

Decision **ALTERNATE PROPOSED DECISION OF PRES. MICHAEL PEEVEY**  
(Mailed 2/10/2006)

**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 pursuant to Public Utilities Code Section 851 approving a Reallocation Agreement with the City of Folsom, as directed by D.04-04-069.

Application 04-07-018  
(Filed July 8, 2004)

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Attorney at Law, Keith Switzer, and Roland Tanner  
for Southern California Water Company, applicant.  
Morrison & Foerster, LLP, Derek F. Foran, for the City of  
Folsom, interested party.  
Cleveland W. Lee, Attorney at Law, and Sung B. Han,  
for the Office of Ratepayer Advocates.

**OPINION APPROVING SALE PURSUANT TO SECTION 851<sup>1</sup> AND  
DETERMINING RATEMAKING TREATMENT FOR PROSPECTIVE  
REVENUES FROM SALE OF WATER RIGHTS**

**Summary**

This opinion approves Southern California Water Company's (SCWC) lease of water rights to the City of Folsom pursuant to § 851 and directs SCWC to

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<sup>1</sup> Unless indicated otherwise, all statutory citations are to the Public Utilities Code.

record proceeds from the lease into a memorandum account, in accordance with § 789 and § 790, for investment in utility infrastructure and plant.

**Background**

In Decision (D.) 04-03-069, the Commission found that SCWC violated Public Utilities Code § 851 when it failed to seek the Commission's approval for its 1994 permanent lease of 5,000 acre feet per year (AFY) of water rights in the American River to the City of Folsom (Folsom). For that reason, the lease was voided; a penalty of \$1,095,000 was assessed, of which \$915,000 was suspended; and SCWC was ordered to credit ratepayers with 70% of the total lease revenues accrued from the inception of the lease through the effective date of the decision, plus 7% interest. The Commission also determined that while Folsom acted in "good faith for value," Folsom was entitled only to retrospective protection of its lease of water rights, pending further record development on the issue of Folsom's prospective rights under the voided lease. Folsom then filed a petition to modify D.04-03-039, indicating that serious and immediate effects had occurred because the Commission did not preserve its prospective rights under the lease.

In D.04-04-069, after a review of new information provided by Folsom, the Commission concluded that § 851 protects Folsom'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. The Commission specifically directed SCWC file a § 851 application in D.04-04-069 and requested that the following three topics be addressed by parties in that application. The three issues are:

1. How SCWC will obtain water sufficient to serve its customer base without the 5,000 acre-feet per year leased to Folsom?

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

On July 8, 2004, SCWC filed this application to obtain § 851 approval for the Folsom transaction and to address these three issues. The Commission's Office of Ratepayer Advocates (ORA) protested the application on July 8, 2004. A prehearing conference was held on October 14, 2004. The Assigned Commissioner issued a scoping memo, which adopted a procedural schedule calling for testimony and evidentiary hearings, and designated the assigned Administrative Law Judge as the principal hearing officer. The scoping memo stated that the Commission had already defined the scope of the proceeding in D.04-04-069 as being the three questions set out above.

Evidentiary hearings were held on June 14, 2005. SCWC presented two witnesses and ORA presented one witness for cross-examination. To accommodate the procedural schedule for SCWC's then-pending general rate case, briefing was delayed to October and November 2005. The proceeding was submitted for consideration by the Commission on November 23, 2005.

### **Resolution of Issues**

SCWC and ORA presented evidence on each of the three issues, which we resolve below, followed by our determination of whether this transaction meets the § 851 statute requirements.

#### ***Issue 1: How SCWC will obtain water sufficient to serve its customer base without the 5,000 acre feet per year leased to Folsom?***

SCWC stated that it serves about 15,027 customers in the Arden-Cordova Service Area, which is comprised of the unconnected Arden and Cordova water systems. The Arden system cannot receive water from the American River

system and is therefore not affected by the transfer to Folsom. The Cordova system currently has 13,240 customers, and SCWC predicts that full “build out” of the service area in 2022 will result in about 15,500 customers. SCWC forecasts that water demand will be about 22,200 acre-feet per year, with maximum daily demand about 25,325 gallons per minute.

SCWC states that it has sufficient ground water and surface water to meet this projected demand. SCWC explained that the Cordova system has 13 active wells with a total system design capacity approximately equal to 32,941 acre-feet, more than enough to meet projected 2022 demand. SCWC further states that while groundwater contaminants may threaten up to nine of its wells, it expects that remediation by the polluters, including providing replacement water, will ensure an adequate supply of groundwater. In addition to its groundwater, SCWC stated that it possesses rights to divert up to 5,000 acre-feet of water per year from the American River, and that it has entered into a five-year water transfer agreement with the Sacramento Municipal Utility District for 10,000 acre-feet of water.

ORA countered that SCWC will be relying heavily on the risky strategy of purchases from third parties to meet the needs of its customers. ORA stated that that the 5,000 acre feet of water rights transferred to the Folsom are an important source of good quality water that SCWC controls from the source to the point of delivery. ORA concluded that the Folsom water rights, as compared to potential future purchases, are a superior source of water for SCWC’s customers.

### **Discussion**

SCWC has demonstrated that it currently has sufficient water supplies to meet the present and future needs of its customers. SCWC has taken prudent steps to secure replacement water for the water rights that it leased to Folsom.

SCWC has an adequate water supply to meet its customers' needs at full build-out of its Cordova system. While ORA has raised concerns about SCWC's ability to economically meet its customers' needs in the future, we find that SCWC has enough water to meet its customers' needs. Therefore, we conclude that the 5,000 acre feet of water leased to Folsom is no longer useful in the provision of water utility service.

**Issue 2: What is the proper accounting and ratemaking treatment of future lease revenues under the Folsom lease?**

SCWC argues that no dollar value for the water rights was recorded in SCWC's rate base, and thus ratepayers have no claim to the water rights or proceeds from the sale thereof. SCWC provided accounting documentation showing that all costs of the acquisition were allocated among the other assets transferred and recorded in SCWC's rate base plant accounts. At no time were the water rights included in rate base. SCWC also cited to D.00-07-018 as supporting an allocation to shareholders of 70% of the proceeds. (D.00-07-018 set forth revenue sharing percentages for non-tariffed utility offerings. For passive activities, 70% of the revenues are allocated to shareholders.)

ORA pointed to D.04-03-039 as dispelling SCWC's contention that the water rights were not included in rate base. ORA reads that decision as concluding that the cost of the acquisition, including the water rights, was included in rate base. Consequently, the ratepayers are entitled to all revenue from the sale. ORA recommended that all revenues for the lease of water rights to Folsom which were not addressed by D.04-03-039 be credited to regulated account No. 607, Sales to Government Agencies by Contracts.

SCWC opposed ORA's allocation of all revenues to ratepayers and contended that ORA provided no justification of such an allocation. SCWC

stated that ORA did not draw any analogy to the Commission's precedent on gain on sale or allocation of revenues from excess capacity.

### **Discussion**

In D.04-03-039, we thoroughly reviewed all aspects of the SCWC's 1964 acquisition of the Natomas Water Company and the subsequent lease to Folsom of 5,000 AFY. We found SCWC had recorded the lease revenues in a non-operating below-the-line account to benefit its shareholders only. The decision further determined that the retrospective revenue from the lease be split between the ratepayers and shareholders, 70/30, respectively. To arrive at this sharing, we first noted that ratepayers had paid the costs associated with acquiring the water rights, and that shareholders had not borne any costs whatsoever. We then observed that the water rights would probably have been underutilized and that the shareholders should be rewarded for leasing this asset to a third party.

Today's decision addresses the prospective revenues.

We have previously concluded that the 5,000 acre feet of water leased to Folsom is no longer useful in the provision of water utility service. As such, § 789 and § 790 of the Public Utilities Code apply. § 790 in relevant part states:

790. (a) Whenever a water corporation sells any real property that was at any time, but is no longer, necessary or useful in the performance of the water corporation's duties to the public, the water corporation shall invest the net proceeds, if any, including interest at the rate that the commission prescribes for memorandum accounts, from the sale in water system infrastructure, plant, facilities, and properties that are necessary or useful in the performance of its duties to the public. ...The amount of the net proceeds shall be a water corporation's primary source of capital for investment in utility infrastructure, plant, facilities, and properties that are necessary or useful in the performance of the water corporation's duties in providing water utility service to the public.

§ 790 requires that SCWC invest the proceeds from its Folsom water lease into water system infrastructure that are “necessary or useful in the performance of its duties to the public.” § 790 (c) further requires that proceeds not invested be returned to ratepayers.

790. (c) This article shall apply to the investment of the net proceeds referred to in subdivision (a) for a period of 8 years from the end of the calendar year in which the water corporation receives the net proceeds. The balance of any net proceeds and interest thereon that is not invested after the eight-year period shall be allocated solely to ratepayers.

Hence, the proper accounting and ratemaking treatment with regard to the Folsom lease is covered by statute. We direct SCWC to establish a memorandum account to which Folsom lease revenue shall be recorded. Interest shall accrue on this account at the 3-month commercial paper rate. Any proceeds not used for water utility infrastructure or plant within an 8-year period, shall be allocated solely to ratepayers. This memorandum account shall be subject to audit.

*Issue 3: What measures are appropriate to ensure ratepayers are not adversely affected by the lease of water rights to Folsom?*

ORA recommended that the Commission “order whatever measures will make the ratepayers whole,” and specifically suggested that SCWC replace the 5,000 AFY sold to Folsom with like-kind water rights. SCWC offered no recommendations.

### **Discussion**

The record shows that ratepayers have not suffered any diminution in service or extra expense due to the sale of water rights to Folsom. In fact,

ratepayers have benefited from their portion of the revenue being used to offset other expenses.

As a certificated public utility, SCWC is obligated to “furnish and maintain such adequate, efficient, just, and reasonable service ... as are necessary to promote the safety, health, comfort, and convenience of its patrons.” § 451. Meeting this obligation requires that SCWC prudently acquire such water resources as are necessary to meet the needs of its customers. SCWC has demonstrated that it currently has sufficient water supplies to meet the present and future needs of its customers. SCWC has secured replacement water for the 5,000 AFY of water leased to Folsom.

By treating lease revenues under § 789/ § 790, SCWC will have to invest lease proceeds in utility infrastructure and plant. If SCWC does not invest the lease proceeds within an eight year period, ratepayers will be allocated these proceeds, plus interest. The risk of losing lease proceeds, combined with not earning a return on plant additions, will provide SCWC incentive enough to make timely investments in its water system. And ratepayers will benefit in either case. Thus, no additional measures to protect ratepayers are needed.

We reject ORA’s recommendation that we order SCWC to acquire similar resources at shareholder expense, and to also allocate the full revenue from the permanent lease to ratepayers. Ratepayers are not entitled to have the 5,000 AFY and the revenue from the sale of the same resource.

We find that this resolution is reasonable and in the public interest.

**Should the permanent lease of 5,000 AFY be approved pursuant to § 851?**

We recognize that we are evaluating an after-the-fact transaction that was consummated in November 1994, nearly twelve years ago. While our past issued



decisions on this matter have dealt with retroactive issues, we are called upon to evaluate the transaction on a prospective basis.

Pursuant to § 851, no public utility shall “sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or part of any of its ... property necessary or useful in its performance of its duties to the public ... without having secured from the Commission an order authorizing it to do so.” Every sale made without “an order of the Commission authorizing it is void.” The statute exempts good faith purchasers for value from its requirements.

The purpose of § 851 is to enable the Commission to review a proposed encumbrance of utility property useful in the performance of its duties before it takes place, in order to take such action as the public interest may require. Thus, we must determine whether to grant approval of the water lease on a prospective basis. Granting approval on a retroactive basis would thwart the purpose of § 851.

In D.04-03-039, we determined that § 851 applied to the transaction with Folsom, and that SCWC had failed to file the required application. Consequently, we determined that the transaction was void, and fined SCWC for its failure to file the agreement. We subsequently modified that decision with D.04-04-069 to clarify that Folsom met the requirements for the exception to §851, and that § 851 protects Folsom acquired interest in the water rights.

In D.04-03-039, we stated that in § 851 reviews “...the Commission typically considers at least three factors...whether the proposed transaction will impair the utility’s ability to provide service to the public...the ratemaking and accounting treatment of the proceeds of the proposed transaction...,” and “...the environmental impacts of the proposed transaction...”

We find that SCWC has demonstrated that it currently has sufficient water supplies to meet the present and future needs of its customers. We conclude that the 5,000 acre feet of water leased to Folsom in perpetuity is no longer useful in the provision of water utility service, given that SCWC has secured replacement water supplies that exceed its anticipated needs at system build-out. Thus, SCWC's ability to continue to provide public utility service is not impaired.

We have addressed the appropriate ratemaking and accounting treatment of the Folsom water lease earlier in this decision. Since the water rights leased to Folsom are no longer necessary or useful in the provision of water utility service, § 789 and § 790 are applicable. § 790 requires that SCWC invest the proceeds from its Folsom water lease into water system infrastructure that are necessary or useful in the performance of its duties to the public. § 790 (c) further requires that proceeds not invested be returned to ratepayers.

With respect to CEQA, we note that because the water lease transaction took place twelve years ago, any activity which may have warranted our timely environmental review has long since occurred. Consequently, for practical purposes meaningful CEQA review at this time would have no effect because we are unable to conduct review prior to the consummation of the transaction. In its application, SCWC states that its Reallocation Agreement with Folsom transferring the water rights contained a provision that the "City (Folsom) shall have complied with the California Environmental Quality Act (CEQA) and national Environmental Policy Act (NEPA) to the extent required." SCWC states that Folsom did comply with this provision of the agreement in 1994.

We approve the transaction pursuant to § 851.

**Comments on Alternate Proposed Decision**

The draft alternate decision of President Peevey was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.6 of the Rules of Practice and Procedure.

Comments were filed by \_\_\_\_\_.

**Assignment of Proceeding**

Michael R. Peevey is the Assigned Commissioner and Maribeth A. Bushey is the assigned ALJ.

**Findings of Fact**

1. SCWC has sufficient water resources to meet the present and future needs of its customers.
2. The 5,000 AFY of water rights leased to Folsom are no longer useful in the provision of water utility service.
3. The Folsom water lease does not impair SCWC's ability to provide service to the public.
4. Ratepayers have not suffered any diminution in service or extra expense due to the sale of water rights to Folsom.
5. § 789 and § 790 address the ratemaking and accounting treatment of utility property that is no longer necessary or useful in providing water utility service to the public.
6. § 789 and § 790 protect ratepayers by requiring the return of the unused proceeds from the lease not invested in water utility infrastructure or plant solely to ratepayers.
7. SCWC's application meets § 851 statutory requirements and adequately addresses the typical factors considered by the Commission in such applications.
8. The lease is not adverse to the public interest.

**Conclusions of Law**

1. SCWC's application to permanently lease 5,000 AFY of American River water rights to Folsom should be approved pursuant to § 851.
2. SCWC should establish a memorandum account to record Folsom lease revenues in accordance with § 789 and § 790.
3. Today's decision should be effective immediately.

**O R D E R**

**IT IS ORDERED** that:

1. SCWC's application to approve, pursuant to § 851, the permanent lease of 5,000 AFY of American River water rights to Folsom is approved.
2. SCWC shall record the revenue from the permanent lease of 5,000 AFY of American River water rights to Folsom in a memorandum account as prescribed by § 789 and § 790 of the Public Utilities Code. Interest shall accrue on this account at the 3-month commercial paper rate. Any proceeds not used for water utility infrastructure or plant within an 8-year period from first being booked, shall be allocated solely to ratepayers. Any lease revenues collected from the effective date of D.04-03-069 through the effective date of this decision, shall be recorded in this memorandum account with interest.
3. Application 04-07-018 is closed.

This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.