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WRITER'S DIRECT DIAL NUMBER

954-0237

January 9, 1984

Steven S. McCray, Esq.
Hoge, Fenton, Jones & Appel, Inc.
4 N. 2nd Street
San Jose, CA 95113

RE: Odd Fellows Sierra Recreation Assn.
Your File RDD-15076

Dear Steve:

By our letter of May 27, 1983, we provided you with a brief outline of the regulatory issues raised by the proposed provision of water by the Odd Fellows Sierra Recreation Association (the "Association") to residences at the Association's campground in Tuolumne County. The recommendations set forth in our letter focused on the proposed establishment of a mutual water company (Public Utilities Code Section 2705) by the Odd Fellows Sierra Homeowners Association (the "Homeowners Association").

Our recommendations were intended to further the twin goals of (1) ensuring that neither the Association nor the Homeowners Association achieve public utility status as a result of the <u>proposed</u> operations and (2) preventing scrutiny leading to a possible determination by the Public Utilities Commission ("PUC") that the Association's <u>present</u> operations are that of a public utility. In furtherance of these goals we presented recommendations regarding the transfer of certain water distribution facilities from the Association to the Homeowners Association and made further recommendations with regard to the membership provisions of the by-laws governing the Homeowners Association.

You have recently advised us that the Association and the Homeowners Association have reviewed our May 27, 1983 letter and have concluded that they wish to proceed with the proposed provision of water from the Association to the Homeowners Association. They wish to, however, do so under the following conditions relevant to the advice provided in our May 27, 1983 letter:

(1) The Association does not wish to transfer any water distribution assets to the Homeowners Association.

(2) The Homeowners Association does not wish to form a mutual water company for the purpose of purchasing water from the Association for resale.

You have asked us to evaluate, in light of the above-referenced conditions, risks attendant to the provision of water by the Association to the Homeowners Association. You have also requested advice with regard to the steps that can be taken to minimize an assertion of jurisdiction by the Public Utilities Commission over either the Association or the Homeowners Association.

DEDICATION

A. The Association

As we indicated in our May 27, 1983 letter, a key determinant of a public utility status is dedication of service to the public at large. Under the arrangement we would recommend, dedication on the part of the Association would be defeated by the existence of a contract providing for water service by the Association to a single customer, the Homeowners Association. Ideally, such a contract would provide that the Homeowners Association would be the sole purchaser of water from the Association.

We do not believe that the Association's use of its water supply for its own purposes (such as necessary irrigation) would raise an issue of dedication. We would, however, strongly urge that the Homeowners Association retain a first priority of use of the Association's water supply - a priority superior even to water use by the Association itself. While priority use by the Association in derogation of service to the Homeowners Association would not in any legal sense impact the issue of dedication, it could well prompt disgruntlement among residential users and trigger

inquiry by the PUC. As we will stress repeatedly herein, a happy customer base is essential to the success of the proposed water supply arrangement.

B. The Homeowners Association

Establishing lack of dedication by the Homeowners Association poses a more difficult question. Dedication should be defeated by a restriction of service by the Homeowners Association to its own members on a nonprofit basis - in essence the operation of a *de facto* mutual water company. However, under present conditions such a restriction would result in a politically unacceptable termination of service to some residences. As an alternative, water service could only be provided to owners who are eligible for membership in the Homeowners Association, a group which presumably includes all current owners receiving water service. This latter alternative provides the all-important continuity of service during the transition from water service by the Association to water service by the Homeowners Association - a transition which ideally should be practically imperceptible from the standpoint of the end user.

STRUCTURING OF HOMEOWNERS ASSOCIATION RULES FOR PROVISION OF WATER SERVICE

The key to the unregulated provision of water by the Homeowners Association to its members turns on steps to avoid scrutiny by the PUC while developing procedures to avoid adverse treatment in the event of such scrutiny.

A. Rates

We have already noted generally the importance of virtually eliminating any customer perception of the changeover from service by the Association to service by the Homeowners Association. To the extent possible, one feature of this strategy would be a certain element of rate stability during and immediately following the transition. While we are not familiar with the operating budget of the Association's water system, I suspect that this should not pose too much of a problem for the Homeowners Association.

B. Termination of Service

Clearly, no single act of the Homeowners Association is more likely to pique the Commission's interest or promote a customer complaint to the Commission than that of termination of water service for nonpayment of bills. In our discussion of by-laws below we discuss the importance of structuring governance of the Homeowners Association to elicit the most favorable response from the PUC staff in the event of what one should prudently regard as an inevitable PUC investigation of the Homeowners Association's operations. Consistent with such an approach is the establishment of termination procedures generally in line with statutory and regulatory requirements applicable to water utilities under the Commission's jurisdiction. It is in this one area that we would recommend the Homeowners Association depart from the *de facto* mutual water company approach discussed below. We believe there are two principal benefits to be derived from such an approach. First, as we have mentioned, the Commission staff is likely to view with much more favor termination procedures which are undeniably fair to the party whose service is being terminated. As the PUC staff is well aware, a customer whose service is terminated pursuant to strict PUC and statutory procedural requirements has truly "asked for it" and the water purveyor generally cannot be viewed in an unfavorable light. Secondly, the ability of the Homeowners Association to advise its members that termination procedures are consistent with those required of water utilities throughout the state is likely to stave off at least some complaints to the PUC. Undoubtedly, adherence to PUC/statutory procedures rather than those generally available to a mutual water company will result in some level of uncollectibles. It is therefore important that the Homeowners Association incorporate an uncollectibles factor in developing water rates and give due consideration to this fact in developing cash flow projections for the system.

C. Establishment of a *De Facto* Mutual Water Company

While steps can be taken to keep the Homeowners Association customer base happy, it would be imprudent to assume that the PUC will never scrutinize the operations of

the Homeowners Association system. In the event the Commission does review the operations of the Homeowners Association system, it is almost certain that they will follow the recommendations of their staff with regard to action to be taken. It is essential that the Homeowners Association by-laws governing the operation of water system be structured in a fashion which presents the most favorable image to the Commission staff. In our view the most favorable image to proffer would be that of a de facto mutual water company. In our letter of May 27, 1983, we recommended several by-law provisions which were, pursuant to the advice set forth in our May 27, 1983 letter, premised on our recommendation that the Homeowners Association establish a separate mutual water company. Given the Association's reluctance to establish a de jure mutual, we now restate those recommendations as follows:

(1) As we recommended in our May letter, the by-laws should provide for two classes of membership similar to that provided for in Sections 2.01 and 3.11 of the existing by-laws. One class of members ("regular") would have an interest in and voting rights with respect to all activities of the Homeowners Association. A second class of members ("associate") would have the right to attend special meetings of the Homeowners Association called solely for the purpose of determining matters related to the provision of water. Ideally such meetings would be called once a year and would essentially solicit ratification of all acts of the Homeowners Association Board of Directors with regard to the provision of water to the Association as well as the provision to regular and associate members of an accounting of water revenues and expenditures (see Accounting discussion below). While our May letter made reference to the associate members holding a proprietary

interest in water system assets, your desired system of operation does not contemplate the Homeowners Association owning any water system assets.

(2) Obviously, we continue to recommend that no disparity exist between assessments for water service for regular members and associate members.

(3) The Association by-laws should clearly provide for separate accounting for water system operations. It is essential that the books and records of the Homeowners Association establish without a doubt the nonprofit nature of the Homeowners Association provision of water service.

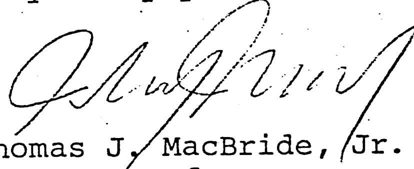
This latter point is particularly important. The nonprofit status of the Homeowners Association will preclude the Commission or its staff from concluding that anything is to be gained by ordering a refund of water assessments. Absent the existence of large numbers of shareholders who are not also customers, little would be accomplished by the ordering of refunds.

In essence, we believe that if a *de facto* mutual is established, pursuant to our recommendations, that the worst that could occur in the event of a PUC investigation would be a requirement that the Homeowners Association take steps to become (1) a fully certificated water utility or (2) a *de jure* mutual water company. The staff, well aware of the Commission's aversion to regulating small water companies, will surely prefer the latter result. While not likely, it is even possible that the staff would decline to act at all given the fact that customers served under the arrangement we propose would receive no additional benefits if served by a *de jure* mutual.

We hope that this is responsive to your inquiry. Give me a call if you have any questions or require a more detailed discussion.

With best wishes.

Very truly yours,



Thomas J. MacBride, Jr.
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TJM:km