

Decision 00-05-047 May 18, 2000

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

FORMAL FILE COPY

Joint Application of California Water Service Company (U-60-W), Dominguez Water Company (U-330-W), Kern River Valley Water Company (U-295-W), and Antelope Valley Water Company (U-281-U) for Approval of a Plan of Merger of California Water Service Company, Dominguez Water Company, Kern River Valley Water Company, and Antelope Valley Water Company.

Application 99-02-004
(Filed February 5, 1999)

(See Appendix A for a List of Appearances.)

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OPINION AUTHORIZING MERGER, WITH CONDITIONS

1. Summary

We conclude that the proposed merger, as revised by applicants' enhanced guarantee, and subject to other conditions in the ordering paragraphs, is not adverse to the public interest and we authorize the transfer of control.

2. Procedural Background

In our interim opinion in this proceeding, Decision (D.) 99-09-030, we held that recently enacted Section 2718 et seq. of the Public Utilities Code, the "Public Water System Investment and Consolidation Act of 1997" (Stats. 1997, ch. 675), is applicable to the proposed water utility merger at issue and controls rate base valuation if we approve the merger.¹ Our interim opinion also relates various procedural matters which we repeat here only as necessary to provide context.

Applicants, California Water Service Company (CWS), Dominguez Water Company (Dominguez), Kern River Valley Water Company (Kern River) and Antelope Valley Water Company (Antelope) (or collectively, applicants) jointly filed this application on February 5, 1999 and filed an amendment on April 22. Applicants filed the amendment following negotiation of certain changes in the proposed stock conversion after the holding company that owns Dominguez, Kern River and Antelope received an unsolicited bid from American States Water Company (American States) in March.

¹ Unless otherwise indicated, all subsequent citations to sections refer to the Public Utilities Code.

In accordance with the schedule set following the April 27 prehearing conference, settlement negotiations were held on September 13. These proved unfruitful, and on October 12 the Ratepayer Representation Branch (RRB) of the Commission's Water Division and the Office of Ratepayer Advocates (ORA), issued a joint report opposing the merger.

Applicants and ORA/RRB presented their respective positions at the three public participation hearings (PPHs) in the applicants' service territories: Lake Isabella on October 25; Quartz Hill on October 26; and the City of Carson (Carson) on October 27.

At the first day of evidentiary hearing, November 1, applicants made an unopposed motion for a continuance until November 15 so that the parties might engage in further discussion. Prior to the November 1 recess, three additional parties entered appearances for limited purposes: Ed Yates stated he expected to cross-examine applicants' witnesses on behalf of the California League of Food Processors and Deena Chacanaca, on behalf of the Fremont Valley Annexation Committee, and Jack L. Chacanaca, on behalf of the Leona Valley Water Rate Committee, stated they would be monitoring the hearings. (Antelope serves the Fremont and Leona Valleys.)

When evidentiary hearing resumed on November 15, Carson appeared and made an opening statement via its representative (though Carson did not participate in the hearings thereafter). ORA and RRB announced that they were no longer aligned, as RRB had dropped its opposition to the merger. RRB established separate representation and ORA stated it expected to cross-examine RRB as well as applicants.

On November 18, the fourth day of hearings that week, the Administrative Law Judge (ALJ), after consultation with the assigned commissioner's office, directed applicants to prepare a written showing on the merger's alleged

financial benefits, set a date for other parties to offer written responses, and continued hearings to December 7.

The following parties filed opening briefs on December 23, 1999: applicants, ORA, RRB, Carson, Fremont Valley Annexation Committee, and the Leona Valley Water Rate Committee. This proceeding initially was submitted on January 5, 2000 upon the filing of reply briefs by applicants, ORA and RRB. Thereafter, on March 21, 2000, the Commission heard oral argument and then resubmitted the proceeding.

3. The Proposed Merger

3.1 The Companies Involved

We repeat, in a somewhat abbreviated form, background information contained in D.99-09-030. The signatories to the Agreement and Plan of Reorganization (merger agreement) are CWS, its holding company California Water Service Group (CWSG) and Dominguez Services Corporation (DSC), the holding company for Dominguez, Kern River, and Antelope. The merger agreement is Exhibit F to the application. The portion of the transaction subject to our jurisdiction is CWS' acquisition of and merger with Dominguez, Kern River, and Antelope.

CWS, a Class A water utility, is the largest investor-owned water utility in California, with some 373,500 accounts in 20 operating districts that serve 58 communities. Taken together, DSC's three regulated subsidiaries serve less than 40,000 customers.

Dominguez is the fourth smallest of the 12 Class A water companies in California. It provides water to over 34,000 customers in two operating divisions. The South Bay division, located in southern Los Angeles County, serves about 32,400 of these customers, primarily in the cities of Carson,

Compton and Torrence. The Redwood Valley division serves the remainder of these customers in a number of mostly rural northern California communities, including two areas along the Russian River in Sonoma County, an outlying part of the city of Santa Rosa, part of Lake County, and a part of coastal Marin County.

Kern River and Antelope, the other two regulated DSC subsidiaries, each operate a number of small water systems serving, respectively, about 4,100 customers in the Isabella Lake area of southern Kern County and about 1,250 customers in northern Los Angeles County.

3.2 Overview of the Proposed Transaction

As noted in D.99-09-030, the merger agreement provides for the merger of DSC's non-regulated and regulated subsidiaries into CWSG's corresponding non-regulated and regulated subsidiaries. The proposal for DSC's regulated subsidiaries to merge into CWS, with CWS surviving, requires our approval under Section 851 et seq.²

In D.99-09-039 we described the financial structure of the proposed merger as:

"a tax-free stock for stock transaction. The exchange ratio originally proposed was 1.18 CWSG common shares for each DSC common share. Applicants' estimated the combined value of the merger at \$58 million and estimated the value to DSC shareholders at approximately \$31.79 per share, based on the relative closing prices of the stocks the day before the merger agreement was signed. Following the unsolicited bid from American States, the signatories to the merger agreement

² On the non-regulated side, DSC Investments would be absorbed by CWS Utility Services.

negotiated an increase in the exchange ratio in order to provide DSC stockholders approximately \$33.75 per share. The amendment to the merger agreement (Exhibit A to the amendment of the application) establishes a 'collar' designed to deliver that value. The collar is defined by minimum and maximum exchange ratios depending upon the market price of the benchmark stock (in this case, CWSG) during a defined period of days prior to the effective date of the merger. Here the parameters are 1.25 to 1.49 shares of CWSG common stock for each share of DSC common stock." (D.99-09-030, p. 4.)

Our approval would authorize transfer of the Dominguez, Kern River and Antelope Certificates of Public Convenience and Necessity to CWS, whereupon CWS would assume all concomitant public utility obligations (including Safe Drinking Water Bond Act loans with outstanding debt of about \$3 million) and all direct control of the respective water systems.

3.3 Overview of Ratemaking Implications

With one exception, as initially filed the application proposes that CWS operate and manage each of the DSC subsidiaries as a separate rate district with separate tariffs. The exception, which provoked much public comment at the Carson PPH, concerns the application's proposal to combine Dominguez' existing South Bay division and CWS' existing Hermosa-Redondo and Palos Verdes districts into a single district post-merger. Subsequently applicants have revised that plan -- their proposal is to combine the three districts for administrative and operational purposes but to continue to set rates for customers based on historical levels, i.e., to have three separate tariff schedules in the combined district. Under such a tariff structure, customers in the existing South Bay division will continue to enjoy lower rates than their neighbors in CWS' districts. Three major factors contribute to these low rates historically: 50% of the South Bay division's water is produced by Dominguez' wells

(averaging \$210 per acre foot -- compared to \$526 per acre foot for water purchased from the Metropolitan Water District); commercial customers, who are less costly to serve, account for approximately 50% of the demand in the South Bay division; and Dominguez has little water loss because of an extensive and very accurate metering and monitoring program.

The most controversial ratemaking consequence of the proposed merger is the \$32.6 million rate base "write up" that would occur under Section 2720(a) of the new Act.³

Table 1, below, is drawn from Exhibit 107 and reflects the financial impact on the purchase price of the revised stock conversion ratio negotiated following the hostile bid from American States. The purchase price of each of the regulated Dominguez subsidiaries is less than the undisputed value of reproduction cost new less depreciation (RCNLD).

³ Section 2720 provides:

(a) *The commission shall use the standard of fair market value when establishing the rate base value for the distribution system of a public water system acquired by a water corporation. This standard shall be used for ratesetting.*

(1) For purposes of this section, "public water system" shall have the same meaning as set forth in Section 116275 of the Health and Safety Code.

(2) For purposes of this section, "fair market value" shall have the same meaning as set forth in Section 1263.320 of the Code of Civil Procedure.

(b) If the fair market value exceeds reproduction cost, as determined in accordance with Section 820 of the Evidence Code, the commission may include the difference in the rate base for ratesetting purposes if it finds that the additional amounts are fair and reasonable. In determining whether the additional amounts are fair and reasonable the commission shall consider whether the acquisition of the public water system will improve water system reliability, whether the ability of the water system to comply

Footnote continued on next page

TABLE 1
Summary of Asset Valuation Analysis

	<u>Book Value</u>	<u>RCNLD Value</u>	<u>Purchase Price</u>
SOUTH BAY-DOMINGUEZ	34,609,146	124,470,323	53,722,143
REDWOOD VALLEY-DOMINGUEZ*	901,214	1,107,732	901,214
KERN RIVER VALLEY*	4,211,209	7,185,765	4,843,881
ANTELOPE VALLEY	2,346,079	3,686,656	2,631,213
TOTAL	\$42,067,648	\$136,450,476	\$62,098,451

*SDWA assets are excluded.

After applying the principles of statutory construction to Section 2720 and the other provisions of the new Act, we concluded in D.99-09-030 that: (1) the Act is applicable to this merger proposal and (2) pursuant to Section 2720(a) of the Act, the Commission lacks discretion to condition approval of the merger upon valuation, below fair market value, of the rate base of the distribution systems of the acquired public water systems.

(See D.99-09-030, Ordering Paragraphs 1 and 2.)

with health and safety regulations is improved, whether the water corporation by acquiring the public water system can achieve efficiencies and economies of scale that would not otherwise be available, and whether the effect on existing customers of the water corporation and the acquired public water system is fair and reasonable.

(c) The provisions of subdivisions (a) and (b) shall also be applicable to the acquisition of a sewer system by any sewer system corporation or water corporation.

(d) Consistent with the provisions of this section, the commission shall retain all powers and responsibilities granted pursuant to Sections 851 and 852. (Pub. Util. Code § 2720, emphasis added.)

Accordingly, if we approve this merger, we must authorize the indicated rate base additions for the distribution systems of Dominguez, Kern River and Antelope. But in D.99-09-030 we also concluded that Section 2720(a) does not conflict with the Commission's obligation to assess whether a proposed water utility merger is in the public interest. Therefore, were we to find that this rate base "write up" would lead to an unreasonable increase in rates, nothing in the Act would diminish our authority to deny the merger. (See *Id.*, Conclusions of Law 4 and 5.)

In 2001, when applicants propose to file the first post-merger general rate case (GRC), the revenue requirement impact of these rate base additions, together with allowances for associated rate of return, expenses and depreciation, equals approximately \$4.484 million. (See Ex. 108.) This sum taken alone (without considering any offset for merger savings), translates roughly into a 15% rate increase for customers of DSC's three regulated subsidiaries. Annual depreciation (about \$705,000/year) will continue to reduce this revenue requirement over time, though the rate base "step-up" associated with land, which is not depreciable, will be a permanent component of future rates.

We review, below, applicants' initial position that merger benefits and synergies will offset merger costs and their final proposal to guarantee that no rates will increase as a result of the merger.

4. Legal Standard for Approval of Water Utility Mergers

This is the first contested merger application we have reviewed since enactment of Section 2718 et seq., but the new Act does not alter the legal standard we must apply in determining whether to approve the merger. As we discuss at length in D.99-09-030, the rate base valuation mandates of Section 2720(a) apply if we determine we should approve the merger.

What is the legal standard we must use to determine whether this merger is in the public interest? At hearing and in their briefs, applicants and ORA dispute what showing must be made, and by whom.

We begin our analysis by summarizing the statutes with most direct bearing on our review: Section 851, in relevant part, requires Commission approval before a public utility may sell the whole of its system; Section 852, requires a public utility to secure Commission authority before acquiring any capital stock of any other public utility; and Section 854(a) requires Commission authorization before any person or corporation may acquire or merge with any public utility.

ORA contends we should look to Section 854, paragraphs (b) through (f), for additional guidance. By adding these paragraphs in 1989, the Legislature raised the bar to approval of electric, gas and telephone utility mergers where any of the parties to the transaction have gross annual California revenues in excess of \$500 million.⁴ In a merger application where these provisions govern, the merger proponents must make detailed showings of the merger's short-term and long-term economic benefits, its impact upon the financial condition of the surviving utility and the quality of service, as well as its impact upon management, employees, shareholders, and the local and state economies, among other things. (See Pub. Util. Code Section 854(b) through (f).)

A plain reading of Section 854(b) through (f) requires the conclusion these provisions do not govern this proceeding since each of the applicants is a water utility and their combined annual revenues are less than half that specified in the

⁴ (Stats. 1989, ch. 484.) Two additional paragraphs, (g) and (h), were added in 1995 (Stats. 1995, ch. 622) but they are inapplicable here.

statute. CWS' operating revenues for the 12 months ending September 30, 1998 were approximately \$185 million; the 1998 revenues of DSC's three regulated subsidiaries, as a group, were approximately \$25 million. (Application at Ex. D and Ex. E; Ex. 102.)

While ORA admits that the provisions of Section 854(b) through (f) are not expressly applicable to water mergers, it nonetheless argues the "major criteria are valid requirements of all mergers of regulated entities, including water companies." (ORA brief, p. 12.) ORA cites no authority for the interpretation it urges. We think ORA has overstated the legal import of Section 854(b) through (f) and find no basis for holding applicants to the extensive evidentiary showing those provisions require.

In their opening brief, applicants argue that decisions of the courts, decisions of our predecessor the Railroad Commission, and our own decisions have consistently followed the legal standard that a merger or other transfer must not be adverse or injurious to the public interest.

Thus, with respect to the statutory precursor of Sections 851 and 854, the applicants point to the California Supreme Court's explanation that "[a]ll that the commission is concerned with ... is whether a proposed transfer will be injurious to the rights of the public. If not, the owner may be authorized to make the transfer." (*Hanlon v. Eshleman*, (1915) 169 Cal. 200, 203.)

Several decades later, applicants note, the Court similarly stated that the Commission "is merely authorized to prevent an owner of a public utility from disposing of it where such disposition would not safeguard the interests of the public." (*Sale v. Railroad Commission*, (1940) 15 Cal. 2d 612, 620.)

Recently, citing an early Railroad Commission water utility decision, we explained the purpose of Sections 851 and 854 as being "to enable the Commission, before any transfer of public utility property is consummated, to

review the situation and to take such action, as a condition of the transfer, as the public interest may require." (*Application of Global Crossing Ltd.*, D.99-06-099, p. 4 citing *San Jose Water Company*, (1916) 10 CRC 56, 63.) In that decision we granted the authority requested, concluding "[t]he proposed transfer of control is not adverse to the public interest." (*Global Crossing Ltd.*, D.99-06-099, Conclusion of Law 1.)

Applicants' opening brief cites numerous other water utility decisions in which we have applied this standard. ORA's briefs do not directly challenge applicants' reliance on these authorities. Rather, ORA argues – accurately, but in light of Section 2718 et seq., unpersuasively – that because none of the applicant water utilities is a small, troubled company, the showing required by Section 854(b) though (f) should be made here. ORA urges, as precedent, our decision (D.91-05-028) in the merger application of Southern California Edison Company and San Diego Gas & Electric Company, where we applied Section 854(b) though (f) to the proposed merger of two large electric utilities.

The parties' arguments on the burden of proof are not always consistent and it is unnecessary to recount them in detail. In essence, applicants suggest that Section 2718 et seq. creates a legal presumption that a water utility merger is in the public interest which then shifts the burden of proof to opponents of the merger to establish the merger is not in the public interest. Applicants rely on Section 2719, which codifies the Legislature's findings that (a) many public water systems require replacement and upgrading to meet state and federal safe drinking water laws and regulations governing fire flow standards for public protection; (b) these infrastructure improvements require sizeable capital investment; (c) public water system operation is subject to scale economies; and (d) ratepayers will benefit if water corporations have an incentive to achieve scale economies.

ORA strongly opposes applicants' position and cites Evid. Code Section 500, which codifies the common law rule on the burden of proof, as well as case law on this issue. We conclude applicants' argument is weak, for many of the reasons ORA contends, and because it ignores the express provision in Section 2720(d), that "the Commission shall retain all powers and responsibilities" under Sections 851 and 852. Under those provisions, as we discuss above, the Commission must be satisfied that a water utility merger is not adverse or injurious to the public interest. The burden is on the applicant to make the necessary showing.

At times both parties' arguments appear to confuse the burden of proof with the burden of producing evidence, but we will not belabor this issue. We review the record in this proceeding below.

5. Discussion

Having identified the parties, described the nature of the merger proposal in general terms, and clarified the legal standard we must apply, we embark on a more detailed review of the evidence.

5.1 The Application and Amendment

Initially, applicants asserted that "the cost savings from operations efficiencies and synergies – as well as the savings from a lower corporate equity structure" would not result in a significant impact on the revenue requirements of DSC's regulated subsidiaries. (Application at p. 14.) Applicants' position reflected their view of the first stock conversion ratio, which translated to a \$29.92 million rate base write up. They estimated operating expense savings in excess of \$3 million, attributable to "merger synergies" of about \$2.6 million and purchased water cost savings of \$670,000. (Application at Exhibit H.) Applicants

did not quantify the financial benefits associated with reducing the equity component of Dominguez' capital structure.

In the April amendment to the application filed after the failed American States bid, applicants reported the revised stock conversion ratio and revised their position, as follows:

"If Applicants are able to achieve merger synergies *in excess* of the projected \$2.6 million by the time of the test year for their first general rate case as a combined company, then Applicants propose that they be allowed a *corresponding* increase in rate base to reflect the increased purchase price due to the new exchange ratio ... Applicants propose that such a rate base increase be allowed *only* to the extent that its revenue requirement effect does not exceed the *reduction* in revenue requirement attributable to the achievement of merger synergies beyond the \$2.6 million already projected by Applicants." (Amendment of Joint Application, p. 4, emphasis in original.)

This was applicants' position at the time ORA/RRB released their joint report on October 12. Chapter 11 of the report, titled "Deficiencies" states applicants' discovery responses have been nonresponsive (though ORA/RRB never moved to compel discovery) and asserts the claimed merger benefits are "unidentified, unquantified, and unsupported." (Ex. 201.) ORA/RRB, through their respective project managers, William Thompson and Raymond Charvez, recommend the Commission deny the merger application.

At about this time the Commission began to receive a stream of letters from ratepayers in the applicants' service territories. Most of the letters oppose the merger or register skepticism about its value, though many address issues in the pending GRC proceedings for Dominguez, Kern River and Antelope, A.99-05-020 et al. We have also received letters from a few CWS ratepayers.

5.2 The Guarantees

Applicants released their response to the ORA/RRB report on October 25 as scheduled, which also was the day of the first PPH in Lake Isabella. This response consists of the prepared testimony of Francis S. Ferraro, CWS' Vice President, Regulatory Matters (Ex. C-101) and the prepared testimony of John S. Tootle, Dominguez' Vice President, Chief Financial Officer and Secretary (Ex. 102).

Ferraro's prepared testimony is particularly significant for two reasons. It proposes a ratemaking guarantee to ensure customers of DSC's regulated subsidiaries will see no rate increase as a result of the merger and it includes workpapers (Attachments FSF-2 and FSF-3 of Ex. C-101) which update and provide additional support for savings quantifications applicants provided to ORA/RRB previously. The revised savings projection is \$3,732,477, which reflects water production savings of only \$100 thousand but increased operating and administrative cost savings.

Applicants presented this revised position to the approximately 70 people who attended the Lake Isabella PPH, the 40 or so at Quartz Hill, and about 80 at Carson. At Lake Isabella and Quartz Hill, the speakers among those present generally asked questions about the pending GRC, rather than the merger, or raised service issues. At both places, several individuals registered opposition to the merger or signaled skepticism; a very few voiced conditional support. All speakers at Carson, which is Dominguez' headquarters and part of its South Bay division, addressed the merger exclusively, eleven opposing it and three (a utility employee, a representative of the Chamber of Commerce, and an industrial customer), expressing support.

The final revisions to applicants' proposal were fashioned sometime between the October 25 Carson PPH and November 15, when evidentiary hearings resumed following the break for further negotiations among the parties.

These commitments, which the parties came to refer to as the "enhanced guarantee," are:

- The rate guarantee applies to all customers of CWS, Dominguez, Kern River and Antelope.
- The financial benefits of all water rights presently held by Dominguez will continue to accrue to South Bay customers, barring any action beyond the control of CWS.
- Though merged for operational and administrative purposes, Dominguez' South Bay division and CWS' Hermosa-Redondo and Palos Verdes districts will continue to have separate rates. The rates in each of the three former districts will be set to reflect historical differences in their costs of service, such as the source and cost of water supplies.
- CWS will offer continued employment in the Los Angeles area to all of Dominguez' operational (field and customers service) employees. All other Dominguez employees will be offered equivalent, continued employment, but that may mean relocation to the San Jose area, where CWS' headquarters are located.
- CWS will file an application in 2000 to determine "Base Year 2000" revenue requirements for the Palos Verdes and Hermosa-Redondo districts and for CWS' general office. These base case revenue requirements will provide the benchmark for assessing merger-related synergies in the first combined-district GRC filed in mid-year 2001 (with rates effective in 2002) and the second combined-district GRC filed in 2004 (with rates effective in 2005). The benchmark for Dominguez, Kern River and Antelope, as standalone utilities, will be established in their pending GRCs. If necessary to ensure rate neutrality, reductions in the 2002 and 2005 GRC revenue requirements will be imputed. If an imputation is required in the 2005 GRC, CWS' operating expenses

will be adjusted permanently to reflect the reduced revenue requirement.

- In calculating merger-related cost savings for ratemaking purposes post-merger, the utility will be given full credit for the first \$3 million in annual net cost savings but will receive credit for only 90% of any net cost savings above \$3 million.
- CWS will impute a 52% equity ratio in calculating its cost of capital for ratemaking purposes until it is able to issue sufficient debt to return its capital structure to the current 52% ratio.

5.3 The Record for Merger

What does this evidentiary record show? Applicants' late-filed exhibit forecasts the value of the financial (lower cost financing) and other (operational/administrative/water production) savings, based on net plant increases of 7.5% per year over a 30-year period, will be \$5.5 million if net annual synergies start at \$3 million, \$12 million if net annual synergies start at \$4.5 million, and \$15 million, if net annual synergies start of \$5 million. (Ex. 108.) By "net synergies" applicants refer to the net of merger cost savings less the rate base increase, after the removal of all one-time merger-related costs (which are shareholder expenses). Ferraro testified he thought the \$4.5 million middle range most likely.

Thus, in the near term (the period of the 2002 and 2005 GRCs), in the worst case ratepayers of the merged utility will experience no merger-related rate increases. All one-time merger costs will be removed from applicants' expenses and the revenue requirement increase attributable to the rate base write up will be offset by operational and financial savings attributable to the merger. Best case, ratepayers will see small revenue requirement reductions associated with merger-related cost savings above the increase in rate base. While

imputation in the 2002 and 2005 GRCs will guarantee rate neutrality even if the cost savings do not materialize, rate reductions are not guaranteed.

Allowing the merged utility, as an offset, only 90% of any cost savings above \$3 million strengthens the guarantee and increases the likelihood that the merger will yield a quantitative ratepayer benefit – however small – in the near term. Ferraro testified in this vein, pointing out that under the mechanism, not only must the merged utility achieve greater merger cost savings to satisfy the rate guarantee, but it has a clear regulatory incentive to achieve cost savings greater than the revenue requirement associated with the write-up in rate base.

Of course, applicants' guarantee against a merger-related rate increase is only as good as the ratemaking method that enforces it. ORA argues that political and ratemaking vagaries render the guarantee questionable. ORA specifies several problematic ratemaking variables -- the need to segregate both one-time merger expenses and all other merger-induced administrative and operational cost impacts, and the incentive applicants have to show a high "base case" in order to minimize savings. ORA identifies areas which indeed will require scrutiny. However, the ratemaking guarantee – comparison of a base case against two subsequent GRC filings, relies upon standard "cost of service" ratemaking principles and practices. Cost of service ratemaking, and its methods, remain the norm in the water utility industry. In the case of applicants, the Commission has years of historical data on which to judge the reasonableness of any utility expense categories. Still, accurate merger-related costs and savings identification and measurement will be critical. We will impose an additional safeguard as an aid to the review of the base case and the 2002 and 2005 GRC filings. Before the base case filings, and annually thereafter until the 2005 GRC is filed, CWS shall prepare an "information only" report for the Director of the

Water Division, which explains (1) any significant changes in post-merger implementation plans;⁵ (2) additional areas of merger-related costs savings; and (3) any areas where costs will necessarily increase due to the merger.

Ratepayers in the current service territories of Dominguez, Kern River and Antelope may see certain additional, "qualitative" benefits, such as increased in-house resources for fire protection and emergency response. These benefits are somewhat speculative, however; while they indisputably are a product of CWS' greater size, no clear need for them has been established, as DSC's regulated subsidiaries have not been deficient in these areas to date.

While the financial benefits (for ratepayers in the Dominguez, Kern River and Antelope service territories) of the merged utility's lower-equity capital structure and stronger borrowing power will be subsumed in the rate guarantee through 2008 (the last year under the 2005 GRC), they will provide a small, longer-term benefit. Applicants forecast a cumulative benefit of \$30 million in nominal terms, between 2008 and 2028, or \$2.4 million net present value, attributable to the impact of lower financing costs on the growth of net plant.

Dominguez' Tootle testified about an associated "financial" benefit of the merger – avoidance of delisting by NASDAQ, and the resultant adverse financial impact on both shareholders and ratepayers of the DSC regulated subsidiaries. NASDAQ has notified Dominguez, the smallest of the publicly traded Class A water companies in California, that it has too few shareholders to continue to be listed (though delisting has been postponed in light of the merger

⁵ Such changes may not include abandonment of any of the terms of the enhanced guarantee, of course.

application). Tootle also testified that the size, location, and relative operational and financial soundness of Dominguez makes it an attractive merger target; the competing bid from American States would appear to confirm this perspective.

For the approximately 70 permanent employees at DSC's regulated subsidiaries, applicants promise continued employment but not necessarily in the same position. Some employees can anticipate improved financial circumstances -- unlike CWS, the Dominguez, Kern River and Antelope field and operations workforce is not unionized but post-merger the Dominguez workforce will be, with concomitant salary and benefits increases. Applicants state 18 positions in rural areas and all customer service and field positions in the Los Angeles area will remain. However, the consolidation of administrative and executive functions will likely result in the relocation of approximately 20 positions from Carson to San Jose. Permanent employees currently holding these positions will have the option of alternative employment within the merged utility (which may require relocation) or a severance package. Currently, a half dozen or so of those positions are vacant or filled with temporary employees.

RRB removed its opposition to the merger after applicants proposed the enhanced guarantee. Each of RRB's witnesses testified that one or more of the guarantee provisions satisfy the concerns that witness raised in the ORA/RRB report. ORA continues to oppose the merger, but recommends imposition of four conditions if the Commission authorizes the merger. We discuss these below, after reviewing the positions of the three other parties who filed briefs.

The Fremont Valley Annexation Committee's brief comments on various aspects of the record, finds the 90% credit "welcome" but declines to endorse the merger. In response to testimony about Dominguez' lesser clout in

financial markets, this party suggests Dominguez consider other options than merger for increasing its financial footing and analogizes to a homeowner paying off a high interest mortgage early by making extra principal payments. The Leona Valley Water Rate Committee's brief rejects the guarantees and argues "[c]hange in ownership will only bring risks of increased rates."

Though Carson did not otherwise participate in the evidentiary hearings, on November 15 Carson offered a letter from its City Manager and a statement from Dr. Rita Boggs, a representative of its city council-appointed merger review committee.⁶ Dr. Boggs stated the council had voted to oppose the merger, with one member abstaining. In its brief, Carson expresses continuing concerns about the merger and states it can support the merger only if seven conditions are met. These are:

1. concrete benefits to Dominguez ratepayers;
2. a clear, uncomplicated enforcement mechanism;
3. Dominguez ratepayers continue to receive the benefit of Dominguez' water rights;
4. CWS maintains a field and customer service office in the Carson area and continues existing employment levels;
5. separate rates for South Bay and Hermosa-Redondo;
6. a requirement the Commission approve any future sale of the Dominguez water system; and
7. a requirement that all merger conditions apply to any successors of CWS.

ORA also recommends Items 3 and 7. In addition, ORA recommends that the Commission specifically order the merged utility to undertake the capital

⁶ The letter, dated November 4, 1999 was marked for identification as Ex. 300. An identical copy of the letter is part of Ex. 202.

structure rebalancing which is part of the enhanced guarantee and that the Commission modify the guarantee to require a \$7 million benefit to ratepayers. ORA initially proposed this savings target in the supplemental prepared testimony (Ex. 202) it drafted in response to applicants' enhanced guarantee. ORA reasons \$7 million would bring this merger in line with the benefits sharing we ordered in D.98-03-073, which authorized the San Diego Gas & Electric Company/Southern California Gas Company merger.

A number of the Carson and ORA conditions essentially emphasize the importance to those parties of aspects of the enhanced guarantee. We think applicants generally have addressed Carson's Items 2, 3, 4 and 5 and the condition we impose, in the form of the "information only" reports prior to the base case and GRC filings, further addresses Item 2. We put applicants on notice that, pursuant to the enhanced guarantee, we expect the base case to carefully document existing positions and the 2002 and 2005 GRCs to substantiate the continuation of customer service and field positions. With respect to the proposal for three separate tariffs in the post-merger combined district, we note that such a result would not be unique. Different geographic areas in CWS' Salinas district have had different tariffs since the late 1980s. We address ORA's capital structure concerns, and all other provisions of the enhanced guarantee, in the ordering paragraphs.

With respect to Carson's Item 1, while Carson does not further detail what it considers "concrete" ratepayer benefits, we suspect Carson seeks something more than the "neutrality plus" which has been established on this record. However, Carson recognizes approval turns on our finding that the merger is not adverse to the public interest. The savings which ORA seeks, \$7 million, are highly speculative; there is no evidence in the record that this merger will produce economic savings on that order. However, if there are merger-related

cost savings greater than the revenue requirement associated with the rate base increase, the offset measurement plan (90% credit above \$3 million) improves the likelihood that they will be realized. We discussed in D.99-09-030 our inability, unilaterally, to condition a merger to alter or avoid the rate base valuation the Legislature has imposed on water utility mergers pursuant to Section 2718 et seq.

Carson's Items 6 and 7 essentially ask us to impose, as a condition of the merger, requirements that statute already mandates. There is no need for us to order what the law requires, namely that any future sale of the Dominguez distribution system requires our approval and that any successor of CWS is bound by our decision in this proceeding.

Recognizing the value of Dominguez' adjudicated water rights, we will impose a further condition. CWS shall provide notice to the director of the Commission's Water Division before converting the "used and useful" status of any portion of those water rights in future. While a change in categorization may not be contemplated by applicants, and may never come to pass, the dynamics of water marketing in California are evolving. Sale of utility property that is not used and useful does not require our approval and the proceeds of such sales accrue to shareholders. We wish to avoid discovering after the fact that any portion of those water rights has been sold for the benefit of shareholders.

We have reviewed the record closely and cannot determine whether the merger will generate the "substantial economic and non-economic benefits" for ratepayers which applicants' testimony and briefs argue is the likely outcome. (See for example, Ex. C-101, Applicants' opening brief, p. 2.) We can determine, however, that ratepayers of the existing water utilities will not be harmed by this merger, may benefit in small qualitative and quantitative ways in the near-term

and longer-term, and that on balance, there appear to be no other "adverse" or "injurious" effects.

5.4 Record Development Problems

The record established at the conclusion of evidentiary hearings on December 7, 1999 provides a much more detailed quantitative and qualitative assessment of the merger proposal than applicants included with their February 1999 application. Applicants argue they provided more detailed savings assessments when the work of the CWS/Dominguez Integration Team in the fall of 1999 yielded that detail. For example, an attachment to Ferraro's prepared rebuttal testimony maps the South Bay division personnel changes and associated wage/benefits cost savings for the merged utility at a level of detail not provided before. (C-101, Attachment FSF-2.) Applicants' witnesses describe the difficulties, particularly for the smaller Dominguez, of conducting business as usual while the employment and operational uncertainties of a merger subject to regulatory review is pending. The guarantees were fashioned, applicants state, to respond to the ORA/RRB report and to address public concerns voiced at the PPHs, including the concerns of Carson.

We recognize that many sensitivities surround planning for a utility consolidation but disagree that the "evolving record was unavoidable," as applicants claim. (Applicant's reply brief, p. 12.) We think ORA and RRB justifiably criticize applicants' showing for creating a moving target for them to analyze. In response to that problem here, RRB/ORA requested a clearer statement of applicants' guarantees and the ALJ directed applicants to provide it. (Ex. 105.) But another evidentiary problem, applicants' anecdotal reliance upon financial benefits but failure to quantify them, required a continuance in the

hearing schedule while the quantification was developed and then reviewed by other parties. (Ex. 108.)

The end result of applicants "evolving" showing has been a delay of several months in a proceeding, where from the beginning, applicants urged our speedy review. Our recently adopted rules for processing future Class A and B water utility mergers should avoid many of the problems we experienced here, since the rules require a detailed notice of intent (NOI) before a merger application is filed.⁷

6. Other Matters

6.1 Environmental Review

The Commission's staff has determined that the transfer of control proposed by applicants constitutes "a project" under the California Environmental Quality Act (CEQA), Pub. Resources Code § 21000 et seq. However, since it can be seen with certainty that no significant effect on the environment could result from our granting the authorization, the proposed project itself qualifies for an exemption from CEQA pursuant to

⁷ In October 1997 we opened Rulemaking (R.) 97-10-048 to examine the need for changes in regulations surrounding the acquisition or merger of public utility water systems. We expanded the rulemaking to address implementation of Section 2718 et seq. In D.99-10-064, we adopted a settlement agreement which contains rules for processing and review of utility merger applications. Among other things, the settlement agreement requires a Notice of Intention (NOI) prior to the filing of a request for authorization to acquire a Class A or B water utility. The NOI is to include "a showing as to how the merger or acquisition would affect reliability, compliance with regulations relating to health and safety, economies of scale, and customers." CWS, Dominguez and RRB are among the signatories to the settlement agreement, which is dated February 2, 1999, a month before A.99-02-004 was filed.

Section 15061(b)(3) of the CEQA guidelines. Therefore, no further environmental review by the Commission is required.

7. Health and Safety Code Compliance

Health and Saf. Code § 116525 requires the owner of a public water system to obtain a permit to operate the system from the DHS and the ensuing sections establish the application and review processes. As recently amended, Health and Saf. Code § 116540(a) provides:

"No public water system that was not in existence on January 1, 1998, shall be granted a permit unless the system demonstrates to the department that the water supplier possesses adequate financial, managerial, and technical capability to assure the delivery of pure, wholesome, and potable drinking water. This section shall also apply to any change of ownership of a public water system that occurs after January 1, 1998." (Emphasis added.)

Accordingly, upon the change of ownership, CWS must comply with Health and Saf. Code § 116525 et seq.

8. Conclusion

Upon review of the record, we conclude that the proposed merger, as revised by applicants' enhanced guarantee, and subject to other conditions in the ordering paragraphs, is not adverse to the public interest. Accordingly, we authorize the transfer of control.

Comments on Proposed Decision

The proposed decision of the ALJ in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(g)(1) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed on March 6, 2000 by applicants, ORA and RRB, and reply comments were filed on March 13, 2000 by applicants and RRB.

ORA's comments, and applicants' reply, largely reargue law and policy positions which we have already addressed in this opinion. RRB's comments, however, take a new tack. While RRB does not oppose this merger, RRB appears to challenge the draft decision's interpretation of the legal standard for authorization of water utility mergers. RRB does not state expressly what language in the draft it finds troubling, but argues "[t]he cases cited by the Proposed Decision certainly impose no limitation on the Commission's review, other than to require that the public interest be protected." (RRB comments, p. 5.) RRB reminds us, for example, that in *Hanlon v. Eshelman*, which we cite above, the Supreme Court stated: "The Commission's power is to be exercised for the protection of the rights of the public interested in the service, and to that end alone." (*Hanlon v. Eshelman*, *supra* at p. 202.) RRB does not explain how the draft decision, which fashions several consumer protections beyond the important safeguards in the enhanced guarantee, fails to uphold this charge. To the extent RRB's comments register disagreement with our conclusions regarding the impact of the rate base valuation imposed by Section 2718 et seq., those comments are misplaced, and should have been directed to the draft decision underlying D.99-09-030.

Findings of Fact

1. Applicants propose the acquisition and merger of CWS, Dominguez, Kern River and Antelope, with CWS surviving.
2. The financial structure of the merger is a tax-free stock exchange of DSC stock for CWSG stock.
3. The financial impact of the revised stock conversion ratio negotiated following the hostile bid from American States yields a purchase price for the utility assets of Dominguez' South Bay district of \$53,722,143; for Dominguez'

Redwood Valley district of \$901,214; for Kern River of \$4,843,881; and for Antelope of \$2,631,213. These values do not include the value of Safe Drinking Water Bond Act Loans held by Dominguez and Kern River.

4. The purchase price of each of the regulated Dominguez subsidiaries is less than the value of reproduction cost new less depreciation (RCNLD).

5. The merger will result in a rate base "write up" (the difference between book value and the sales price) of approximately \$32 million; the 2001 revenue requirement impact of the rate base additions, together with allowances for associated rate of return, expenses and depreciation, equals approximately \$4.484 million.

6. Merger-related operating/administrative/water production cost savings will be approximately \$3,732,477.

7. The financial (lower cost financing) and other (operational/administrative/water production) merger-related cost savings are \$5.5 million if net synergies start at \$3 million, \$12 million if net synergies start at \$4.5 million, and \$15 million, if net synergies start at \$5 million. The \$4.5 million projection is most likely.

8. Net synergies are defined as the net of merger-related cost savings less the rate base increase, after the removal of all one-time merger-related costs which are shareholder expenses.

9. Under applicants' rate guarantee, in the near term (the period of the 2002 and 2005 GRCs), in the worst case ratepayers of the merged utility will experience no merger-related rate increases.

10. Applicants' guarantee against a merger-related rate increase requires an accurate and enforceable ratemaking method.

11. The ratemaking method proposed -- comparison of a base case against two subsequent GRC filings -- relies upon standard "cost of service" ratemaking

principles and practices and is reasonable. "Cost of service" ratemaking is the regulatory norm in the water utility industry.

12. The Commission has years of historical data on which to judge the reasonableness of any utility expense categories in the base case and 2002 and 2005 GRCs.

13. Ratepayers in the current service territories of Dominguez, Kern River and Antelope may see certain additional, "qualitative" benefits, such as increased in-house resources for fire protection and emergency response.

14. The financial benefits (for ratepayers in the Dominguez, Kern River and Antelope service territories) of the merged utility's lower-equity capital structure and stronger borrowing power will provide a small benefit in the longer-term. A reasonable forecast is a cumulative benefit of \$30 million, in nominal terms between 2008 and 2028, or \$2.4 million net present value, attributable to the impact of lower financing costs on the growth of net plant.

15. An associated benefit of the merger is avoidance of delisting by NASDAQ, and the resultant adverse financial impact on both shareholders and ratepayers of the DSC regulated subsidiaries.

16. Employment for the approximately 70 permanent employees at DSC's regulated subsidiaries will be continued, but not necessarily in the same position.

17. Post-merger, the Dominguez field and operations workforce will be unionized and enjoy concomitant salary and benefits increases.

18. Eighteen positions in rural areas and all customer service and field positions in the Los Angeles area will remain.

19. The consolidation of administrative and executive functions will likely result in the relocation of approximately 20 positions from Carson to San Jose; currently, a half dozen or so of those positions are vacant or filled with temporary employees.

20. RRB removed its opposition to the merger after applicants proposed the enhanced guarantee. Each of RRB's witnesses testified that one or more of the guarantee provisions satisfy the concerns that witness raised in the ORA/RRB report.

21. The Fremont Valley Annexation Committee's brief suggests Dominguez consider other options than merger for increasing its financial footing.

22. The Leona Valley Water Rate Committee's brief opposes the merger.

23. ORA continues to oppose the merger, but recommends imposition of four conditions if the Commission authorizes the merger.

24. Carson recommends that seven conditions be imposed.

25. Applicants' enhanced guarantee addresses two of ORA's conditions and four of Carson's. Another of ORA's conditions is already required by statute, as are a further two of Carson's conditions.

26. The \$7 million in savings which ORA seeks as a condition of the merger is highly speculative; there is no evidence in the record that the merger will produce economic savings on that order.

27. Carson does not detail what it considers "concrete" ratepayer benefits but appears to seek something more than the "neutrality plus" which has been established on this record.

28. The adjudicated water rights currently held by Dominguez are valuable utility assets. While a change in the "used and useful" categorization of the adjudicated water rights currently held by Dominguez may not be contemplated by applicants, and may never come to pass, the dynamics of water marketing in California are evolving.

Conclusions of Law

1. Application of Section 2718 et seq. results in the following rate base valuations, for ratesetting purposes, for the utility assets acquired by CWS: for the South Bay district, \$53,722,143; for the Redwood Valley district, \$901,214; for Kern River, \$4,843,881; and for Antelope, \$2,631,213.

2. To approve this merger, we must conclude that it is not adverse or injurious to the public interest.

3. There is no need for us to order what the law already requires, namely that any future sale of the Dominguez distribution system requires our approval and that any successor of CWS is bound by our final decision in this proceeding.

4. Requiring CWS to provide notice to the director of the Commission's Water Division before converting the "used and useful" status of any portion of the adjudicated water rights currently held by Dominguez will avoid the possibility that the Commission does not learn until after the fact that those water rights, or any portion of them, has been sold for the benefit of shareholders.

5. Requiring CWS to prepare an "information only" report for the Director of the Water Division before the base case filings, and annually thereafter until the 2005 GRC is filed, will provide an additional regulatory safeguard.

6. The acquisition and transfer of control is a "project" that qualifies for an exemption from CEQA pursuant to Section 15061(b)(3) of the CEQA guidelines.

7. Pursuant to Health and Saf. Code § 116540(a), upon change of ownership after January 1, 1998, a public water system must obtain a permit from the DHS.

8. The proposed merger, as revised by applicants' enhanced guarantee, and subject to other conditions consistent with these conclusions of law, is not adverse to the public interest.

9. In order to provide certainty to the parties in their business dealings, this decision should be effective immediately.

O R D E R

IT IS ORDERED that:

1. The acquisition and merger of Dominguez Water Company (Dominguez), Kern River Valley Water Company (Kern River) and Antelope Valley Water Company (Antelope) by and into California Water Company (CWS), is approved subject to the mitigating conditions of applicants' enhanced guarantee and all further mitigating conditions in these ordering paragraphs.
2. In accordance with the enhanced guarantee, upon merger CWS:
 - a. Shall not apply to increase the rates of in any rate district to recover any merger-related costs or expenses.
 - b. Shall ensure the financial benefits of the adjudicated water rights currently held by Dominguez will continue to accrue to Dominguez' customers, barring any action beyond the control of CWS.
 - c. Is authorized to combine the South Bay, Hermosa-Redondo and Palos Verdes districts into a single district for operational and administrative purposes but shall not consolidate their rate schedules. CWS shall design rates separately for each of the three former districts based on their historic costs of service which shall reflect differences, among other things, in the source and cost of water supplies.
 - d. Shall offer continued employment in the Los Angeles area to all of Dominguez' operational (field and customers service) employees. CWS shall offer all other Dominguez employees equivalent, continued employment within the merged utility.
 - e. Shall file an application in 2000 to determine "Base Year 2000" revenue requirements for the Palos Verdes and Hermosa-Redondo districts and for CWS' general office. These base case revenue requirements will provide the benchmark for assessing merger-related synergies in the

first combined-district GRC filed in mid-year 2001 (with rates effective in 2002) and the second combined-district GRC filed in 2004 (with rates effective in 2005). If necessary to ensure rate neutrality, reductions in the 2002 and 2005 GRC revenue requirements will be imputed. If an imputation is required in the 2005 GRC, CWS' operating expenses will be adjusted permanently to reflect the reduced revenue requirement.

- f. Shall be given full credit for the first \$3 million in annual net merger-related cost savings, in calculating merger-related cost savings for ratemaking purposes, but shall receive credit for only 90% of any net merger-related cost savings above \$3 million.
- g. Shall impute a 52% equity ratio in calculating its cost of capital for ratemaking purposes until it is able to issue sufficient debt to return its capital structure to the current 52% ratio.

3. For ratesetting purposes, the value of the rate base of the utility assets acquired by CWS shall be set as follows: South Bay district at \$53,722,143; Redwood Valley district at \$901,214; Kern River at \$4,843,881; and Antelope at \$2,631,213.

4. Dominguez, Kern River and Antelope shall transfer their Certificates of Public Convenience and Necessity to CWS and upon such transfer, their obligations as independent public utilities shall terminate.

5. CWS is authorized to assume the Safe Drinking Water Bond Act Loan obligations of Dominguez and Kern River.

6. CWS shall provide notice to the director of the Commission's Water Division, or its successor, before converting the "used and useful" status of any portion of the adjudicated water rights currently held by Dominguez.

7. CWS shall prepare an information only report for the Director of the Water Division before filing the base case in 2000 and annually thereafter until the 2005 GRC is filed. The report shall explain (1) any significant changes in post-merger implementation plans, (2) any additional areas of merger-related

cost savings, and (3) any areas where costs will necessarily increase due to the merger.

8. Application 99-02-004 is closed.

This order is effective today.

Dated May 18, 2000, at San Francisco, California.

LORETTA M. LYNCH

President

HENRY M. DUQUE

JOSIAH L. NEEPER

RICHARD A. BILAS

Commissioners

I will file a dissent.

/s/ LORETTA M. LYNCH
Commissioner

[Signature]
Certified as a True Copy
of the Original

ASST. EXECUTIVE DIRECTOR, PUBLIC UTILITIES COMMISSION
STATE OF CALIFORNIA

I abstain.

/s/ CARL W. WOOD
Commissioner

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Last updated on 15-FEB-2000 by: SMJ
A9902004 LIST

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Dissenting Opinion of Commissioner Loretta Lynch:

This case involves a merger between Dominguez Water Company and California Water Company. I respectfully dissent from the opinion of the majority to approve the transfer because the record provides no evidence that the merger will provide benefits to ratepayers or the public generally. As a general principle, I believe the Commission should deny a merger unless it is convinced that utility customers will benefit from it. My view is founded on principles of equity and my interpretation of the inter-relationship of Sections 851 and 854 of the Public Utilities Code with The Public Water System Investment and Consolidation Act, Sections 2718 through 2720 of the Public Utilities Code.

Transfers of utility property are controlled by Article 6 of Chapter 4 of the Public Utilities Act, Sections 851 through 856. Section 851 governs sales or other transfers of utility property. It provides in part:

851. No public utility other than a common carrier by railroad subject to Part I of the Interstate Commerce Act (Title 49, U.S.C.) shall sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its railroad, street railroad, line, plant, system, or other property necessary or useful in the performance of its duties to the public, or any franchise or permit or any right thereunder, nor by any means whatsoever, directly or indirectly, merge or consolidate its railroad, street railroad, line, plant, system, or other property, or franchises or permits or any part thereof, with any other public utility, without first having secured from the commission an order authorizing it so to do. Every such sale, lease, assignment, mortgage, disposition, encumbrance, merger, or consolidation made other than in accordance with the order of the commission authorizing it is void.

This provision requires that the Commission determine that the public interest is promoted before a transfer is approved. D. 71758, La Puente Cooperative Water Company, 66 PUC 614, 628 (1966); D. 70449, Plunkett Water Company, 65 PUC 313 (1966). As the California Supreme Court noted in the first case interpreting the predecessor of this section:

The commission's power is to be exercised for the protection of the rights of the public interested in the service, and to that end alone. (Hanlon v. Eshleman, 169 C. 200 at 202 (1915), emphasis added.)

Since this clear enunciation of an intention to protect consumer rights, the public interest standard in water utility transfer cases has been consistently understood by the Commission to require that the ratepayers in fact benefit from a transfer. For example, in Plunkett Water Company, supra, the Commission rejected a proposed transfer of water utility assets because the possibility of a rate increase for customers served by the transferred assets outweighed the benefits of improved fire protection. (65 PUC 313-315-16.) The basis for the result was declared by the Commission to be, in part, that "...[t]he 231 customers who would be concerned in this transfer have not consented to assume the burden which would be involved, nor were they advised of the possibility or contingency...." (Ibid. at 315.) Captive water customers, and the facilities used to serve them with water, ought not to be traded among investors unless the Commission determines that it is in their interest that the transfer take place. Compare, D.70772, Anderson Water Company, 65 PUC 607 (1966), approving a sale to a municipal entity proposing to upgrade and interconnect water systems, despite an admittedly inflated ratebase.

In Corona City Water Company v. Public Utilities Commission, 54 C. 2d 834, 9 Cal Rptr. 245 (1960) the California Supreme Court upheld a rejection by the Commission of the sale of a valuable water well by a utility (Corona) to a related entity asserted to be exempt from CPUC regulation (Temescal). The effect of the sale would have been to deprive the Corona customers of a lower cost source of water – i.e., to raise their rates. The issue before the Court and

the Commission was whether the Commission should exert its jurisdiction over entities that were arguably exempt from regulation. In the face of a strong legal argument that -- due to anomalies in the water rights -- the well could not be pumped at all by Corona, the transferring utility, the Supreme Court upheld the Commission:

...whether or not ...an infringement [of Corona's rights] has occurred, the intercorporate relationship is fraught with hazards to Corona and its customers. Thus the largely agricultural independent stockholders of Temescal are in a position to subsidize their water service at the expense of Corona and to prevent Corona's objecting by their control of it. It is the existence of such power, not merely its improper exercise, that violates the principles underlying the exemption [from regulation.]

(9 Cal Rptr. 245 at 248.)

The basis for the Commission's power to approve transfers of water utility property under section 851 is the need to protect captive ratepayers from exploitation or abuse, either actual or threatened. It is the essence of the Commission's exercise of that power that it determine that the captive ratepayers will benefit from the transfer.

Section 851 governs dispositions of utility property. Section 854(a) governs acquisitions of utility property. Enacted in 1971 and extensively amended in 1989, it provides:

854. (a) No person or corporation, whether or not organized under the laws of this state, shall merge, acquire, or control either directly or indirectly any public utility organized and doing business in this state without first securing authorization to do so from the commission. The commission may establish by order or rule the definitions of what constitute merger, acquisition, or control activities which are subject to this section. Any merger, acquisition, or control without that prior authorization shall be void and of no effect. No public utility organized and doing

business under the laws of this state, and no subsidiary or affiliate of, or corporation holding a controlling interest in a public utility, shall aid or abet any violation of this section.

This statute has also been consistently understood to require a finding that acquisition of control is in the public interest and will benefit the affected ratepayers, including appropriate conditions. (Application of Benjamin and Lourdes Nepomuceno, D.87781, 82 PUC 504, 505 (1977), citing Hempy v. PUC, 56 C.2d 214 (1961).) In that case, the Commission went so far as to control rates charged consumers by a court-appointed receiver in order to assure ratepayer benefits. (82 PUC 504, 509, Ordering Paragraph 7.)

These authorities, stretching over more than 80 years of consistent interpretation, convince me that the public interest standard under Sections 851 and 854 includes a requirement that the transaction result in ratepayer benefit, that there be a positive contribution to the well-being of the water users who obtain that essential service from the water utility or property being transferred. Ratepayer benefit, not ratepayer indifference is the essence of the public interest standard under Section 851.

It was in this context that the Legislature enacted SB 1268 in 1997, the Public Water System Investment and Consolidation Act, Public Utilities Code Sections 2718 through 2720. Significantly, in enacting the statute the Legislature specifically preserved to the commission "all powers and responsibilities granted pursuant to Sections 851 and 852." (Public Utilities Code Section 2720(d).) In making certain findings and declarations, the Legislature specifically reaffirmed the "ratepayer benefit" requirement of those sections:

2719. The Legislature finds and declares all of the following:

- (a) Public water systems are faced with the need to replace or upgrade the public water system infrastructure to meet increasingly stringent state and federal safe drinking water laws and regulations governing fire flow standards for public fire protection.

- (b) Increasing amounts of capital are required to finance the necessary investment in public water system infrastructure.
- (c) Scale economies are achievable in the operation of public water systems.
- (d) Providing water corporations with an incentive to achieve these scale economies will provide benefits to ratepayers. (Emphasis added.)

The statute lists types of items that might support a ratepayer benefit determination: "...whether the acquisition of the public water system will improve water system reliability, whether the ability of the water system to comply with health and safety regulations is improved, whether the water corporation by acquiring the public water system can achieve efficiencies and economies of scale that would not otherwise be available, and whether the effect on existing customers of the water corporation and the acquired public water system is fair and reasonable." (Public Utilities Code Section 2720(b).)

The principal provision of SB 1268 is Public Utilities Code Section 2720(a), which sets out a procedure for establishing rates following the completion and approval of an acquisition of a public water system by a regulated water utility. This section provides in pertinent part:

2720. (a) The commission shall use the standard of fair market value when establishing the rate base value for the distribution system of a public water system acquired by a water corporation. This standard shall be used for ratesetting. (1) For purposes of this section, "public water system" shall have the same meaning as set forth in Section 116275 of the Health and Safety Code. (2) For purposes of this section, "fair market value" shall have the same meaning as set forth in Section 1263.320 of the Code of Civil Procedure.¹

¹ CCP Section 1263.320 provides:

1263.320. (a) The fair market value of the property taken is the highest price on the date of valuation that would be agreed to by a seller, being willing to sell but under no particular or urgent necessity for so

This provision establishes a post-transfer ratemaking methodology for transferred systems. Its existence becomes a consideration for the Commission when it is faced with an application for transfer, but of course has no bearing on the merits of the transfer itself or the standard to be utilized in approving the transfer. Indeed, to the extent that it purports to guarantee recovery of inflated sale prices through ratebase treatment for acquisition premiums, it may raise the bar for Commission approval because it may make more difficult a Commission determination of ratepayer benefit if a large rate increase would be required by the section. In fact the statute contains its own limitation on the extent to which purchase prices can be inflated – the definition of market value based on a “willing buyer” would be violated by a buyer who was relieved of all risk and restraint through guaranteed recovery of any level of investment. In any case, the existence of the statute heightens the scrutiny that we give to water utility transfers, to ascertain the ratepayer benefit that may justify ratebase treatment for an acquisition premium.

Following the enactment of SB 1268, the Section 851 approval process requires a finding of ratepayer benefit that involves a balancing approach.² If ratepayers can see no perceptible improvement in service or service quality, then a rate decrease resulting from a sharing of operational improvements is probably required. On the other hand, an acquisition premium supporting an enhanced ratebase may be balanced by real operational or other improvements in service. These improvements need not be quantified, but they must be concrete, perceptible and real.

doing, nor obliged to sell, and a buyer, being ready, willing, and able to buy but under no particular necessity for so doing, each dealing with the other with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available. (b) The fair market value of property taken for which there is no relevant, comparable market is its value on the date of valuation as determined by any method of valuation that is just and equitable.

² It is not necessary in this case to address the extent to which the public interest considerations listed in Sections 854(b) and 854(c) may also weigh in the balance. These sections, which require the commission to make certain explicit findings, do not apply by their terms to water utilities. However, the itemization of issues may inform the commission's deliberations on how to strike the public interest balance, and parties

In this case, there is an acquisition premium, and potential ratebase write-up as a result of the sale price. Following the logic of the Anderson Water Company case above, this premium is not justified by a showing that the merger will result in lower rates, operational improvements, better service or water quality, or any other benefit.

To the contrary, the merger would increase utility rate base by more than \$32 million. The merging companies promise not to seek rate increases in the next five years for costs related to the merger. Even if they are held to this promise, the merger may result in rate increases in the longer term.

I am not convinced that in passing Section 2718 et seq. the Legislature intended to promote mergers that provide no benefits to utility customers or that may result in rate increases in the longer term. Because the majority is not similarly convinced, I propose the Commission seek Legislative clarification of the statute so that it specifies the need to consider utility customer interests in the Commission's review of mergers.

Dated May 18, 2000, in San Francisco, California.

Loretta M. Lynch

/s/ _____

LORETTA M. LYNCH
President

seeking to justify a transfer which involves a rate increase may present how the transfer touches on the itemized issues.

Dissenting Opinion of Commissioner Loretta Lynch:

This case involves a merger between Dominguez Water Company and California Water Company. I respectfully dissent from the opinion of the majority to approve the transfer because the record provides no evidence that the merger will provide benefits to ratepayers or the public generally. As a general principle, I believe the Commission should deny a merger unless it is convinced that utility customers will benefit from it. My view is founded on principles of equity and my interpretation of the inter-relationship of Sections 851 and 854 of the Public Utilities Code with The Public Water System Investment and Consolidation Act, Sections 2718 through 2720 of the Public Utilities Code.

Transfers of utility property are controlled by Article 6 of Chapter 4 of the Public Utilities Act, Sections 851 through 856. Section 851 governs sales or other transfers of utility property. It provides in part:

851. No public utility other than a common carrier by railroad subject to Part I of the Interstate Commerce Act (Title 49, U.S.C.) shall sell, lease, assign, mortgage, or otherwise dispose of or encumber the whole or any part of its railroad, street railroad, line, plant, system, or other property necessary or useful in the performance of its duties to the public, or any franchise or permit or any right thereunder, nor by any means whatsoever, directly or indirectly, merge or consolidate its railroad, street railroad, line, plant, system, or other property, or franchises or permits or any part thereof, with any other public utility, without first having secured from the commission an order authorizing it so to do. Every such sale, lease, assignment, mortgage, disposition, encumbrance, merger, or consolidation made other than in accordance with the order of the commission authorizing it is void.

This provision requires that the Commission determine that the public interest is promoted before a transfer is approved. D. 71758, La Puente Cooperative Water Company, 66 PUC 614, 628 (1966); D. 70449, Plunkett Water Company, 65 PUC 313 (1966). As the California Supreme Court noted in the first case interpreting the predecessor of this section:

The commission's power is to be exercised for the protection of the rights of the public interested in the service, and to that end alone. (Hanlon v. Eshleman, 169 C. 200 at 202 (1915), emphasis added.)

Since this clear enunciation of an intention to protect consumer rights, the public interest standard in water utility transfer cases has been consistently understood by the Commission to require that the ratepayers in fact benefit from a transfer. For example, in Plunkett Water Company, supra, the Commission rejected a proposed transfer of water utility assets because the possibility of a rate increase for customers served by the transferred assets outweighed the benefits of improved fire protection. (65 PUC 313-315-16.) The basis for the result was declared by the Commission to be, in part, that "...[t]he 231 customers who would be concerned in this transfer have not consented to assume the burden which would be involved, nor were they advised of the possibility or contingency...." (Ibid. at 315.) Captive water customers, and the facilities used to serve them with water, ought not to be traded among investors unless the Commission determines that it is in their interest that the transfer take place. Compare, D.70772, Anderson Water Company, 65 PUC 607 (1966), approving a sale to a municipal entity proposing to upgrade and interconnect water systems, despite an admittedly inflated ratebase.

In Corona City Water Company v. Public Utilities Commission, 54 C. 2d 834, 9 Cal Rptr. 245 (1960) the California Supreme Court upheld a rejection by the Commission of the sale of a valuable water well by a utility (Corona) to a related entity asserted to be exempt from CPUC regulation (Temescal). The effect of the sale would have been to deprive the Corona customers of a lower cost source of water – i.e., to raise their rates. The issue before the Court and

the Commission was whether the Commission should exert its jurisdiction over entities that were arguably exempt from regulation. In the face of a strong legal argument that -- due to anomalies in the water rights -- the well could not be pumped at all by Corona, the transferring utility, the Supreme Court upheld the Commission:

...whether or not ...an infringement [of Corona's rights] has occurred, the intercorporate relationship is fraught with hazards to Corona and its customers. Thus the largely agricultural independent stockholders of Temescal are in a position to subsidize their water service at the expense of Corona and to prevent Corona's objecting by their control of it. It is the existence of such power, not merely its improper exercise, that violates the principles underlying the exemption [from regulation.]

(9 Cal Rptr. 245 at 248.)

The basis for the Commission's power to approve transfers of water utility property under section 851 is the need to protect captive ratepayers from exploitation or abuse, either actual or threatened. It is the essence of the Commission's exercise of that power that it determine that the captive ratepayers will benefit from the transfer.

Section 851 governs dispositions of utility property. Section 854(a) governs acquisitions of utility property. Enacted in 1971 and extensively amended in 1989, it provides:

854. (a) No person or corporation, whether or not organized under the laws of this state, shall merge, acquire, or control either directly or indirectly any public utility organized and doing business in this state without first securing authorization to do so from the commission. The commission may establish by order or rule the definitions of what constitute merger, acquisition, or control activities which are subject to this section. Any merger, acquisition, or control without that prior authorization shall be void and of no effect. No public utility organized and doing

business under the laws of this state, and no subsidiary or affiliate of, or corporation holding a controlling interest in a public utility, shall aid or abet any violation of this section.

This statute has also been consistently understood to require a finding that acquisition of control is in the public interest and will benefit the affected ratepayers, including appropriate conditions. (Application of Benjamin and Lourdes Nepomuceno, D.87781, 82 PUC 504, 505 (1977), citing Hempy v. PUC, 56 C.2d 214 (1961).) In that case, the Commission went so far as to control rates charged consumers by a court-appointed receiver in order to assure ratepayer benefits. (82 PUC 504, 509, Ordering Paragraph 7.)

These authorities, stretching over more than 80 years of consistent interpretation, convince me that the public interest standard under Sections 851 and 854 includes a requirement that the transaction result in ratepayer benefit, that there be a positive contribution to the well-being of the water users who obtain that essential service from the water utility or property being transferred. Ratepayer benefit, not ratepayer indifference is the essence of the public interest standard under Section 851.

It was in this context that the Legislature enacted SB 1268 in 1997, the Public Water System Investment and Consolidation Act, Public Utilities Code Sections 2718 through 2720. Significantly, in enacting the statute the Legislature specifically preserved to the commission "all powers and responsibilities granted pursuant to Sections 851 and 852." (Public Utilities Code Section 2720(d).) In making certain findings and declarations, the Legislature specifically reaffirmed the "ratepayer benefit" requirement of those sections:

2719. The Legislature finds and declares all of the following:

- (a) Public water systems are faced with the need to replace or upgrade the public water system infrastructure to meet increasingly stringent state and federal safe drinking water laws and regulations governing fire flow standards for public fire protection.

- (b) Increasing amounts of capital are required to finance the necessary investment in public water system infrastructure.
- (c) Scale economies are achievable in the operation of public water systems.
- (d) Providing water corporations with an incentive to achieve these scale economies will provide benefits to ratepayers. (Emphasis added.)

The statute lists types of items that might support a ratepayer benefit determination: "...whether the acquisition of the public water system will improve water system reliability, whether the ability of the water system to comply with health and safety regulations is improved, whether the water corporation by acquiring the public water system can achieve efficiencies and economies of scale that would not otherwise be available, and whether the effect on existing customers of the water corporation and the acquired public water system is fair and reasonable." (Public Utilities Code Section 2720(b).)

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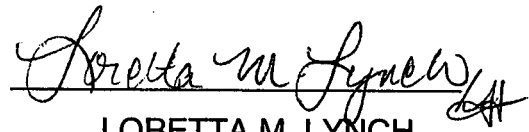
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Dated May 18, 2000, in San Francisco, California.


LORETTA M. LYNCH
President

seeking to justify a transfer which involves a rate increase may present how the transfer touches on the itemized issues.

PROOF OF SERVICE BY MAIL

I, Sandra Jackson, declare:

I am over the age of 18 years, not a party to this proceeding, and am employed by the California Public Utilities Commission at 505 Van Ness Avenue, San Francisco, California.

On 5-31-2000, I deposited in the mail at San Francisco, California, a copy of:

00-05-047
(DECISION NUMBER OR TYPE OF HEARING)

5-18-2000
(DATE OF HEARING)

A.99-02-004
(APPLICATION/CASE/OII/OIR NUMBER)

in a sealed envelope, with postage prepaid, addressed to the last know address of each of the addressees in the attached list.

I declare under penalty of perjury that the foregoing is true and correct and that this declaration was executed on 5-31-2000, at San Francisco, California.

Sandra Jackson

A.99-02-004

~~ITEM 3~~

~~3/16/00~~

H-3

5/18/2000

DECISION: 00-05-047

MAIL DATE: 5-31-2000

Copy of "OPINION AUTHORIZING MERGER WITH CONDITIONS" and order
mailed to the following.

SEE ATTACHED LIST FOR APPEARANCES, STATE SERVICE

3/16/00
lpd

Count 21

***** SERVICE LIST *****

Last Update on 15-FEB-2000 by: SMJ
A9902004 LIST

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A9902004 LIST

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