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Ratesetting
Agenda Item 88 4/22/04

Decision _____

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

In the Matter of the Application of SOUTHERN CALIFORNIA WATER COMPANY (U 133-W), for an order authorizing it to increase rates for water service by \$19,826,100 or 29.72% in the year 2003; by \$6,327,800 or 7.31% in the year 2004; and by \$6,326,200 or 6.81% in the year 2005 in its Region III Service Area and to increase rates for the General Office Allocation in all of its Customer Service Areas in this Application including: Arden-Cordova, Bay Point, Clearlake, Los Osos, Ojai, Santa Maria, Simi Valley and Metropolitan.

Application 02-11-007
(Filed November 4, 2002)

OPINION GRANTING PETITION TO MODIFY D.04-03-039**I. Summary**

On March 16, 2004, the Commission adopted Decision (D.) 04-03-039, which grants Southern California Water Company (SCWC) authority to increase rates in its Region III Service Area. The Commission found that SCWC violated Public Utilities Code Section 851 (§ 851) when it failed to seek the Commission's approval for its lease of water rights to the City of Folsom (City). Additionally, the Commission held that the City's retrospective use of the water rights was unaffected by the voided lease agreement. The Commission deferred to a subsequent decision, following briefing by the parties, the issue of Folsom's prospective rights under the voided lease. The City seeks relief, as it believes

that serious and immediate effects have occurred because the Commission did not preserve its prospective rights under the lease. As such, the City has filed a petition to modify D. 04-03-039's treatment of prospective water rights leased from SCWC. After a review of the new information provided to the City, we conclude that § 851 protects the City's acquired interest in the water both with respect to the past and to the future notwithstanding our voiding of the lease as to SCWC.

II. Background

By D.71889 issued January 24, 1967, the Commission authorized SCWC to transfer the City water system and 22,000 acre feet per year (AFY) to the City of Folsom. In November 1994 SCWC signed an agreement to lease in perpetuity an additional 5,000 AFY to the City. SCWC did not seek Commission approval under Public Utilities Code § 851 for the 1994 lease with the City. As a result, the Commission determined that SCWC violated § 851 by not seeking approval for a water rights lease agreement that it entered into with the City (D.04-03-039). Accordingly, the Commission fined SCWC a net total of \$180,000 (\$1,095,000 with \$915,000 suspended) for that violation. Moreover, the Commission determined that while the City acted in "good faith for value", the City was entitled only to retrospective protection of its lease of water rights, pending further record development in the issue of Folsom's prospective rights under the voided lease.

III. Discussion

This petition to modify narrowly focuses on the issue of prospective water rights leased by the City in an agreement with SCWC in 1994. The Commission found in D.04-03-039 that SCWC had violated § 851 by failing to seek Commission approval to lease 5,000 AFY to the City in perpetuity. The City

alleges that by not protecting its future rights under the lease, the Commission has caused immediate and severe harm. Specifically, by placing a cloud over the City's right to the leased water, the Commission has made it difficult or impossible for the City to refinance on unfavorable terms over \$100 million of existing utility bonds; has placed the City in potential default under existing bond indentures; jeopardized planned expansion in the City's East Area particularly including the planned development of a desperately needed hospital and urgent care facility; and generally rendered doubtful various developments contained in the City's master plan for the East Area all of which assume the continuing availability of the leased water.

To address these concerns we revisit the plain words of the relevant statute. The relevant part of § 851 reads:

...any disposition of property by a public utility shall be conclusively presumed to be of property which is not useful or necessary in the performance of its duties to the public, as to any purchaser, lessee or encumbrancer dealing with such property in good faith for value...

D.04-03-039 (page 53) concludes that the City is a good faith purchaser for value and therefore entitled to protection of its water rights on a retrospective basis. The City argues that the Commission, by not also granting a prospective approval of the leased water rights, is misinterpreting the language and intent of the statute.

The Commission, however, must reconcile the City's needs with its obligation to enforce § 851 in order to determine whether the transaction (in this case, the agreement between the City and SCWC for leased water) serves the public interest. To this end, D.04-03-039 notes that there are several factors that the Commission must consider before granting § 851 approval. For example, the

Commission must assess whether the proposed transaction will impair the utility's ability to provide service to the public. As such, SCWC must demonstrate that its water quality and supply problems can be addressed without the leased water supply (see Decision at page 44).

In D.04-03-039 it was concluded that SCWC violated § 851 when it failed to gain the Commission's approval prior to entering into an agreement with the City for leased water rights. As part of the remedy outlined in D.04-03-039, the Commission voids the lease as to SCWC, and fines SCWC the net sum of \$180,000.

In its petition to modify D.04-03-039, the City of Folsom has presented new evidence that heretofore has not been considered by the Commission. Ten years after the execution of the leased water rights agreement with SCWC, on March 16, 2004, the City first learned that the Commission had issued a decision voiding the leased water agreement. On March 26, 2004, the City filed a petition to modify D.04-03-039. Upon further review of the City's petition, we conclude that § 851 protects the City's acquired interest in the water both with respect to the past and to the future notwithstanding our voiding of the lease as to SCWC. Accordingly, within 30 days from the issuance of this opinion, we direct SCWC to file a § 851 application for the leased water rights agreement with the City. This requirement provides clarity to SCWC that it is expected to file a § 851 application.

In view of this revision to our original decision, we also revise our order. We direct that the parties in that application proceeding address the following topics:

1. How SCWC will obtain water sufficient to serve its customer base without the 5,000 AFY leased to the City.

2. The proper accounting and ratemaking treatment of future lease revenues under the City lease.
3. Any appropriate measures to ensure ratepayers are not adversely affected by the lease of water rights to Folsom.

IV. Comments on the Proposed Draft Decision

On March 26, 2004, a “Proposed Draft Decision of President Peevey and Commissioner Kennedy”, which addressed Folsom’s petition for modification was issued. Comments were due on March 30, 2004. Comments were timely filed by Southern California Water Company, City of Folsom and the Office of Ratepayer Advocates. By way of summary, Folsom supported the draft decision with minor changes. Their comments were considered and changes to the draft decision were not deemed necessary. The SCWC supported the draft decision but sought clarification as to whether or not they had to file a brief addressing the rights of Folsom under three different circumstances. The draft decision provided clarity and required that SCWC file a § 851 decision within 30 days of the decision. ORA challenged the draft decision’s conclusion that Folsom is a “bona fide purchaser” and entered into the leased water rights agreement with SCWC in good faith for value. ORA argued that an appropriate reading of § 851 would lead one to conclude that the water rights still are useful to SCWC and that prospective use of the leased water could not be granted until the Commission determines that the property is not useful to SCWC. We disagree.

The Commission does not have the power under § 851 to declare Folsom's entitlement to the water rights void; it has only the power to declare the lease of those rights void. The second paragraph of § 851, in our opinion, recognizes that a good faith purchaser for value from an owner with good title, like the water company, is going to acquire good title from his seller.

On March 26, 2004, an Alternate Draft Decision of Commissioner Lynch was issued for comment. The voiding of the lease pursuant to Ordering

Paragraph 7 of D.04-03-039 was stayed in order to clarify Folsom's continuing right to use water under the lease. The alternate draft decision was adopted at the April 1, 2004 Commission Meeting. There was no action taken on the Peevey and Kennedy draft decision. Accordingly, an Assigned Commissioner's Ruling was issued on April 2, 2004 that bifurcated the issue of Folsom's prospective use of the leased water from the Commission's consideration of SCWC's § 851 application. Also, an oral argument on April 19, 2004 was granted to allow parties further opportunity to comment on the prospective use of leased water by Folsom. Due to the very short comment period for the March 26, 2004 draft decision, additional comments were taken.

The re-circulated draft decision of President Peevey and Commissioner Kennedy in this matter was mailed to the parties in accordance with Public Utilities Code Section 311(g)(1) and Rule 77.7 of the Rules and Practice and Procedure. Comments were due on April 14, 2004, and an oral argument was held on April 19, 2004. Comments were timely filed by Southern California Water Company, City of Folsom and the Office of Ratepayer Advocates. SCWC argues that § 851 provides that a disposition of property by a public utility shall be conclusively presumed to be property, which is not useful or necessary of its duties to the public, as to any purchaser, lessee or encumbrancer dealing with such property in good faith for value. SCWC suggests that past Commission decisions and California case law would provide Folsom with a favorable reading of its prospective right to the leased water.

Folsom again supports the Peevey and Kennedy draft decision and in doing so provides an extensive legal analysis of the legislative intent of § 851, past Commission decisions, and California case law. In sum, Folsom argues that the plain language of § 851 conclusively establishes the rights of good faith purchasers for value in their acquired property. Folsom adds that the legislature

clearly intended to protect purchasers dealing with such property in good faith for value. In short, Folsom concludes that the Commission is statutorily precluded from voiding the property rights of a good faith purchaser for value. We agree.

ORA, after having more time to reflect and analyze the legal implications of granting Folsom's prospective use of the leased water rights, reverses its earlier course and acknowledges that Folsom has a continuing right to the leased water, assuming it is a good faith purchaser. ORA now recognizes that underlying Commission decisions and a Supreme Court opinion supports Folsom's argument that it as a good faith purchaser is prospectively entitled to the leased water. Nonetheless, ORA is not convinced that Folsom has conclusively demonstrated that it is a bona fide purchaser to the leased water, although no party (including ORA) asserts otherwise, and would require that this issue be disposed of in SCWC's § 851 application. To our knowledge, no party has provided evidence that Folsom is not a bona fide purchaser; in fact Folsom has submitted two declarations by its City attorney that it indeed is a bona fide purchaser, and, further argued that the Commission has already disposed of this factual issue in D. 04-03-039, by finding Folsom properly used the water rights since the inception of the sale transaction.

On April 16, 2004, Folsom submitted a Motion to Strike Section II of ORA's supplemental comments. We will not strike ORA's comments as we believe that ORA is entitled to provide analysis and conclusion on the issue of Folsom's water rights. However, we decline to devote further hearing or deliberative efforts on this issue. Additionally, Folsom filed a supplemental declaration of Mr. Steven P. Randolph on April 16, 2004 in support of Folsom's petition for modification. This filing is similar to the declaration that Mr. Randolph executed on March 25, 2004.

V. Assignment of Proceeding

Michael R. Peevey is the Assigned Commissioner and David Fukutome is the assigned ALJ in this proceeding.

Findings of Fact

1. In D.04-03-039, the Commission found that SCWC violated § 851 by not seeking the Commission's approval for its lease of water rights to the City.
2. As part of the remedy outlined in D.04-03-039, the Commission voided the lease as to SCWC, and fined SCWC the net sum of \$180,000.
3. In D.04-03-039, the Commission safeguarded the City's retrospective rights under the voided lease agreement and reserved decision on the City's prospective right pending further record development.
4. As a result, the City has filed a petition to modify D.04-03-039 because of the serious and immediate effects that occurred because the Commission did not protect its prospective rights under the lease.
5. The City may have to refinance on unfavorable terms over \$100 million of existing utility bonds.
6. The City may be in jeopardy in being able to finance planned expansions of the City's East Area.

Conclusions of Law

1. The City has demonstrated that there are severe and immediate impacts to its water supply and financial health because the Commission did not grant prospective approval of its leased water rights.
2. Pursuant to Government Code Section 11125.3 (a)(2), there exists a need to take immediate action in that the City of Folsom's water supply may be severely curtailed and its financial condition negatively impacted if the Commission does

not review its D.04-03-039 adopted March 16, 2004; this need for action came to the Commission's attention subsequent to the mailing of its April 1, 2004 agenda.

3. The Commission in D.04-03-039 concludes that the City is a good faith purchaser for value in compliance with § 851.

4. In this instant case, the Commission must reconcile the City's needs for the leased water rights to its obligation to enforce § 851 by determining whether or not the agreement between the City and SCWC for leased water serves the public interest.

5. After a review of new information, the Commission concludes that § 851 protects the City's acquired interest in the water both with respect to the past and to the future notwithstanding the voiding of the lease as to SCWC.

O R D E R

IT IS ORDERED that:

1. Within 30 days from the issuance of this opinion Southern California Water Company is to file a § 851 application for the leased water rights agreement with the City of Folsom.

2. We direct that the parties in that application proceeding address the following topics:

- a. How SCWC will obtain water sufficient to serve its customer base without the 5,000 AFY leased to the City.
- b. The proper accounting and ratemaking treatment of future lease revenues under the City lease.
- c. Any appropriate measures to ensure ratepayers are not adversely affected by the lease of water rights to Folsom.

Dated _____, at San Francisco, California.