

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

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STATEMENT OF POLICY ON RATES
FOR WATER SERVICE

(Issued September 21, 1978)

When we authorize rates to be charged by a water company, or by a water supplier operating as a legal or functional adjunct to a land development company, one of the factors we must evaluate is the company's investment in plant.^{1/} For ratemaking purposes in New York, the company's plant investment generally is understood to equal the total plant investment, minus "customer contributions" to plant. The policy we set forth here^{2/} concerns the manner in which customer contributions should be recognized, in evaluating the rate base for water companies that have been established in the course of real estate development ventures. Such companies pose special analytic problems.

^{1/}"Plant investment," for purposes of this Statement of Policy, has the same meaning as for purposes of rate base computations: it denotes net investment, i.e., original cost of plant minus depreciation.

^{2/}We have discussed this policy also in Case 27178, Dennis Land Development Co., Inc. (Order Adopting. . .Recommended Decision, issued April 11, 1978, mimeo at pp. 2-3); Case 26865, Sterling Forest Water Corp., 16 NY PSC 464, 471, n. 5 and text accompanying (1976); Case 26861, Wild Oaks Water Co., Inc., 16 NY PSC 446, 449-50 (1976); and Case 26861, Wild Oaks Water Co., Inc. (Order Denying Petition for Rehearing, issued June 24, 1976, mimeo at pp. 3-4).

I

In examining rate proposals by water companies operated in a legal or functional relationship to land development companies, we find frequently that a water plant has been installed as a necessary part of a broader development program involving the sale of lots to builders or purchasers of houses. Typically, the company seeks our approval of a new rate only after the lapse of a period during which it has been charging consumers some rate for water service, or giving them ostensibly "free" service, without our approval.

In many cases, the initial rate submitted for our approval is two or three times the sum of the previous, unregulated rate (if any) plus increments attributable to changes, in expenses and in capital costs, that have occurred since the water service was established. At the same time, however, the proposed initial rate may seem reasonable when we evaluate all current expenses and capital costs (rather than considering only changes that have occurred among these items since service began, which typically would justify only an increase approximately parallel to the rate of inflation). In such cases, obviously, the company originally was providing service without charging a rate that sufficed to cover the expenses and capital costs of the water system.

This practice has two undesirable features. First, it is inconsistent with the consumer's reasonable expectation (in the absence of a clear warning to the contrary) that the rate charged for water service will not increase substantially faster than increases in the cost of providing the service. When they begin receiving water service, consumers are likely to realize that the rate may change in proportion to inflation-related changes in the company's operating expenses and changes in the company's capital costs, but not that the rate may be doubled or trebled

because it was insufficient to cover expenses and capital costs originally.

Second, if we approve a proposed regulated rate merely because it reflects the cost of providing service during the period when the new rate will be in effect, and we do not also examine whether such approval will result in a rate increase greater than any increase in the cost of providing service, we may effectively be annulling a customer contribution that was reflected in the previous, unregulated rate. This is because companies normally do not provide water service on a noncompensatory basis; if the unregulated rate failed to cover the operating expenses and the apparent capital costs of the water system, we can infer that the company was compensated for such costs and expenses by means of the proceeds it realized from real estate sales instead of through water rates. In such circumstances, the sale price of the real estate reflects a customer contribution to the water plant, which we might improperly fail to recognize if we authorized a rate increase greater than any increase in the company's operating expenses and capital costs.

As a matter of economic logic, a developer normally will not provide water service free of charge or at a low rate unless the combined revenues, from realty sales and water service, provide the maximum return on the combined realty and water investments that the developer thinks the local realty market will permit. Based on this judgment about the market, the developer will set a first, unregulated rate that may or may not be the sole source of return on the investment in water plant; and will demand the maximum obtainable price for the realty, whose marketability will of course be affected by the availability and price of water (as well as by numerous other variables). Therefore, if the consumer enjoys ostensibly "free" water service or service

at a rate that does not cover the operating expenses and capital costs of the water system, what makes this bargain possible is that the consumer has made a capital contribution to the water system (either directly to the developer or through some intermediate vendee) in the guise of a payment for realty.

It is quite reasonable that parties apportion revenues between water charges and realty prices in this fashion as a result of marketing decisions by sellers who are attempting to make their property as attractive as possible to buyers. These decisions create difficulty only if the developer, having already obtained a customer contribution of capital to the water system partly or wholly by means of real estate sale proceeds rather than water rates, is then allowed to charge a regulated rate that fails to recognize the customer contribution and therefore effectively "recovers" the contribution a second time. Fairness to the developer does not require such a double recovery, and fairness to the ratepayer precludes it.

II

In recognition of the problems that may result from the disparity between an unregulated rate (or "free" service) and the initial regulated rate subsequently authorized by the Commission, the Legislature effectively has abolished the unregulated rate in future land developments: Public Service Law § 89-e(2) provides that 120 days before initiating water service, the operator must submit a rate schedule for our approval.^{1/} Thus, in water systems that begin operating

^{1/}L. 1977, c. 370, § 1; eff. July 6, 1977. We note that the Federal government also has recognized the significance of this problem, by requiring that the "statement of record," to be filed with the Department of Housing and Urban Development by land developers in interstate commerce, contain information about probable terms and conditions of utility services at the development site.

after the effective date of the statute, the first rate that consumers experience will be a previously published, regulated rate. Regardless of whether we must diminish the proposed regulated rate in any particular case because there have been customer contributions to the system, the problems of violated expectations and double recovery will be eliminated in systems controlled by the statute because the initial rate will be ascertainable in advance. Purchasers will be able to develop sound expectations and pricing decisions, secure in the knowledge that rate changes thereafter will be limited to the extent of changes in operating expenses and capital costs.

But the statute does not solve the problem posed by companies that began water operations before its effective date but have not yet proposed initial regulated rates, and companies now charging regulated rates that fail to reflect customer contributions collected in the form of realty sale proceeds. On several occasions, we have declared our reluctance to disregard the possibility that some return on water plant investment was realized through realty prices rather than through water rates;^{1/} but applicants have continued to present cases in a manner that fails to address this concern. We therefore find it necessary to announce the following policy on this subject, which will be applied in evaluating all proposed water rates filed after September 31, 1978.

We shall presume that a regulated rate will afford the company reasonable opportunity to earn a fair return on its investment in water plant if the rate reflects all new developments, in operating expenses, capital costs, and value of plant, since the time when service began free of charge or at an unregulated rate. The company will bear the

^{1/}Cases cited at p. 1, n. 2, above.

burden of overcoming this presumption.^{1/} The reason for the presumption (in summary of what has been explained previously at greater length) is that water service, from its inception, will have been provided on terms that create a full opportunity to earn a reasonable return on investment in plant either through water rates or through realty sales proceeds.

Obviously, however, a rate is not reasonable if it implies that foreseeable cost increases, during the period for which the rate is expected to be in effect, will result in an operating loss. We therefore shall recognize not only current data, but also a reasonable, additional allowance for the dual purpose of (a) encouraging efficiency, by assuring the operator that expenses will be reimbursed as

1/Although we have said that our policy will be applied to "all proposed water rates," consideration of the principles involved will show that the policy will have a practical effect only on water companies whose rates reflect some concurrent or past transactions in non-utility activity such as realty development. The policy itself effectively sorts companies or operating entities according to whether non-utility transactions have affected the rates they charge for utility service; thus it becomes unnecessary to prescribe special rules of analysis according to criteria such as whether the water company is a subsidiary of a land development company, or has appropriated some land development company assets in the process of becoming an independent water company, or always has made independent decisions about rates despite its affiliation with a land development company, or exemplifies any of the other myriad possibilities that might emerge. All that is needed is an inquiry whether water revenues, segregated from all other types of revenue, cover the operating expenses and capital costs of the water plant. (Where working capital is held for more than one corporate purpose, a reasonable portion can be attributed to the requirements of the diversified company's water operation.) If a company is exclusively a water utility, it always will attempt to have revenues equal utility-related expenses and capital costs. If it is involved in some other activity, it may pursue a different objective. In either case, the main issue is not the corporate structure, but whether customer contributions are recognized consistently when service begins and when a regulated rate is authorized.

they accrue and by assuring lenders that repayment schedules can be maintained; and (b) offsetting reasonably foreseeable rate base attrition and earnings erosion, attributable to various phenomena such as inflationary changes and increased maintenance costs as plant deteriorates.

Depending on its persuasiveness, several types of evidence might tend to refute the presumption that a rate is adequate if it reflects changes since service began. For example, a company might attempt to show that the property was sold with actual knowledge on the buyer's part that water rates would lack the comparative stability one associates with rates that change only in response to changes in operating expenses and capital costs (as contrasted with the instability associated with drastic rate base changes resulting from disregard of customer contributions). If the buyer did not expect comparative stability, the bargain between buyer and seller may not have included a customer contribution to the water system.

We also would consider relevant an express warning that water rates would accelerate substantially faster than the cost of service, if the warning were included in the contract of sale (or in a publicly filed subdivision plan if the buyer had actual rather than constructive notice of the plan). Similarly, if a buyer experienced a low unregulated rate or service free of charge, and the company can show that it was unreasonable for the buyer to assume that water would be provided on such terms indefinitely (as, for example, if service were offered free of charge, but meters were being installed, at the time of sale), we might deem the buyer to have been warned constructively that rates would increase faster than changes in operating expenses and capital costs.

In summary, the company will bear the burden of showing that it based its realty sale price on the expectation of realizing an adequate return on water plant investment through the medium of water rates rather than through realty sale proceeds. This may be demonstrated by showing that the unregulated rate was designed to cover the operating expenses and capital costs attributable to water service. If the company can make such a demonstration persuasively, we shall conclude that no part of the realty sale proceeds represents a customer contribution to water plant.^{1/}

1/If the facts of a particular case preclude the use of comparatively reliable and convenient modes of proof such as we have suggested, we may be willing to consider more questionable indicia, such as contractual recitals that some specified part of the purchase price represents a contribution to water plant, or such as entries in the company's tax records.

With regard to contractual terms, however, the very problem that prompts this statement of policy is that when a buyer and seller agree upon a total price for realty supplied with water, neither of them has any motive for ensuring that there be an actual "meeting of the minds" as to what percentage of the mutually accepted price represents a payment for water service. Thus, although experience may prove otherwise, it seems to us that an express but casual contractual allocation of a certain amount for water plant is no more illuminating than the allocation implied by the establishment of an overall sales price in a contract that says nothing about water plant.

As for tax records, it seems regrettable but perhaps inevitable that small water companies, lacking the resources to prepare records based on generally accepted accounting principles (and the Uniform System of Accounts) in addition to records prepared for tax purposes, will continue to offer only the latter in rate proceedings despite our general view that records used for ratemaking purposes should reflect the concepts and items expressly relied on in setting rates. Since tax records are prepared for wholly different purposes, we seriously doubt (without foreclosing the attempt) that they could be used as conclusive evidence regarding the value of rate base adjusted for customer contributions. They might have some value, however, as supplementary proof of outlays and receipts.

Finally, in the absence of enough comparatively convenient and reliable evidence, a company might attempt to show that its proposed rate is similar to, or dissimilar from, rates charged by other, comparable water companies; or to show that among comparable items of realty, traded under comparable conditions, there are price differentials that can be isolated and attributed specifically to the differing terms on which water is provided to these various properties.