues of \$19,310, or 54.5%, for a total of test year 2008 revenue of \$54,761, which is estimated to provide a rate of margin of 20%.

Within 30 days of the effective date of this resolution, Arroyo shall contact the DWA to properly account for plant funded by special assessment fees authorized by the Commission in Resolution (Res.) W-4380 and to account for any funds that remain.

**BACKGROUND**

Arroyo is a Class D water utility and has requested authority, under Section VII of General Order 96-B, Rule 7.62 and Industry Rule 7.3.3(5), and Section 454 of the Public Utilities Code (Pub. Util. Code), to increase its annual flat water rates by \$282 per customer, or 49.3%, for a total \$17,484, for Test Year 2008. The purpose of the rate increase is to recover increased operating expenses and to provide an adequate rate of return.

Arroyo's last increase, to its flat rate, was granted on January 6, 2000, for test year 1999, per Res. W-4183. Res. W-4183 authorized an increase in total annual revenues of \$2,585 or 7.7%, thereby authorizing an annual flat rate of \$571.80 per customer. The purpose of the increase was to recover increased operating expenses and to provide a return of margin.

In 2003, the Monterey County Department of Environment Health (MCDEH) issued a notice to Arroyo. The MCDEH indicated that Arroyo needs to comply with the requirements of the Federal Safe Drinking Water Act, which requires the installation of a disinfection and filtration system on surface water sources of supply. On March 13, 2003, by Res. W-4380, the Commission approved an assessment of \$700 per year, per customer, for five years, be added to Arroyo's annual flat rate of \$571.80 for this purpose. Pursuant to Res. W-4380, Arroyo was authorized to collect \$220,500, in total, over the five year period, from 63 customers. The assessment expired on December 31, 2007. According to its annual report on 2007, Arroyo spent approximately \$190,631 of these funds.<sup>1</sup>

Arroyo is owned by the local homeowners' association and Arroyo claims that it virtually operates as a not-for-profit water utility.<sup>2</sup> According to Arroyo, it currently serves approximately 62 flat rate customers in the community of Arroyo Seco, near Greenfield, Monterey County. Arroyo's system is supplied by two wells and associated utility plant at the Arroyo Seco River Bed. According to Arroyo's 2007 annual report, the wells pump approximately 30 and 20 gallons per minute, respectively, into a 19,200 gallon concrete storage tank. Arroyo's present distribution systems consist of approximately 5,000 feet of pipeline that is 2 inches or less in diameter.

## **DISCUSSION**

The DWA made an independent analysis of each part of Arroyo's test year summary of earnings and annual reports for 2005-2007, in order to determine what rates should reasonably be charged to ratepayers.

Appendix A shows Arroyo's estimated summary of earnings at present rates, staff's recommendation for test year rates, Arroyo's request for test year rates, the difference between staff's recommendation and Arroyo's request for test year rates, and rates authorized in the current case.

### ***Operating Expenses***

Arroyo's workpapers, submitted with its draft advice letter, showed forecasted total operating expenses of \$43,325. However, Arroyo's forecasted 2008 operating expenses, as filed, actually total \$43,331. Arroyo did not provide an explanation or

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<sup>1</sup> \$185,784 on water treatment plant and \$4,847 on pumping equipment.

<sup>2</sup> Per Arroyo's response to Data Request 002, dated March 31, 2008.

documentation showing how it calculated the majority of its forecasted expenses. However, Arroyo did provide some documentation to support its expenditures in 2007. There are differences between DWA's and Arroyo's forecast amounts in the following operating expense categories: Purchased Power, Employee Labor, Other Plant Maintenance, Employee Pension, Office Supplies and Expenses, Professional Services, Insurance, and Regulatory Expenses. DWA's recommended total operating expenses of \$40,134 is based on a determination of each individual expense category, utilizing historical amounts, applicable inflation factors, and past billed amounts.

DWA utilized the inflation rates of -0.8% for non-labor,<sup>3</sup> 3.9% for the annual change in compensation per hour,<sup>4</sup> and a composite of 1.08% for items with both non-labor and labor components.<sup>5</sup> For example, DWA calculated the cost of Employee Pensions and Benefits by applying the applicable inflation factor of -0.8% to the four year average (2005-2007) of this expense category, to arrive at a test year estimate of \$962.

DWA calculated Arroyo's Taxes Other than Income, based on employee payroll taxes of \$1,528, property taxes of \$152 and other taxes and license fees of \$1,712, which totals \$3,392. DWA based its estimates of these items on historical employee payroll taxes, historical other taxes and license fees, and historically billed Monterey County Tax Collector property tax amounts.

Staff reviewed Arroyo's response to Data Request Number 002, dated February 11, 2008, which stated that even though Materials and Water Testing Contract Work expenses were not included in past annual reports, they were now necessary expenditures. Based on the Arroyo's explanations reviewed by staff, DWA determined that \$2,406 of Materials and \$1,800 of Water Testing Contract Work are reasonable expenditures in the test year.

Arroyo requested \$5,800 for insurance expense. In its March 31, 2008 response to Data Request 002, Arroyo stated that it allocates 50% of the liability insurance to the parent company and 50% to the utility. Since the parent company does not have any paid employees, it charges the water utility for all workmen's compensation insurance. Staff reviewed this allocation of insurance expense and determined that it is reasonable. Therefore, DWA recommends a total insurance expense of \$4,670 (\$4,033+\$637), which

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<sup>3</sup> Division of Ratepayer Advocates: Estimates of Non-labor and Wage Escalation Rates for 2008 through 2012 from the January 2009 Global Insight U.S. Economic Outlook, dated January 31, 2009.

<sup>4</sup> DRA January 2009 Summary of Compensation Per Hour, dated January 31, 2009.

<sup>5</sup> Ibid. "In accordance with a 1991 agreement between the CPUC Water Division and the California Water Association (CWA), the monthly non-labor rate is to be weighted by 60 percent and the Compensation per Hour Index weighted 40 percent."

equates to 50% of the liability insurance ( $\$8,066/2=\$4,033$ ) plus the total workmen's compensation insurance of \$637.

DWA's estimated total operating expenses of \$40,134 is reasonable, because it is based on specific estimating methods utilizing specific data inputs that have been reviewed and assessed by staff.

### *Depreciation*

Arroyo's Plant in Service is fully depreciated, so neither Arroyo nor DWA include an estimate for depreciation expense.

### *Special Assessment Funded Plant*

In Res. W-4380, the Commission authorized Arroyo to collect \$220,500 via a special assessment of \$700 per customer per year, for five years. These funds were to be used for the construction of a filtration and disinfection facility, additional storage and booster pumps, and the renovation and/or replacement of distribution system mains. The Commission required that Arroyo exclude all plant constructed with these funds from rate base. Therefore, this plant should be treated as Contributions-in-Aid of Construction (CIAC), which includes "All non-refundable contributions of cash, land, or other property received by the utility in connection with the construction or extension of its water system."<sup>6</sup>

In its review of Arroyo's recent annual reports, DWA found that, in its report on 2007, Arroyo included \$190,631 of plant funded with the special assessment funds in its Plant in Service.<sup>7</sup> However, Arroyo did not include the \$190,631 of plant funded with these special assessment funds in its Balance Sheet under CIAC nor did it show any entry in its Balance Sheet under Accumulated Amortization of Contributions. Additionally, Arroyo erroneously included \$4,847 of pumping equipment funded with the special assessment funds in its Reserve for Depreciation of Utility Plant Account 403.<sup>8</sup> The plant funded by the special assessment funds should be amortized each year in the Reserve for Depreciation of Utility Plant Account 272.

Since plant constructed with funds authorized in Res. W-4380 is required to be treated as CIAC, we will order Arroyo to work with staff from DWA to correct its accounting for the CIAC plant.

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<sup>6</sup> See D.85-04-076.

<sup>7</sup> \$185,784 on water treatment plant and \$4,847 on pumping equipment.

<sup>8</sup> Pumping equipment should be capitalized and amortized over its useful life.

In responding to Data Request Number 3, Arroyo stated that the remainder of the special assessment funds had been spent on “final connections of the system.” Since this provides insufficient detail of how the balance of these funds has been expended, Arroyo should work with staff from DWA to clarify how the remainder of the assessment funds were spent or accounted for, and ensure that the new plant or the remainder is recorded properly on the books of the utility.

### *Rate Base*

Arroyo estimated a rate base of \$52,935 for 2008. However, it appears that Arroyo erroneously based its rate base on a total of its regular flat and assessment rates, instead of its adjusted Plant in Service. Arroyo did not provide any justification for adding \$52,635 to its rate base.

DWA utilized information from Arroyo’s 2007 Annual Report, Schedule B and C, Plant in Service and Reserve for Depreciation of Utility Plant, respectively. In its estimate of the test year rate base, DWA utilized Arroyo’s Plant in Service of \$23,684 less the recorded depreciation reserve of \$23,384, as shown in Arroyo’s annual report for year 2007.

The remainder of \$300 represents land. Since DWA’s estimate is based on Arroyo’s recorded Plant in Service and Reserve for Depreciation, DWA’s recommended rate base of \$300 should be utilized in the rate of return calculation in the current case.

### *Rate of Return/Rate of Margin*

In Decision (D.) 92-03-093, Ordering Paragraph 8, the Commission stated, “[DWA] is directed to calculate rates using both return-on-rate base and operating ratio methods of ratemaking for Class C and Class D water companies requesting new rates and to recommend to the Commission that rate method that produces the higher result.”

Arroyo requests a rate of return of 13.75%, or \$7,272, on its estimated erroneous rate base of \$52,935, Arroyo’s requested return of 13.75% is at the high end of the range of rates of return for Class D water utilities recommended by DWA in its 2007 memo dated April 3, 2007. Arroyo did not provide justification for using a high rate of return.

Pursuant to D.92-03-093, DWA calculated both the rate of margin and the rate of return, to determine which produces a higher result. As ordered in D.92-03-093, DWA must recommend the method that produces the higher revenues. In the rate of margin method, the utility’s revenue requirement is defined as the sum of its operating and maintenance expenses, depreciation, and taxes other than income, multiplied by the

rate of margin. This method gives the small water utilities the opportunity to earn a more reasonable and appropriate revenue requirement when the utility has only a small amount of rate base.

DWA calculated the rate of margin by applying the 2008 recommended rate of margin for Class D water utilities of 20% to its estimate of operating expenses and taxes other than income of \$43,527.<sup>9</sup> This results in a rate of margin of \$8,705. DWA also calculated the rate of return on rate base using the average of the most current 2008 recommended rates-of-return for Class D water utilities of 13.25%, and applied this to DWA's estimated rate base of \$300, which results in a return on rate base of \$39.75.<sup>10</sup>

DWA compared its estimated rate of margin and rate of return and found that the rate of margin provides the higher result of the two methods. Therefore, DWA recommends using a rate of margin of 20%, resulting in an authorized net income of \$8,705.

### *Revenue*

Arroyo forecasted \$54,681 in revenues. Arroyo's revenues were based on its estimation of net income of \$7,272, plus \$47,409 in estimated operating expenses.<sup>11</sup>

DWA estimated Arroyo's revenue to be \$54,761, which is based on operating expenses of \$40,134, taxes other than income of \$3,392, income taxes of \$2,529, and a rate of margin of \$8,705. Determining revenues based on these components is illustrated in Standard Practice U-46-W.

DWA's recommended revenue of \$54,761 is reasonable because it is calculated utilizing the method normally used by the Commission and provides for the recovery of expenses, taxes, and a reasonable return.

### *Rates*

Arroyo requests a flat rate of \$853.80 per year, which is an increase of 49.3% over its currently authorized annual flat rate of \$571.80. Arroyo indicates its rate increase request is primarily based on an increase in operating expenses, as described earlier.

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<sup>9</sup> "Rates of Return and Rate of Margin" memorandum issued annually by DWA, dated March 10, 2008, provides DWA's recommended Rates of Return and Rates of Margin for Class C and D water utilities.

<sup>10</sup> Ibid.

<sup>11</sup> DWA corrected arithmetic errors in company calculations of Net Income and Total Expenses.

DWA estimated an annual flat rate of \$883.25 per year, by dividing Arroyo's estimated revenue of \$54,761 by its 62 customers.

DWA's recommended flat annual rate of \$883.25 is reasonable and sufficient based on the results of operations as discussed above. A comparison of customer bills at present and recommended rates is shown in Appendix C.

### **COMPLIANCE**

The utility has been filing annual reports as required. In reviewing Arroyo's recorded income taxes, DWA found that the Annual Report to the Commission stated that only State Income Tax were paid in 2007 and only Federal Income Tax were paid in 2006. After bringing this to Arroyo's attention, the utility stated that the taxes had been miscategorized, and provided the corrected figures for each year. Per Arroyo's response to Data Request Number 3, Arroyo's reported State Income Taxes were \$3,628 in 2006 and \$1,716 in 2007, and its Federal Income Taxes were \$6,156 in 2006 and \$2,695 in 2007.

According to the Monterey County Department of Health - Drinking Water Protection Services, water samples taken in June 2008 were tested for cadmium, coliform, volatile organic compounds, and were found to be either non-detect or below the maximum contaminant level.

### **NOTICE AND PROTEST**

On September 18, 2008, Arroyo sent a notice to all customers, informing them of Arroyo's request for a rate increase, as well as a request for public comment. To date, DWA has received letters from two customers that are concerned with Arroyo's request for a rate increase. The concerns raised by these customers include: 1) Arroyo was authorized a rate increase in March 2003, and now five years later, is requesting another rate increase; 2) Arroyo is not in compliance with legal requirements of registered California Corporations, in particular, that it does not keep minutes of Board meetings and the Annual shareholders meetings; 3) the phone number listed in the notice requires the caller to call a second number, but does not give the complete number; and 4) concerns regarding the treatment of the water. DWA has responded.

### **COMMENTS**

This is an uncontested matter in which the resolution grants the relief requested, including a modified results of operation. Accordingly, pursuant to PU Code 311(g) (2), the otherwise 30-day period for public review and comment is being waived.

**FINDINGS**

1. In its review of Arroyo's annual reports, DWA found that Arroyo had improperly accounted for \$190,631 in plant funded with the special assessment fees authorized in W-4380. Arroyo should contact DWA to correct its accounting for the plant funded with the special assessment fees.
2. Since Arroyo provided insufficient detail of how the balance of the special assessment funds has been expended or accounted for, Arroyo should work with DWA to properly account for the remainder of the special assessment funds.
3. The summary of earnings developed by DWA, as shown in Appendix A, is reasonable and should be adopted.
4. The flat rate of \$883.25 per year per customer recommended by DWA, as shown in Appendix B, is reasonable and should be adopted.
5. This is an uncontested matter subject to the public notice comment exclusion provided in the Pub. Util. Code Section 311(g) (2).

**THEREFORE IT IS ORDERED THAT:**

1. Authority is granted under Pub. Util. Code Section 454 to Arroyo Center Water Company (Arroyo) to file an advice letter incorporating the summary of earnings and the revised rate schedule attached to this resolution as Appendices A and B, respectively, and concurrently cancel its presently effective rate Schedule No. 2, Annual General Flat Rate Service. The effective date of the revised schedule shall be five days after the date of this filing.
2. Arroyo is authorized to increase its annual revenues by \$19,310, or by 54.5%, for test year 2008.
3. Arroyo incorrectly accounted for \$190,631 of plant constructed with its special assessment funds authorized by Res. W-4380. In addition, Arroyo provided insufficient information to DWA accounting for the remainder these funds. Within 30 days of this resolution, Arroyo shall contact and work with staff from the Division of Water and audits (DWA) to correct its accounting for plant constructed with these funds and any funds that remain unspent.

4. This resolution is effective today.

I certify that the foregoing resolution was duly introduced, passed, and adopted at a conference of the Public Utilities Commission of the State of California held on March 26, 2009; the following Commissioners voting favorably thereon:

/s/ PAUL CLANON

Paul Clanon  
Executive Director

MICHAEL R. PEEVEY  
President

DIAN M. GRUENEICH

JOHN A. BOHN

RACHELLE B. CHONG

TIMOTHY ALAN SIMON

Commissioners

**APPENDIX A**  
**ARROYO CENTER WATER COMPANY**  
**Summary of Earnings**  
**Test Year 2008**

Account Description	Present Rates	Recommendations		Difference	Authorized
		Staff	Utility <sup>A</sup>	Amount	
<b>Operating Revenues</b>					
Flat Rates	\$ 35,451	\$ 54,761	\$ 54,681	\$ 80	\$ 54,761
<b>Total Revenue</b>	<b>\$ 35,451</b>	<b>\$ 54,761</b>	<b>\$ 54,681</b>	<b>\$ 80</b>	<b>\$ 54,761</b>
Purchased Power	1,412	1,427	2,500	(1,073)	1,427
Employee Labor	16,800	18,328	18,000	328	18,328
Plant Maintenance	2,747	3,314	4,000	(686)	3,314
Materials	0	2,406	2,406	0	2,406
Water Testing Contract	5,175	1,800	1,800	0	1,800
Management Salaries	0	0	0	0	0
Employee Pension	1,105	962	1,100	(138)	962
Office Services	9,147	0	0	0	0
Office Supplies	306	849	1,200	(351)	849
Professional Services	4,095	3,833	3,500	333	3,833
Insurance	8,081	4,670	5,800	(1,130)	4,670
Regulatory Expense	3,077	2,545	3,025	(480)	2,545
General Expenses	271	0	0	0	0
<b>Total Operating Exp.</b>	<b>\$ 52,216</b>	<b>\$ 40,134</b>	<b>\$ 43,331</b>	<b>\$ (3,197)</b>	<b>\$ 40,134</b>
Depreciation	4,847	0	0	0	0
Taxes Other Than Inc.	1,341	3,392	1,960	1,432	3,392
State Income Tax <sup>B</sup>	1,716	993	0		993
Federal Income Tax <sup>B</sup>	2,695	1,536	2,118	411	1,536
<b>Total Deductions</b>	<b>62,815</b>	<b>46,056</b>	<b>47,409</b>	<b>(1,353)</b>	<b>46,056</b>
<b>Net Income</b>	<b>\$ (27,364)</b>	<b>\$ 8,705</b>	<b>\$ 7,272</b>	<b>\$ 1,433</b>	<b>\$ 8,705</b>
<b>Rate Base:</b>					
Average Plant	23,684	23,684			23,684
Less Average Advances					
Less Avg Accum. Depn.	23,384	23,384			23,384
Net Plant	300	300			300
<b>Rate Base</b>	<b>300</b>	<b>300</b>	<b>52,935</b>	<b>(52,869)</b>	<b>300</b>
<b>Rate of Return</b>			<b>13.74%</b>		
<b>Rate of Margin</b>		<b>20%</b>			<b>20%</b>

<sup>A</sup> DWA corrected arithmetic and other errors in company calculations of Net Income and Total Expenses. DWA notes that the company incorrectly estimated test year revenue and rate base at present rates.

<sup>B</sup> Utility used a combined state and federal tax rate to calculate income tax. Consequently, the utility's estimate for State Income Tax is included in its estimate of Federal Income Tax. DWA utilized current tax rates of 15% federal and 8.84% for state.

**APPENDIX B**  
**ARROYO CENTER WATER COMPANY**

**Schedule No. 2**  
**ANNUAL GENERAL FLAT RATE SERVICE**

**APPLICABILITY**

Applicable to all flat rate residential water service furnished on an annual basis.

**TERRITORY**

The area known as Arroyo Seco in Monterey County.

**RATES**

	<u>Per Service Connection</u>
	<u>Per Year</u>
For a single-family residence flat rate	\$883.25

**SPECIAL CONDITIONS**

1. The above residential flat rates apply to a service connection no larger than one-inch diameter.
2. The annual flat rate charge applies to service during the 12-month period commencing January 1 is due in advance. If a permanent resident of the area has been a customer of the utility for at least 12 months, he may elect, at the beginning of the calendar year to pay prorated flat rate charges in advance at intervals of less than one year (monthly, bi-monthly, or quarterly) in accordance with the utility's established billing periods.
3. The opening bill for flat rate service shall be the established annual flat rate charge for the service. Where initial service is established after the first day of any year, the portion of such annual charge applicable to the current year shall be determined by multiplying the annual charge by one three hundred-sixty-fifth (1/365) of the number of days remaining in the calendar year. The balance of the payment of the initial annual charge shall be credited against the charges for the succeeding annual period. If the service is not continued for at least one year the date of initial service, no refund of the initial annual charge shall be due to the customer.
4. The established billing cycle for water used is quarterly. The prorated quarterly rates for the annual charges are one-fourth the applicable annual charge. In the event a customer fails to pay one or more quarterly charges, service will not be restored until the delinquency is paid.
5. All bills are subject to the reimbursement fee set forth in Schedule No. UF.

**(END OF APPENDIX B)**

**APPENDIX C**  
**ARROYO CENTER WATER COMPANY**  
**Test Year 2008**

**COMPARISON OF RATES:**

FLAT RATE ANNUAL SERVICE	Per Service Connection Per Year:		
	<u>Present</u> <u>Rates</u>	<u>Proposed</u> <u>Rates</u>	<u>Percent</u> <u>Increase</u>
Annual Service	\$ 571.80	\$ 883.25	54.5%

**(END OF APPENDIX C)**

**APPENDIX D**  
**ARROYO CENTER WATER COMPANY**  
**Adopted Quantities -Test Year 2008**

**Purchased Power**

Pacific Gas & Electric Co.  
Schedule A-1 for both wells  
Effective Date December 2008

**Pumped Water**

	Test Year kWh	Rate Per kWh	Energy Cost	Annual Service Charge	Total Cost
Wells	4,048	\$ 0.326	\$ 1,319	\$ 108	\$ 1,427

**Service Connections**

Flat Rate	Number of Customers
Total	62

**Water Sales, CcF:                    4,048**

**Tax Calculations**

Operating Revenues	\$ 54,761
Operating Expenses	\$ 40,134
Depreciation	\$ 0
Taxes other than Income	\$ 3,392
Taxable Income for State	\$ 11,235
State tax	\$ 993
Taxable Income for Federal	\$ 10,241
Federal tax	\$ 1,536

**(END OF APPENDIX D)**