

**ORIGINAL**

MAILED  
10/29/97

**BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA**

Order Instituting Rulemaking on the )  
Commission's Own Motion to set rules )  
and to provide guidelines for the )  
Acquisition and Mergers of Water )  
Companies. )  
\_\_\_\_\_ )

**FILED**  
**PUBLIC UTILITIES COMMISSION**  
**OCTOBER 22, 1997**  
**SAN FRANCISCO OFFICE**  
**R.97-10-048**

**ORDER INSTITUTING RULEMAKING**

**Background**

In October of 1996 at our first Water Roundtable and again in mid-November at the Fall California Water Association Meeting, we expressed a keen interest in facilitating a greater understanding of the problems and the changes taking place in the water industry. Those problems and changes were (1) mergers and acquisitions, which we are addressing in this OIR; (2) privatization and excess capacity; and (3) alternative ratemaking procedures, such as cost of living increases, ratebase offsets and performance based regulation.

We included these issues as an integral part of the Commission's first Business Plan. As a result, over the period from May, 1997 through August, 1997 our Water Division hosted three workshops to address these issues. Workshop reports have been written, distributed, and commented upon by the industry and interested parties on all but alternative ratemaking procedures, which is due to be distributed shortly.

In addition to our concern with the forces of change in the water industry, the California Legislature through the introduction of SB 1268 (Stat.1997, Ch.675) expressed its desire to facilitate infrastructure improvements to meet the increasingly stringent state and federal drinking water laws and regulations governing standards for public fire protection, to recognize that economies of scale were achievable in the operation of public water systems, and that water corporations should be provided with an incentive to achieve economies that would benefit the ratepayers. SB 1268's incentive for California's investor owned water utilities requires the

Commission to use the standard of fair market value for the water distribution system when establishing the rate base of any acquired utility or, if the sales price exceeded reproduction cost, to require the acquiring utility to justify any premium. SB 1268's provisions, in addition to the agenda items prepared by our Water Division were the focal points of the first workshop held on May 20 and 28, 1997.

#### Workshop Results

The workshops were attended by almost all of our Class A water utilities, representatives of some of our smaller water companies, the California Water Association (CWA), and representatives of the Commission's Office of Ratepayer Advocates, Energy Division and the host Water Division. At times during the two days of the workshop, Commissioners Duque and Nepper and their advisors attended. A workshop report was mailed to all participants on June 24, 1997.

Simply stated, the water utilities want to change the manner in which the purchase price of an acquisition is treated for setting rates. Historically, this Commission and commissions in other states applied the principle that the purchasing company would only be allowed to earn upon the depreciated original cost of the water investment first devoted to public use. This meant that, if it paid twice the original cost to the purchasee, only the original cost would be allowed in the purchaser's ratebase. In fact, in some cases, if the purchase price was less than original cost, the lesser amount was allowed in ratebase.

The enactment of SB 1268 signals that the times have changed. Most of the 200 or so water companies that the Commission regulates are Class C and D, with less than 1,000 customers. Many of these are not earning an adequate return nor providing the best service. The policy of the Commission has always been to support the acquisition of smaller, troubled water companies by municipal water companies, water districts, or by our larger, more efficient investor-owned water companies. We note that Proposition 218 may dampen the "public" water sector's incentives to purchase the small, troubled companies. That leaves the investor-owned companies and regionalized management companies as the market for helping resolve this issue.

During the workshop discussions, this goal of facilitating the purchase of small troubled water companies was common to all participants. Various incentives were discussed as a means for the larger, better managed companies to take over the smaller ones. While the industry favored the inclusion of sales price in ratebase, many of the staff felt that, unless the purchasing water company could make a case that the purchase was in the best interest of both companies' ratepayers, only the original cost should be allowed. The water industry pointed out that when a company or operating district is purchased by a municipality or water district the sales price is generally based on reproduction cost new less depreciation (RCNLD) and that that should be the basis upon which the Commission establishes the new ratebase of the purchasing company. We are aware of purchases by Class A's of nearby small companies, but we are concerned that there may not be an incentive for the Class As to take over more distant troubled companies. A possible incentive proposed by the staff was to allow the purchasing water company to earn the higher return granted to Class C and D companies for a period of 5-10 years for the acquired Class C or D utility. Also, the staff suggested that an appropriate alternative may be for additions to infrastructure of the purchased company to be allowed the higher return for a reasonable period of time.

Where the participants differed was in the development of guidelines for the purchase of a large Class A water company by a similarly sized one and how that should be handled for ratesetting. The industry believed that provisions of SB 1268, no matter what the size of the companies involved, should be the criteria. Staff was concerned with the possibility of an artificial increase in ratebase, and therefore an increase in rates without any real change in investment. The utilities pointed out that economies of scale would exert downward pressure on rates, and that, in spite of SB 1268, the Commission always can approve or reject proposed sales of investor-owned companies under Public Utilities Code Section 851. The enactment of SB 1268 makes this debate moot, but we include it here to provide a complete picture of the origin of current policy to comply with SB 1268.

With this brief introduction, we are ready to ask the parties to comment on the following questions that we have developed from the workshop report, our water roundtable of last October, and various discussions we have had over the past year with the industry, the staff, and the Legislature. In addition, we invite parties to propose policies and findings consistent with their answers to our questions. We plan to have final rules or guidelines in place as soon as possible after the first of the year. We believe this OIR is the correct forum to lay out guidelines and rules for both our regulated water utilities and our staff. The end result of this process will be a set of guiding principles to allow the water industry to make sound, well reasoned business decisions for acquisitions and mergers. Once we receive comments and answers to our questions, we will prepare a proposed decision which will contain our rules and guidelines for acquisitions and mergers. The proposed decision will be served on all regulated water companies and on all interested parties, including the workshop's participants.

**We would like the parties to address the following questions and propose policies and findings:**

1. What specific rules or guidelines, if any, should the Commission promulgate to implement SB 1268?
2. Who should have the burden of proving whether the purchasing company made an arm's length transaction with the acquired company?
3. With the enactment of SB 1268, what showing will be necessary by the company to justify the purchase price? What showing will be necessary by the staff?
4. How should the Commission's jurisdiction over sale of a utility's property, as provided for in Section 851 of the PU Code be administered? Could the Commission deny a sale if it would have an unreasonably adverse impact on either the selling or the buying company's ratepayers?
5. Should the Commission provide any additional incentives to the purchasers of small, troubled water companies when taken over by a Class A, Class B, or a Class C? How long should such an incentive be allowed?
6. Do the provisions of SB 1268 provide sufficient incentive to encourage the larger water companies to take over the smaller ones?

7. How should the Commission, consistent with SB 1268 value the sale price for ratemaking if it is increased through competitive bidding?
8. How should sales of utilities, water districts, and mutual water companies be treated for valuation of ratebase consistent with SB 1268?
9. Should all sales and mergers conform to the Commission's uniform system of accounts for regulated water companies?
10. Are investor-owned water companies at a disadvantage when competing for the purchase of a private water company with a water district or municipality?

**IT IS ORDERED that:**

1. A rulemaking on the Commission's own motion is instituted to solicit comments and recommendations regarding rules and guidelines consistent with SB 1268 for acquisitions and mergers of public water systems.

2. All Class A water utilities subject to the Commission's jurisdiction, the California Water Association, the Water Division, and the Office of Ratepayer Advocates are made respondents to this proceeding. Other regulated water companies and interested parties are invited to respond to the questions set forth above.

3. An original and 7 copies of all comments shall be filed with the Commission's Docket Office at 505 Van Ness Avenue, San Francisco, California, 94102 within 30 days of the date of the issuance of this order. Two additional copies each shall be mailed to the Directors of the Water Division and the Office of Ratepayer Advocates. A copy of the comments should be mailed to all Class A water companies. Class A water companies shall serve each other and other interested parties. The Commission's Process Office shall compile and mail to all commenting parties a list of all parties who have filed comments. Each commenting party is required to serve its comments upon request.

4. Reply comments must be filed within 45 days of the date of the issuance of this order, as specified in Ordering Paragraph 3, above.

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5. The Executive Director is directed to mail a copy of this order to all regulated water utilities, interested parties, and the workshop's participants.

This order is effective today.

Dated October 22, 1997, at San Francisco, California.

P. GREGORY CONLON  
President  
JESSIE J. KNIGHT, JR.  
HENRY M. DUQUE  
JOSIAH L. NEEPER  
RICHARD A. BILAS  
Commissioners