

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Investigation on the Commission's Own Motion into the Operations and Practices of Mesa-Crest Water Company (U 333 W) with Respect to a Series of Financial Transactions, and Possible Threats to the Health and Safety of its Ratepayers.

FILED
PUBLIC UTILITIES COMMISSION
JUNE 25, 2015
SAN FRANCISCO OFFICE
I.15-06-018

ORDER INSTITUTING INVESTIGATION

I. INTRODUCTION

By this Order, the California Public Utilities Commission (Commission) institutes a formal investigation to determine whether Mesa-Crest Water Company (Mesa-Crest),¹ F. Patrick Flynn, and Timothy Flynn (collectively, the Respondents) violated any provisions of the California Public Utilities Code, Commission general orders, decisions, or rules of practice and procedure, or other applicable laws or requirements, regarding a series of financial transactions between the Respondents that took place between about 1997 and the present (the subject years), and their alleged failure to ensure the safety and reliability of their supply of water to ratepayers. Staff from the Commission's Safety and Enforcement Division (SED) have prepared an investigative report (Staff Report) underlying this Order, and have compiled a number of documents supporting that Staff Report, which due to their volume are not being served with this Order but are available upon request.

¹ The Commission has, in various proceedings, referred to the utility as both "Mesa-Crest Water Company" and "Mesa Crest Water Company"; i.e., both with and without the hyphenated name. According to the listing on the website of the California Secretary of State, the utility is called "Mesa-Crest Water Company," with the hyphen. For consistency, this Order will use the hyphen.

The utility Respondent is Mesa-Crest, a Class C water company subject to the Commission's jurisdiction and to state law, and to the Commission's general orders, rules, and decisions. The individual Respondents are F. Patrick Flynn, Mesa-Crest's sole shareholder, Secretary, and Treasurer; and Timothy Flynn, Mesa-Crest's President. Timothy Flynn is also F. Patrick Flynn's son. Another of F. Patrick Flynn's sons, Thomas Flynn, also works for Mesa-Crest; he is not currently named as a respondent to this Order, but the Commission reserves the right to name him as a respondent should additional facts make that appropriate.

The Staff Report alleges that, over a period of about fifteen years, F. Patrick Flynn and Timothy Flynn (the Flynn's) extracted \$307,629 from Mesa-Crest's cash reserves, leaving it with insufficient funds to meet its capital, financial, and operating needs.² Mesa-Crest recorded these transactions as unsecured, zero-interest, short-term loans on its annual reports to the Commission, but Staff asserts that Respondents misrepresented these cash extractions as "short-term loans":³ there were no written loan contracts, no payment schedule, and no maturation date; no consideration was given; none of the "loans" were repaid within one year of their issuance; and the Flynn's repaid only token amounts over the subject years. Staff further asserts that Respondents failed to maintain relevant information needed by the Division of Water and Audits (DWA) to identify, analyze, and verify all the facts surrounding these transactions.⁴

The Staff Report also alleges that the Flynn's' extraction of funds left Mesa-Crest with insufficient cash to pay its purchased water bills from September to December of 2009.⁵ Staff alleges that to remedy the cash flow problem, without Commission approval, Mesa-Crest borrowed \$110,000 at 4.5% interest from F. Patrick Flynn, secured with Mesa-Crest's water revenue, and then used the proceeds to pay for its purchased

² Staff Report at 1.

³ Staff Report at 6.

⁴ *Id.*

⁵ *Id.* at 12-14.

water.⁶ Staff asserts that when DWA became aware of the unauthorized loans, DWA directed Mesa-Crest to stop repayments of principal and interest to F. Patrick Flynn, but Respondents refused. Staff alleges that Mesa-Crest continued to make payments on the unauthorized loans, in violation of DWA's directives.⁷

In addition, the Staff report shows that during the subject years, overall management compensation at Mesa-Crest – i.e., compensation to the Flynns – has risen sharply. During the subject years, Mesa-Crest declared \$71,868 in dividends and actually paid \$84,468, all to F. Patrick Flynn, Mesa-Crest's sole shareholder.⁸ Resolution (Res.) W-4531, issued in 2005, approved Mesa-Crest's most recent General Rate Case (GRC). That Resolution approved management salaries of \$26,000 per year.⁹ Yet the Staff Report shows that management salaries at Mesa-Crest had risen to \$136,000 per year by 2013.¹⁰ As the Staff Report notes, Mesa-Crest "has 708 metered connections in an area that has been fully developed for several decades and does not expect to add any new customers. Therefore, the work for [Mesa-Crest's] managers is not expected to change significantly"¹¹ Staff asserts that this rise in overall compensation does not correspond to any increase in the Flynns' responsibilities.¹²

Mesa-Crest has for years been in a weak financial position, and its plant in need of serious work. During the course of a 2004 Commission proceeding, Timothy Flynn testified that Mesa-Crest's system needed about \$700,000 of capital improvements, and stated that the company was "having difficulty obtaining financing for this work."¹³ In Res. W-4531, the 2005 GRC, the Commission stated that "[a] large portion of [Mesa-

⁶ *Id.* at 12-13.

⁷ *Id.* at 16-17.

⁸ *Id.* at 9-10.

⁹ Res. W-4531, Appendix A.

¹⁰ Staff Report at 11, Table 5.

¹¹ Staff Report at 11.

¹² Staff Report at 10-11.

¹³ *Application of F. Patrick Flynn and Joyce H. Flynn*, [Decision (D.) 04-07-032 at 5], __ CPUC 3d __.

Crest's] system is approaching 50 years of age and is in need of replacement or major maintenance in order to avoid unplanned service interruption."¹⁴ The Commission also approved Mesa-Crest's capital improvement plan in Res. W-4531, but Staff asserts that Mesa-Crest to date has not completed the capital improvement work.¹⁵ As a result, Staff alleges that Mesa-Crest's aging water system directly threatens the health and safety of Mesa-Crest's ratepayers.¹⁶

The above conduct, if proven in an evidentiary hearing, may violate a number of California statutes and Commission rules, orders, and decisions, including but not limited to Public Utilities Code¹⁷ §§ 451, 817, 818, 823, 827, 851, 856, and 2110; Rule 1.1 of the Commission's Rules of Practice and Procedure (Rules);¹⁸ and *Re Uniform System of Accounts for Class B, C, and D Water Utilities*, [D. 85-04-076], 17 CPUC 2d 553. This Order directs Respondents to show cause as to why the Commission should not find violations in this matter, and why the Commission should not impose financial penalties and equitable remedies, if any violations are found. The Staff Report also presents a *prima facie* showing that Respondents' conduct indicates that the individual Respondents may be unable or unwilling to adequately serve Mesa-Crest's ratepayers, or have effectively abandoned Mesa-Crest, or are unresponsive to the rules or orders of this Commission. Accordingly, this order provides notice that the Commission will set a hearing to determine whether, under Section 855; the Commission should petition the Superior Court for Los Angeles County to appoint a receiver to assume possession of Mesa-Crest's property and to operate its system.

¹⁴ Res. W-4531 at 2.

¹⁵ Staff Report at 24-29.

¹⁶ *Id.* at 28.

¹⁷ All further statutory references are to the Public Utilities Code unless otherwise specified.

¹⁸ All citations to Rules refer to the Commission's Rules of Practice and Procedure, which are codified at Chapter 1, Division 1 of Title 20 of the California Code of Regulations.

II. BACKGROUND

A. The company and its management

Mesa-Crest provides water service to 708 metered connections in the La Cañada Flintridge community of Los Angeles County. The service area consists of approximately 600 acres in foothills located north of and adjacent to the Los Angeles National Forest, in or near the City of La Cañada Flintridge, and is served by a patchwork of small water companies. Unlike the surrounding utilities, Mesa-Crest does not have any groundwater pumping rights. Mesa-Crest therefore purchases all of the water it serves from the Foothill Municipal Water District (FMWD), a member agency of the Metropolitan Water District (MWD), and pays significantly more for its water supply than do the other local water utilities. A majority of Mesa-Crest's system is approaching 50 years of age, and is in need of replacement or major maintenance to avoid unplanned service interruptions.¹⁹

In 1957, the Commission granted Mesa-Crest public utility status in D. 55615;²⁰ and the Flynn family has owned and operated the company ever since.²¹ Currently, F. Patrick Flynn is Mesa-Crest's sole shareholder, with \$355,000 in common stock and \$60,000 in preferred stock. F. Patrick Flynn also served as Mesa-Crest's Vice President from 1990 to 1994, as Secretary from 1995 to the present, and as Treasurer from 2005 to the present. Timothy Flynn, the son of F. Patrick Flynn and Joyce Flynn, served as Mesa-Crest's Vice President from 1995 to 2004 and as President from 2005 to the present.

B. Proposed sales of Mesa-Crest

The Flynns have, over the years, indicated several times that they wished to get out of the water business. The Commission has twice authorized the Flynns to sell Mesa-Crest to neighboring water companies, but those sales have twice fallen through.

¹⁹ Res. W-4531 at 2.

²⁰ 55 CPUC 721.

²¹ See D.04-07-032, Slip Op. at 3.

In 1986, the Commission authorized the San Gabriel Valley Water Company (SGV) to purchase Mesa-Crest for approximately \$483,000.²² The Flynns stated that they "wish[ed] to discontinue providing water service and to engage in other pursuits,"²³ and that they "want[ed] to be out of the water business as soon as possible"²⁴ F. Patrick Flynn, then Mesa-Crest's general manager, testified that the "income developed by [Mesa-Crest] did not justify retention of the system by its . . . owners."²⁵ The Commission found that SGV had "the capability to operate the system more efficiently"²⁶ than Mesa-Crest and that SGV had "the personnel, equipment, and capital necessary to improve service in the [Mesa-Crest] service area."²⁷ But although the Commission granted the application, the deal did not ultimately go through; Timothy Flynn testified in a later proceeding that SGV withdrew its offer because it was denied the possibility of getting increases on certain of its contributions.²⁸

In 2004, Mesa-Crest returned to the Commission with a proposed sale, this time to MCWC, Inc., a wholly-owned subsidiary of the California-Michigan Land and Water Company (Cal-Mich), which also owned and operated the nearby East Pasadena Water Company (EPWC).²⁹ The Flynns again indicated their desire to get out of the business. In response, the Commission noted that "[t]he current owners of Mesa Crest [were] in their 70s and desire[d] to pass the responsibilities of operating the system and

²² *In re San Gabriel Water Co.*, [D.86-01-022], 20 CPUC 2d 209, 1986 Cal. PUC LEXIS 20.

²³ *Id.* at *6.

²⁴ *Id.* at *10.

²⁵ *Id.* at *11.

²⁶ *Id.* at *22.

²⁷ *Id.* at *30.

²⁸ *Application of F. Patrick Flynn and Joyce Flynn to Sell Shares*, Application (A.) 04-01-024, Reporter's Transcript, May 18, 2004, p. 39.

²⁹ D.04-07-032, Slip Op. at 1.

arranging financing to other qualified operators."³⁰ The sale price was to be \$425,000 cash on closing.³¹

At hearing, Timothy Flynn testified that "the sale of [Mesa-Crest] to a larger operator [would] facilitate needed capital improvements."³² He estimated the cost of the work needed at about \$700,000, and stated that the Flynns were having difficulty obtaining financing for the work, which Cal-Mich had promised to accomplish.³³ The Commission found that Cal-Mich had the financial resources necessary to perform the necessary upgrades, and that Cal-Mich, "because of its experience with a larger Class B water utility, [would] be able to operate Mesa[-]Crest efficiently, with the possibility of economies of scale that otherwise would not be available."³⁴ The Commission therefore concluded that the proposed sale was reasonable and in the public interest, and would provide "tangible benefits" to ratepayers, and approved the application.³⁵ Again, however, the deal fell through: According to Staff, Timothy and Thomas Flynn had sought guaranteed employment with MCWC after the sale, but MCWC would only offer them short-term contracting work, so the Flynns rejected the deal.³⁶

C. Staff alleges that the Flynns extracted cash from Mesa-Crest and misrepresented the nature of those transactions to the Commission.

According to Staff, while stating their desire to get out of the water business and telling the Commission they were having trouble paying for long-needed capital improvements to Mesa-Crest's system, the Flynns were extracting hundreds of thousands of dollars from the utility. As alleged in the Staff Report, F. Patrick Flynn

³⁰ *Id.* at 8.

³¹ *Id.* at 4.

³² *Id.* at 6.

³³ *Id.*

³⁴ *Id.* at 7.

³⁵ *Id.* at 9.

³⁶ Staff Report at 21.

began extracting funds from Mesa-Crest in 1997, and Timothy Flynn followed suit in 2007.³⁷ Broken out by year, the monies taken range in amounts from \$2,500, taken by F. Patrick Flynn in 2007, to \$57,249, taken by Timothy Flynn in 2010 – the year after Mesa-Crest proved unable to pay its purchased water bills.³⁸ As of 2013, F. Patrick Flynn owed Mesa-Crest \$92,687, after making small repayments totaling \$6,976; Timothy Flynn owed \$214,942, with no repayments.³⁹

Staff asserts that Mesa-Crest recorded these transactions on its annual reports as zero-interest, unsecured, short-term loans.⁴⁰ But, as the Staff investigation has raised serious financial questions, the Commission is troubled by the manner in which the transactions were allegedly made and recorded.

In determining whether or not a transaction is a loan, "[s]ubstance is more important than form, and from it the true intent of the parties must be determined."⁴¹ Staff asserts that the transactions at issue cannot be considered loans in form or substance.⁴² In California, "[a] loan of money is a contract"⁴³ One essential element of a contract is that there must be sufficient consideration for the contract.⁴⁴ California defines consideration as "[a]ny benefit conferred, or agreed to be conferred, upon the promisor, by any other person, to which the promisor is not lawfully entitled, or any prejudice suffered, or agreed to be suffered, by such person, other than such as he is at the time of consent lawfully bound to suffer, as an inducement to the promisor"⁴⁵ In short, in order for there to be a valid contract, both parties must benefit in some way from

³⁷ *Id.* at 5, Table 3.

³⁸ *Id.*

³⁹ *Id.*

⁴⁰ Staff Report at 6.

⁴¹ *Harris v. Gallant* (1960) 183 Cal.App.2d 94, 99.

⁴² Staff Report at 6.

⁴³ Civ. Code § 1912.

⁴⁴ Civ. Code § 1550.

⁴⁵ Civ. Code § 1605.

the deal. Staff asserts, however, that Mesa-Crest received nothing in return for providing money to the Flynn.⁴⁶ Moreover, "[a] transaction is likely to be a loan where the recipient has parted with title to property of his own as security . . ." ⁴⁷ but Staff asserts that the "loans" were unsecured by any interest on the Flynn's property.⁴⁸ And in California, loans are "presumed to be made upon interest, unless it is otherwise expressly stipulated at the time in writing . . ." ⁴⁹ but Staff asserts that the "loans" were interest free.⁵⁰ Indeed, Staff alleges that there was no writing at all; no payment schedules were provided; and no maturation dates were set.⁵¹

Staff contends that, as the officers and owners of Mesa-Crest, the Flynn knew or should have known that these were not loans.⁵² Yet they were recorded as such on Mesa-Crest's annual reports to the Commission. Staff finds that Respondents omitted material information necessary for DWA to identify, analyze, and verify all the facts surrounding the transactions.⁵³

In D.85-04-076, the Commission promulgated a Uniform System of Accounts for Class B, C, and D Water Utilities (USOA). The USOA provides in pertinent part:

All books of account, together with records and memoranda supporting the entries therein, shall be kept in such a manner as to support fully the facts pertaining to such entries. The books and records referred to herein include not only the accounting records in a limited technical sense, but also all other records, reports, correspondence, memoranda and

⁴⁶ Staff Report at 6.

⁴⁷ *Golden State Lanes v. Fox* (1965) 232 Cal.App.2d 135, 139.

⁴⁸ Staff Report at 6.

⁴⁹ Civ. Code § 1914.

⁵⁰ Staff Report at 6.

⁵¹ *Id.*

⁵² *Id.*

⁵³ *Id.*

information useful in determining the facts regarding a transaction.⁵⁴

The Commission's Rules of Practice and Procedure also require utilities and persons appearing before the Commission to be truthful and forthcoming:

Any person who signs a pleading or brief, enters an appearance, offers testimony at a hearing, or transacts business with the Commission, by such act . . . agrees . . . never to mislead the Commission by an artifice or false statement of fact or law.⁵⁵

The standard set forth in Rule 1.1 "requires all utilities and practitioners before the Commission to present documents . . . with all relevant and material information in a clear and understandable manner. The burden is on the applicant to present the information necessary to meet this standard . . ."⁵⁶ When utilities withhold material information from the Commission, it substantially harms the regulatory process, "which cannot function effectively unless participants act with integrity at all times."⁵⁷ In order to find a violation of Rule 1.1, the Commission need not find that the person specifically intended to deceive the Commission; rather, "the question of intent to deceive merely goes to the question of how much weight to assign to any penalty that may be assessed."⁵⁸

If it can be proven that Mesa-Crest's annual reports did not contain sufficient information to allow the Commission to determine the nature of the transactions discussed above, the Commission may find that the Respondents violated Rule 1.1 and the USOA.

⁵⁴ 17 CPUC 2d 553, 561.

⁵⁵ Rule 1.1.

⁵⁶ *In re Happy Valley Telephone Co., et al.*, [D.11-03-030, slip op. at 19-20] __ CPUC 3d __.

⁵⁷ *In re So. Cal. Edison, Co.*, [D.13-09-028, slip op. at 36] __ CPUC 3d __ (levying penalties against So. Cal. Edison for failing to provide material information to the Commission).

⁵⁸ *In re Sprint PCS*, [D.01-08-019, Slip Op. at 9] __ CPUC 3d __.

D. Staff alleges that the Flynns increased overall management compensation without any corresponding increase in management duties

In addition to the "loans" described above, Staff asserts that overall management compensation at Mesa-Crest has risen sharply during the subject years, again coming during a time when Mesa-Crest was telling the Commission that it needed to make expensive upgrades to its system in order to maintain adequate service.

The Staff Report documents the following: between 1995 and 2013, Mesa-Crest declared \$71,868 in dividend payments, and actually paid \$84,468, all to F. Patrick Flynn, Mesa-Crest's sole shareholder.⁵⁹ Most of these payments were small; in most years, Mesa-Crest declared and paid \$3,150.⁶⁰ But Mesa-Crest declared and paid \$23,826 in 2007 and \$25,992 in 2008.⁶¹ Mesa-Crest had earned no windfall during these years, its plant still needed maintenance, and it was still faced with large purchased water bills – which it proved unable to pay in 2009.

California law is clear that, while companies may lawfully pay dividends to their shareholders, the payment of dividends should not compromise a company's ability to meet its obligations. California Corporations Code § 501 provide:

Neither a corporation nor any of its subsidiaries shall make any distribution to the corporation's shareholders . . . if the corporation or the subsidiary making the distribution is, or as a result thereof would be, likely to be unable to meet its liabilities (except those whose payment is otherwise adequately provided for) as they mature.

And while this Commission lacks jurisdiction to enforce the Corporations Code, we have also made it clear that utilities should not pay preferred-stock dividends if

⁵⁹ Staff Report at 9, Table 4.

⁶⁰ *Id.*

⁶¹ *Id.*

doing so jeopardizes the utility's ability to pay debt principal and interest, fund utility operations, or provide public utility service.⁶²

Management salaries also allegedly rose over the subject years. The Commission has stated that management salary is the portion of salaries of utility managers, owners, partners, or principal stockholders actually chargeable to utility operations,⁶³ and that the appropriate salary is determined by what a manager actually does.⁶⁴ For example, the Staff Report states as follows:

a manager who is planning the expansion of the company's service territory, negotiating with developers, arranging for low interest loans and interviewing prospective employees deserves a higher salary than a manager who is reading meters and writing out bills, although each activity can be a reasonable one for management.⁶⁵

In Mesa-Crest's last GRC, undertaken in 2005, the Commission approved Mesa-Crest's proposal to pay \$26,000 per year in management salaries.⁶⁶ Mesa-Crest has 708 metered connections in an area that has been fully developed for several decades, and does not expect to add any new customers. Staff asserts that the work the Flynn's performed has not meaningfully changed since 2005. Yet according to Staff, in 2009, management salaries rose from \$39,160 to \$96,750 – more than twice as much.⁶⁷ They

⁶² See *Application of Alisal Water Corp.*, [D.08-11-035, slip op. at 20] __ CPUC 3d __ (ordering water utility not to pay preferred-stock dividends if doing so would jeopardize utility's "ability to . . . fund utility operations, or provide public utility service"); cf. *Decision Adopting Standard Rules and Procedures for Class A and B Water and Sewer Utilities*, [D.10-10-019, Appendix A, at A-8] __ CPUC 3d __ (providing that a Class A or B water utility should have "adequate capital to fulfill all of its service obligations prescribed by the Commission."). The affiliate transaction rules promulgated by D.10-10-019 do not, on their face, apply to Class C water utilities like Mesa-Crest. However, there is no reason that we may not look to those rules for guidance in determining what best practices for smaller water utilities would be; indeed, the principle that the rule represents applies here with considerable force.

⁶³ Standard Practice for Preparing Results of Operation Reports for General Rate Increase Requests of Water Utilities Other Than Major Companies (Standard Practice U-3-SM) at 8; Staff Report, Attachment K

⁶⁴ *Id.* at 9.

⁶⁵ Staff Report at 10.

⁶⁶ Res. W-4531, Appendix A.

⁶⁷ Staff Report at 11, Table 5.

rose again in 2010, to \$106,250.⁶⁸ And again in 2011, to \$128,750, and again in the years thereafter.⁶⁹ Those salaries apparently now stand at \$136,000 per year, more than five times what the Commission approved in 2005.⁷⁰ Staff asserts that such a dramatic increase in management salary is unjustified. More broadly, Staff also alleges that the increase in overall management compensation – i.e., both dividends and salary – may suggest that the Flynns effectively abandoned Mesa-Crest, in violation of Section 855, since the increase depleted the utility of financial resources.⁷¹

E. The Flynns caused a cash crunch that forced F. Patrick Flynn to improperly loan money back to the utility

As noted above, Mesa-Crest has no right to any groundwater or surface water, so it relies on water purchased from the FMWD. Staff asserts that, having been drained of assets by the Flynns, Mesa-Crest became unable to pay its purchased water bills for September through December of 2009.⁷² Staff further asserts that, but for the money that the Flynns took from the company, in the form of "loans" and increased compensation, Mesa-Crest should not have had problems paying its bills.⁷³ As a regulated utility, Mesa-Crest is entitled to cover its purchased water expenses through its ratepayers. The Commission ensured that Mesa-Crest could do so in the 2005 GRC. And although the FMWD increased its price for purchased water above the levels set in the 2005 GRC, Mesa-Crest's purchased water expenses rose more slowly than its overall operating expenses.⁷⁴ In short, Staff alleges that the increased purchased water cost

⁶⁸ *Id.*

⁶⁹ *Id.*

⁷⁰ *Id.*

⁷¹ See *In re Conlin-Strawberry Water Co.* [D.05-07-010, Slip Op. at 27, 35] __ CPUC 3d __ (finding effective abandonment where manager's "excess salary payments directly competed with other necessary operating expenses, setting up circumstances for the decline of the water system.").

⁷² Mesa-Crest had purchased water bills of \$77,905.92 for September 2009, \$61,481.27 for October, \$57,033.12 for November, and \$42,531.84 for December, or \$238,952.15 in total for those four months. Staff Report at 12, fn. 34.

⁷³ Staff Report at 13-14.

⁷⁴ *Id.* 14, Table 7.

would not have caused Mesa-Crest to become unable to pay those bills had the Flynn not been taking money from the company.⁷⁵

In response to Mesa-Crest's 2009 financial shortfall, F. Patrick Flynn allegedly loaned, in two installments, \$110,000 to Mesa-Crest at 4.5% interest. These loans were secured with Mesa-Crest's water revenue. They have not yet been fully repaid.⁷⁶

Section 817 provides that a "public utility may issue . . . evidences of indebtedness payable at periods of more than 12 months after the date thereof" for an enumerated list of purposes, "and no others." The enumerated list of purposes does not include paying operating expenses, such as purchased water bills. Section 818 goes on to state:

No public utility may issue . . . evidences of indebtedness payable at periods of more than 12 months after the date thereof unless, in addition to the other requirements of law it shall first have secured from the commission an order authorizing the issue, stating the amount thereof and the purposes to which the issue or the proceeds thereof are to be applied, and that, in the opinion of the commission, the money, property, or labor to be procured or paid for by the issue is reasonably required for the purposes specified in the order, and that . . . *such purposes are not, in whole or in part, reasonably chargeable to operating expenses or to income.* (Emphasis added)

The Commission never authorized Mesa-Crest to borrow money – i.e., to issue "evidences of indebtedness" – from F. Patrick Flynn. Nor would the Commission have done so, because using borrowed money to pay operating expenses, such as purchased water payments, is not among the "proper purposes" set forth in Section 817,

⁷⁵ *Id.* at 13-14.

⁷⁶ Staff Report at 13.

and Section 818 expressly forbids such actions. Staff therefore alleges that these loans were void under Section 825.⁷⁷

Even if the loans themselves had been proper without Commission authorization, Mesa-Crest was required to obtain Commission approval before using its water revenues as loan security. Section 851 provides in pertinent part:

A public utility . . . shall not . . . encumber the whole or any part of its . . . other property necessary or useful in the performance of its duties to the public . . . without first having either secured an order from the commission authorizing it to do so for qualified transactions valued above five million dollars (\$5,000,000), or for qualified transactions valued at five million dollars (\$5,000,000) or less, filed an advice letter and obtained approval from the Commission authorizing it to do so Every . . . encumbrance . . . made other than in accordance with the advice letter and approval from the commission authorizing it is void.

Staff alleges that, because the Commission did not approve the use of Mesa-Crest's water revenues, which are necessary and useful to Mesa-Crest's utility service, as security for the loans, that encumbrance is void under Section 851.⁷⁸

Staff takes further issue with Respondents' conduct after making the loan. On August 29, 2013, Mesa-Crest filed Advice Letter (AL) 64 asking the Commission to retroactively approve the February 2010 loans from F. Patrick Flynn to Mesa-Crest. DWA rejected AL 64, and directed F. Patrick Flynn to return all principal and interest paid by Mesa-Crest on the unauthorized loans. Staff alleges that F. Patrick Flynn did not do so, and Mesa-Crest continued to make principal and interest payments to F. Patrick Flynn after being directed not to do so.⁷⁹ Staff's allegations, if proven, demonstrate that

⁷⁷ "All . . . evidence of indebtedness, of a public utility, issued without an order of the commission authorizing the issue thereof then in effect or not conforming in its provisions which it is required by the order of authorization to contain, is void." *See* Staff Report at 16-17.

⁷⁸ Staff Report at 16.

⁷⁹ Staff Report at 17.

Respondents are indifferent to the rules and orders of the Commission, in violation of Sections 827, 855, and 2110.⁸⁰

F. The Flynn's failure to undertake capital improvement work threatens the health and safety of Mesa-Crest's ratepayers

The majority of Mesa-Crest's system is aged, and Mesa-Crest has acknowledged that its water system is in need of major maintenance or replacement. For example, Mesa-Crest's reservoirs are coated with an epoxy resin product that Mesa-Crest applied in 1981.⁸¹ That epoxy has now outlived its expected lifespan by about thirteen years, and Mesa-Crest's own visual inspections of the reservoirs demonstrate that they need to be recoated.⁸² Mesa-Crest pumps water from its reservoirs uphill through a series of four booster stations, containing a total of four booster pumps.⁸³ The majority of these pumps have outlived their expected lifespans and, even were they not at risk of failure, their capacity is insufficient to meet customer demand.⁸⁴ Between 2004 and the present, Mesa-Crest has suffered sixteen unplanned service interruptions.⁸⁵ Of these sixteen, eleven were the result of breaks in Mesa-Crest's main pipeline.⁸⁶

In sum, in its 2005 GRC, Mesa-Crest told the Commission that it needed to make approximately \$830,000 in upgrades and maintenance over test years 2004, 2005, and 2006 to ensure the safety and reliability of its system.⁸⁷ The Commission approved the bulk of Mesa-Crest's capital improvement plan, albeit with caps on yearly spending to

⁸⁰ "Every public utility and every officers, agent, or employee of any public utility . . . who fails to comply with any part of any order, decision, rule, direction, demand, or requirement of the commission . . . is guilty of a misdemeanor . . ."

⁸¹ Staff Report at 21.

⁸² *Id.*

⁸³ *Id.* at 22.

⁸⁴ *Id.*

⁸⁵ *Id.* at 28, Table 10.

⁸⁶ *Id.* at 27; *see also Id.* at 28, Table 10

⁸⁷ *See Res. W-4531* at 3-4.

minimize rate shock.⁸⁸ Nevertheless, according to Staff, between 2005 and 2007, Mesa-Crest only completed \$126,142 worth of upgrades; indeed, between 2005 and 2013 Mesa-Crest spent only \$202,262.⁸⁹ Staff alleges that, as a result of the Flynn's alleged financial misconduct described above, Mesa-Crest lacked the liquidity to fund this maintenance work, which the Flynn's had told the Commission was so urgently needed.⁹⁰

Finally, as noted above, in late 2009 Mesa-Crest almost defaulted on its purchased water bills. In other words, Staff asserts that Mesa-Crest ratepayers faced a real possibility of being left without any water service at all.

The California legislature has stated emphatically that "[a]ccess to an adequate supply of healthful water is a basic necessity of human life, and shall be made available to all residents of California at an affordable cost."⁹¹ The primary statutory mechanism by which the Commission ensures that the ratepayers of water utilities within its jurisdiction are provided with an adequate supply of healthful water is Section 451, which provides in pertinent part:

Every public utility shall furnish and maintain such adequate, efficient, just, and reasonable service, instrumentalities, equipment, and facilities . . . as are necessary to promote the safety, health, comfort, and convenience of its patrons, employees, and the public.

Staff alleges that Respondents were basically unconcerned with the safety, health, comfort, and convenience of Mesa-Crest's ratepayers, and that their conduct constitutes unjust and unreasonable acts under Section 451.⁹² Staff is unconvinced that, going forward, the Flynn's will operate Mesa-Crest in the best interests of its ratepayers,

⁸⁸ See Res. W-4531 at 8-9.

⁸⁹ Staff Report at 25.

⁹⁰ *Id.*

⁹¹ Section 739.8(a).

⁹² Staff Report at 28-29.

and therefore asserts that the Commission should petition the Los Angeles County Superior Court to appoint a receiver pursuant to Section 855.²³

III. REMEDIES

A. Fines and Penalties

If proven at an evidentiary hearing, the information discussed above would warrant financial penalties. For proven offenses that occurred before January 1, 2012, under Sections 2107 and 2108, staff may recommend, and the Commission may consider, penalties against Mesa-Crest in the amount of \$500 to \$20,000 per offense, per day. For proven offenses that occurred after January 1, 2012, staff may recommend, and the Commission may consider, penalties in the amount of \$500 to \$50,000 per offense, per day. Under Section 826, the loans from F. Patrick Flynn to Mesa-Crest may warrant additional penalties against Mesa-Crest of \$1,000 to \$40,000 (\$500 to \$20,000 for each loan).

B. Equitable Remedies

In addition to the fines and penalties discussed above, the Commission will consider whether to invoke the equitable remedy available to it under Section 855. That section provides in part:

Whenever the commission determines, after notice and hearing, that any water or sewer system corporation is unable or unwilling to adequately serve its ratepayers or has been actually or effectively abandoned by its owners, or is unresponsive to the rules or orders of the commission, the commission may petition the superior court for the county within which the corporation has its principal office or place of business for the appointment of a receiver to assume possession of its property and to operate its system upon such terms and conditions as the court shall prescribe.

²³ Staff Report at 29.

The alleged conduct of F. Patrick Flynn and Timothy Flynn, which took place over many years, may have significantly harmed Mesa-Crest's financial position,²⁴ and may ultimately have left Mesa-Crest in jeopardy of not being able to provide water to its ratepayers. Respondents have also ignored DWA directives regarding the 2010 loans from F. Patrick Flynn to Mesa-Crest. SED Staff have presented a *prima facie* showing that the Flynn's conduct, taken as a whole, tends to demonstrate that they are unfit to operate Mesa-Crest going forward.

Additionally, under Sections 825 and 851, the Commission may deem null and void the loans F. Patrick Flynn made to Mesa-Crest, as well as the encumbrance of Mesa-Crest's water revenues as security for those loans. The Commission may order Mesa-Crest to stop making payments of principal and interest to F. Patrick Flynn on those loans, and may order Mesa-Crest to take all necessary steps to secure the return of any principal and interest payments already made to F. Patrick Flynn.

Therefore, **IT IS ORDERED** that:

1. Under Rule 5.1 of the Commission's Rules of Practice and Procedure, an Investigation on the Commission's own motion is instituted into the operations and practices of the following Respondents: Mesa-Crest Water Company, a water corporation under the Commission's jurisdiction; F. Patrick Flynn, Mesa-Crest's owner; and Timothy Flynn, Mesa-Crest's President. Respondents shall be subject to Commission orders in this matter.
2. SED is a party to this proceeding.
3. The preliminary scope of issues for this Investigation is as stated in the body of this order.
4. Respondents are directed to show cause why the Commission should not petition the Los Angeles County Superior Court to appoint a receiver to assume possession and operation of Mesa-Crest and its water system under Section 855 of the

²⁴ See D.13-07-036 at 16-18 (applying Section 855 where, among other things, water utility's owners had taken actions that jeopardized utility's financial position, including encumbering utility property in violation of Section 851).

California Public Utilities Code, based on the above-stated information and described violations.

5. Respondents are further directed to show cause why an order imposing fines, penalties, or other remedies should not be issued for their violations of Commission rules, regulations, or orders, as stated herein.

6. Within 30 days after the date of this Order, Respondents must provide the Chief ALJ a written statement indicating whether the Respondents will appear at the hearing and present evidence in response to the issues stated herein. If Respondents fail to file the written statement within the time specified above, Respondents will be deemed to have waived their right to a hearing. In that event, the assigned ALJ (or the Chief ALJ if no ALJ has yet been assigned) will schedule no hearing. Instead, the allegations in this OII will be deemed admitted and constitute this proceeding's record of evidence. A proposed order based on such record of evidence will be prepared to include findings of fact and conclusions of law, as well as any fines and penalties to be imposed on Respondents, and directing the General Counsel of the Commission to apply to the Los Angeles County Superior Court for judicial appointment of a receiver to assume possession and operation of Mesa-Crest and its water system.

7. Respondents must also submit in writing to Ke Hao Ouyang, Safety and Enforcement Division, within 30 days after the date of this Order, the following:

A full and complete verification of any and all financial data stated in its Annual Reports from 1997 to the present;

Information sufficient to allow the Safety and Enforcement Division to verify the amounts "loaned" from Mesa-Crest to F. Patrick Flynn and Timothy Flynn, and any payment made thereon, from 1997 to the present;

Information sufficient to allow the Safety and Enforcement Division to verify the amounts loaned from F. Patrick Flynn to Mesa-Crest, and any payment on principal or interest made thereon, from 2009 to the present; and

State and federal tax returns for Mesa-Crest, F. Patrick Flynn, and Timothy Flynn, from 1997 to the present.

8. Respondents must obtain the Commission's prior written approval before executing any agreement for the sale, transfer, or encumbrance of any ownership interests in Mesa-Crest or its water system.

9. This Order constitutes the Notice of Opportunity for Hearing under Section 855.

10. These ordering paragraphs suffice for the "preliminary scoping memo" required by Rule 6(c) of the Commission's Rules of Practice and Procedure.

11. This proceeding is categorized as an adjudicatory proceeding and is expected to require an evidentiary hearing. Pursuant to Rule 8.2(b) of the Commission's Rules and Practice and Procedure, *ex parte* communications are prohibited. The determination as to the category is appealable under Rule 7.6.

12. To facilitate the completion of this Investigation, and consistent with the provisions of Section 314, SED shall continue discovery and continue to investigate the operations of Respondents. SED may, if it elects to do so, present additional evidence either by testimony or through documentation, bearing on the conduct of Respondents. The additional evidence may show, for example, whether Respondents continued to engage in improper conduct after the issuance of this Order, which may affect the type and level of fines or sanctions imposed in this proceeding. Any additional information that Staff wishes to advance as evidence in this proceeding must be provided to Respondents in advance of any hearings in accordance with the schedule established by the assigned ALJ or Commissioner at a Prehearing Conference.

13. Staff shall be subject only to that discovery relating to the specific violations alleged in this Order, described in the Staff Report, or added to the scope of this proceeding by subsequent motion. Staff need only respond to discovery requests after completion of its direct testimony, including supplemental direct testimony, to allow Staff to complete its investigation.

14. Any applications or advice letters submitted by Respondents after the date of this Order and while this proceeding is open may be suspended pending a resolution in this proceeding.

15. Respondents, and any other person acting on behalf of Respondents, are ordered to cooperate with SED Staff in accordance with Section 314, and provide access to Mesa-Crest's accounts, books, records, and other papers (in whatever form they may be), which the Respondents must preserve until further orders by the Commission.

16. The Staff Report and supporting documents prepared or attached by SED will be entered into the record for this proceeding.

17. A hearing will be held as soon as is practical after an assigned Administrative Law Judge (ALJ) convenes a Prehearing Conference under Rule 7.2 and calendars a date, time, and location for a hearing in a subsequent ruling or order. The ALJ will determine the findings of fact and conclusions of law regarding the issues stated herein.

18. While this proceeding is pending, Respondents must comply with, and cease violating, any and all Commission orders, rules, or regulations, or any pertinent provisions of California law.

19. Staff may propose amending this Order to include additional Respondents or charges. Any such proposal must be presented to the Commission in the form of a motion to amend the Order.

20. The Executive Director shall cause a copy of this Order to be sent via certified mail, return receipt requested, on the Respondents at the following addresses:

Mesa-Crest Water Company
Attn: Agent for Service of Process
4532 Rinetti Lane
La Cañada Flintridge, CA 91011

Mark Fogelman, Esq.
Counsel to Mesa-Crest Water Company
Friedman & Springwater LLP
33 New Montgomery Street, Suite 290
San Francisco, CA 94105

F. Patrick Flynn, Owner
Mesa-Crest Water Company
4532 Rinetti Lane
La Cañada Flintridge, CA 91011

Timothy Flynn, President
Mesa-Crest Water Company
4532 Rinetti Lane
La Cañada Flintridge, CA 91011

This Order is effective as of the date shown below.

Dated June 25, 2015, at San Francisco, California.

MICHAEL PICKER
President
MICHEL PETER FLORIO
CATHERINE J.K. SANDOVAL
CARLA J. PETERMAN
LIANE M. RANDOLPH
Commissioners