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Decision 01-11-064 November 29, 2001

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Joint Application of Southern California Water Company (U 133 W) and Peerless Water Company (U 335 W) for Approval of a Plan of Merger of Southern California Water company and Peerless Water Co.	Application 00-05-043 (Filed May 22, 2000)

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OPINION DENYING APPLICATION

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OPINION DENYING APPLICATION

Summary

The joint motion of Southern California Water Company (SCWC), Peerless Water Company (Peerless), and the Commission Office of Ratepayer Advocates (ORA) to approve a two-party settlement is denied because the plan of merger is unreasonable and not in the public interest. The settlement recommends approval of the proposed merger. The proposed merger includes the acquisition of Peerless by SCWC, placing water rights at market value into rate base, embarking on an $11.5 million improvement plan with $2.64 million invested in the first five years, and the ultimate consolidation of Peerless with SCWC's Metropolitan District.

We conclude that the settlement agreement does not meet the criteria of being reasonable in light of the entire record, in the public interest and consistent with applicable law. While SCWC is financially and technically qualified to assume utility service, these factors are outweighed by the burdens of a proposed 857% increase in rate base and subsequent dramatic rate increases arising from the capital improvement program and integration into SCWC's Metropolitan District. The proposed merger also results in duplicative, wasteful facilities. Equally qualified, financially capable, and willing alternative providers currently have connections with Peerless' eight dispersed service territories, and are capable of serving these customers without the expense of additional connections and at a reduction in existing rates.

On balance, we conclude that the degree of rate increases and duplication of facilities caused by the proposed merger are, in fact, harmful to the public. Moreover, Peerless is not a utility water system in need of take-over to provide

adequate service. Finally, the merger proposal is not one which achieves the economies of scale promoted by the Public Water Systems Investment and Consolidation Act of 1997.

Procedural History

On May 22, 2000, SCWC and Peerless filed a joint application to merge their operations and ultimately transfer control of Peerless to SCWC. The application was protested by the ORA, and the Cities of Bellflower, Lakewood and Paramount. Each of these parties' positions is discussed in detail below.

A Public Participation Hearing (PPH) was held in Bellflower on October 17, 2000. After this hearing, in response to the opposition of customers, applicants modified several terms in the merger proposal to minimize the rate impact.

Settlement negotiations were duly noticed and held December 7 and 13, 2000 and January 9, 2001. During settlement negotiations, applicants resolved all disputed issues with ORA, and modified the initial merger terms. The remaining protestants did not join in the settlement agreement between applicants and ORA.

Applicants and ORA filed a motion to adopt their settlement agreement, which in turn approved a modified application requesting authority to merge and transfer operations. In response, the remaining protestants, the Cities of Bellflower, Lakewood and Paramount, opposed the settlement and requested an evidentiary hearing. This request was granted.

Assigned Commissioner Duque issued a Scoping Memo on September 29, 2000 retaining the preliminary category of "ratesetting" for this proceeding. The issues were outlined, the schedule set and the assigned Administrative Law Judge named as principal hearing officer.

Evidentiary hearings were held on May 21-23, and June 7, 2001 in Los Angeles. The parties filed opening and closing briefs on June 26 and July 3, 2001, respectively. The matter was deemed submitted on August 21, 2001 upon the submission of Joint Exh. 14 which was submitted late as ordered during the proceeding.

Background

Peerless is a small Class B, privately held water company organized under the laws of California on August 12, 1940. Peerless has remained a small, family owned and operated water utility since its inception. The company was started by J. William Zastrow's father to serve approximately 150 houses that had been denied service by the neighboring utility, Bellflower Somerset Mutual Water Company (Bellflower Somerset). Peerless then expanded as developers constructed residential tract homes in the surrounding area. After Zastrow's father died in 1959, his mother operated the company. By 1961, the Company had reached its present size of approximately 2,000 customers. This customer base is not expected to increase in the future.

In 1970, J. William Zastrow became the President of Peerless. Currently, Peerless has five employees, including Zastrow and his son. Zastrow and his wife are the sole shareholders in the company. They jointly hold 54,301 shares of stock.

Peerless serves portions of the cities of Bellflower, Lakewood and Paramount in Los Angeles County. The majority of Peerless customers are residential. The business office is located at 16913 Lakewood Boulevard, Bellflower. Peerless' operating system is spread among eight unconnected

service territories supplied by wells. In 1999, Peerless delivered 360,683 cubic feet of water (including 11,629 cubic feet of reclaimed water).

Peerless' operating revenues for 1998 were approximately $800,000; for 1999 these revenues increased to $949,216. While the company technically is a small Class B water utility, the Commission often views it as a Class C water utility, as evidenced by the current permitted rate of return on equity (ROE), which is consistent with the ROE authorized for Class C water utilities.

In addition to the water distribution system infrastructure, Peerless owns significant water rights and several parcels of land.

Peerless' Reasons for Merging with SCWC

Zastrow decided to sell Peerless because of his age and health, and because he believes a sale is in the best interests of the company and customers. Zastrow believes that because of Peerless' small size, lack of capital, cash flow, age and condition of its facilities, the company could not survive as an independent operation given the allegedly necessary improvements. Thus, Zastrow decided to sell to another company that could resolve his concerns about addressing increased water quality standards and updating Peerless' water system.

SCWC is one of the largest water utilities in the nation and has the largest investor-owned water utility system in Southern California. Zastrow believes this translates into economies of scale that small investor-owned and mutual water companies, or municipal districts, cannot achieve. SCWC also serves customers in Lakewood and Paramount and is well-staffed to address the water quality issues faced by the company. In addition, its parent, American States Water Company (ASW), is currently listed on the New York Stock Exchange and has ready access to the capital markets. Thus, in Zastrow's opinion, SCWC possesses the size, experience, expertise and financial ability to satisfy the

operating, water quality and infrastructure replacement demands now existing

within the Peerless service area, and is capable of providing uninterrupted, responsive customer service.

Zastrow also contends SCWC provided the best terms for the company's customers, employees and investors. SCWC agreed to provide employment to Peerless' three experienced operating employees, including Zastrow's son. These employees will be able to serve an even wider service area, thereby benefiting existing SCWC customers.

The merger will be accomplished on a tax-free basis to Peerless' shareholders, due to ASW's status as a publicly traded company. This results in a reduced purchase price for SCWC and tax advantages for the Peerless investors. According to Zastrow, the other potential purchasers did not offer all of these advantages.

Zastrow rejected Bellflower Somerset's proposal to purchase Peerless for several reasons. First, Bellflower Somerset is a small company (the size of a Class B water utility, with approximately 5,000 customers) that faces most of the same operating and water quality challenges now faced by Peerless. However, it appears to Zastrow that Bellflower Somerset, unlike SCWC, will simply defer addressing the water quality concerns in the Peerless/Somerset service areas.

Second, if Bellflower Somerset acquired Peerless, Zastrow believes it will place complete reliance on serving new Peerless customers through water purchased from member agencies of the Metropolitan Water District (MWD), rather than addressing required infrastructure improvements to increase supply. The cost for purchased water has increased in the last several years substantially above costs for pumped groundwater. These prices are likely to increase even further as the MWD and other water wholesalers extensively restructure their rate design. The other drawback to total MWD reliance, according to Zastrow, is

the potential threat of insufficient water supply. If MWD supply fails, the service territory is left without this reliable source.

Third, if Bellflower Somerset acquired Peerless, Zastrow believes customers would have no assured, cost-free recourse to address service difficulties or other problems. Bellflower Somerset is a mutual water company with no applicable government oversight or consumer complaint procedure, whereas customers of an investor-owned utility like SCWC have the protection of regulation by the Commission.

Fourth, Zastrow contends that Bellflower Somerset failed to provide a competitive offer.

Finally, the most troubling aspect of Bellflower Somerset's proposal to Zastrow was the impact that an acquisition by a mutual water company would have on each Peerless customer. Zastrow believes in order to receive service from a mutual water company, each customer would be forced to pay the acquisition cost of the Peerless system and water rights by purchasing shares or securities issued by the mutual water company. This could prove a potentially impossible financial burden on the company's middle- and lower-income residential customers. In contrast, if an investor-owned utility acquires the company, the utility must finance the acquisition price.

Zastrow is also concerned that if Bellflower Somerset acquired Peerless, the latter's customers could be subject to special assessments to raise capital to fund necessary improvements for this small utility system. On the other hand, SCWC and other large investor-owned utilities finance these projects through external sources of capital or equity investment.

In Zastrow's opinion the Commission has been reluctant to permit mutual water companies to acquire investor-owned utilities. He claims the more

favored buyer has been the large investor-owned utility company, which appears to better satisfy the Commission's and California Legislature's express goals of combining smaller water companies with local Class A investor-owned utilities. (Zastrow provides no citations to support this contention.)

SCWC's Reasons for Merging with Peerless

SCWC's parent company, ASW, and Peerless entered into a merger agreement on December 14, 1999, effective upon the approval of the Commission. The terms on this date and as modified by the settling parties are described below. The acquisition enables SCWC to expand its service territory in Los Angeles County and is expected to increase earnings. SCWC contends this transaction will further the goals of the State by combining a smaller water company in need of infrastructure improvements with a larger adjacent system better equipped to meet increasing operating, water quality and infrastructure replacement demands.

Merger Terms

The merger is structured as a tax-free reorganization within the meaning of Section 368(a) of the Internal Revenue Code of 1986, as amended. The purchase price is $4,039,851, less the amount of any debt owed by Peerless to J. William Zastrow on the closing date. The purchase price includes water rights, land, and infrastructure.

The water rights consist of 986 acre-feet (AF) of allocated water pumping rights in the Central Basin in Los Angeles County, pursuant to the Judgment of Los Angeles Superior Court (Case No. 786656, dated October 11, 1965). The water rights are valued in the merger agreement at $2,958,000, or roughly $3,000 per AF. The application work papers contain an appraisal of water rights at

$2,700 per AF. However, recent sales of water rights range from $2,754 to $3,520 per AF.

The land being sold is six parcels with active wells. SCWC had these well sites appraised by a licensed appraiser prior to entering into the merger agreement with Peerless. (Exh. 3.) The book value of this land is $8,693. The total appraised value of these well sites is $226,380.

The remaining facilities include 13 wells, 83,670 linear feet of cement and welded steel mains, approximately 2,000 meters, and service connections. They had a net book value of $285,029 at year-end 1999 and appraised value of $855,470. These assets were appraised by William K. Ferry, P.E. of San Marino, California, using the method required by the Commission—replacement cost new, less depreciation (RCNLD).

ASW will acquire Peerless through an exchange of stock. The merger will be accomplished in three steps. First, ASW (in the merger plan called, "Parent") forms a wholly-owned subsidiary, ASW Merger Company (in the merger plan called, "Merger Subsidiary" or "Disappearing Corporation"). Two officers of ASW (Floyd Wicks and McClellan Harris III) are the sole officers (president and secretary, respectively) and directors of Merger Subsidiary, whose only asset is common shares of ASW. Merger Subsidiary will be merged into Peerless (in the merger plan called, "Company" or "Surviving Corporation") by exchanging all outstanding common shares of Disappearing Corporation for restricted certificates (which will be exchanged for ASW shares over a two-year period). Wicks and Harris will become the sole officers of Peerless. Next, Merger Subsidiary will cease to exist and Peerless will become a wholly owned subsidiary of ASW. Finally, Peerless will merge into SCWC, the Commission-regulated subsidiary of ASW.

Peerless shareholders will receive shares of ASW common stock based on the price of $30.83 per share of ASW stock, and the 54,301 shares of Peerless stock will cease to exist. The number of common shares to be issued will be determined at closing, but in no event will they be greater than 131,036 shares, nor less than 107,538 shares, plus cash in lieu of payment of fractional shares. ASW currently has approximately 9 million common shares outstanding, with a market value of $32.90 per share as of April 30, 2001.

In conjunction with this merger, SCWC has also entered into a three-year consulting agreement with Zastrow to assist in the transition. Zastrow will be paid $115,000 per year, less any dividends paid on the shares received in the merger. However, the dividends are expected to exceed $115,000 in each of the three years, meaning no net increase of cash payment to Zastrow. Zastrow will also be paid at the rate of $75 per hour, plus expenses, for any other work SCWC requests him to perform.

SCWC has also agreed to purchase certain other real property from Zastrow for $104,400 in cash. This land is personally owned by Zastrow, and is not in Peerless' rate base. The land has not been, and will not be, dedicated to public utility service, but instead will be re-sold by SCWC upon completion of this merger. SCWC customers will neither benefit from this acquired property, nor pay any of the costs to acquire or re-sell it.

The agreement includes the following 5-year, $2.64 million improvement plan:

Five-Year Post-Merger Investment Plan

Year	Well	Project	Expense
2001	2, 3, 8, 10	Removal of Iron and Manganese	$480,000
		Replacement of Bowls	$140,000
2002	4, 16	Removal of Iron and Manganese	$120,000
		Removal of Volatile Organic Compounds (VOC)	$250,000
		Replacement of Bowls	$ 70,000
2003	15	Removal of Iron and Manganese	$120,000
		Removal of VOCs	$250,000
		Replacement of Bowls	$ 35,000
2004	6	Removal of Iron and Manganese	$120,000
		Removal of VOCs	$250,000
		Replacement of Bowls	$ 35,000
2005	14	Removal of Iron and Manganese	$120,000
		Removal of VOCs	$250,000
		Installation of New Pump	$100,000
		Total Investment 2001-2005	$2,640,000

Table Source: Exhibit 2, Tab H

In addition, SCWC's engineers identify a total of $11,505,000 in projects (including those listed in the table above) that they state, "need to be made to the system." (Exhibit 2, Tab K.) The comprehensive capital improvement program includes the following projects:

Comprehensive Capital Improvement Plan for Water Systems Now Owned by Peerless

Abandon five non-producing wells	$100,000
Iron and manganese treatment at five wells	$600,000
Filters for VOC problems at three well sites	$750,000
Miscellaneous bowl and pump replacements	$315,000
Replace 8,000 lin. ft. of main 4" and smaller	$800,000[1]
Replace 1,000 lin. ft. of 5" main	$100,000
Customer meter testing & replacement	$100,000
Treatment at nine well sites & one booster pump site	$90,000
New wells in five areas	$5,250,000
New and replacement fire hydrants	$400,000
Replace 30,000 lin. ft. of 4" mains for fire flows	$3,000,000[1]
Total Improvements	$11,505,000

Modified Terms per Settlement Agreement

The settlement agreement modifies the merger agreement. In summary, ORA agrees that SCWC and Peerless should be authorized to merge pursuant to the terms of their settlement agreement, and should record the total purchase price pursuant to the Uniform System of Accounts prescribed by the Commission. ORA and applicants agree that Peerless' rates should be frozen at their current level through 2001; that SCWC will make specified improvements

[1] SCWC witnesses Putnam and Connay distinguish these two amounts for 4" mains as follows: 8,000 linear feet (lin. ft.) is the pipe in alleys, back yards, and streets; the 30,000 lin. ft. is pipe connected with fire flow. It is not clear whether the same pipe may be included in both categories. (Exh. 2, p. 11 and Exh. 3, Tab B.)

to Peerless' system over the next five years; that SCWC should be allowed to file advice letters to request increases in Peerless' rates to reflect the cost of such improvements when completed; and, that Peerless customers will join SCWC's Metropolitan District in 2005, provided the specified improvements have been completed.

ORA and SCWC made concessions in order to reach a settlement. SCWC agreed to exclude goodwill and contributed plant from recorded rate base. Therefore, SCWC's shareholders will not earn a return on these amounts of their investment in the future. Additionally, after the PPH, SCWC agreed to defer rate increases. Originally, SCWC had requested to immediately charge former Peerless customers the Metropolitan District ME-1 tariff rates. The Settlement instead allows for the merger of the Peerless customers onto the Metropolitan District tariff in 2005, provided the improvements herein identified are completed.

SCWC has also agreed that it will not request to increase Peerless customers' rates in 2001. SCWC will, however, begin to make capital improvements to the Peerless system during 2001, as soon as the merger has been approved by the Commission. These costs may be placed in rate base as projects are completed, which will increase rates. As shown in the Settlement Agreement, SCWC is committed to an initial five-year capital improvement plan. These projects will improve water quality by removing iron and manganese that is currently present in the water served to Peerless customers at a level that exceeds the Department of Health Services secondary drinking water standard. The improvements also include rehabilitation and construction of several wells to decrease the volume of water that has to be purchased from other agencies at a higher cost than pumping groundwater.

Thus, under the terms of the settlement agreement reached between SCWC, Peerless and ORA, Peerless customers would see no rate increase in 2001. However, in each of 2002, 2003 and 2004, the Peerless customers would experience a 10% rate increase, contingent on the completion and placing into service of plant in an amount equivalent to the cost and consistent with the schedule of needed expenditures identified above. In 2005, when merged with the Metropolitan District, former Peerless rates would increase approximately 16%, or to the level of this tariff.

Public Participation

The Commission conducted a PPH in Bellflower on October 17, 2000. Approximately 100 Peerless customers attended this hearing. Numerous customers made statements, the majority opposing the merger. However, several customers spoke in favor of it. Subsequently, Peerless customers wrote over 200 letters to the Commission opposing the merger. The City of Lakewood sent a petition to the Commission signed by 445 Lakewood residents opposing the merger.

Applicants' Arguments in Favor of Settlement Agreement

SCWC contends that the settlement agreement meets the requirements of Rule 51 of the Commission's Rules of Practice and Procedure of being reasonable, lawful, and in the public interest. SCWC alleges that the current customers of Peerless will not suffer significant impact due to the merger. While SCWC's Metropolitan District rates presently are somewhat higher than those charged by Peerless, SCWC expects this difference in rates to be short-lived without the merger because of Peerless' needed infrastructure replacement and water quality improvements.

Peerless customers will also benefit from SCWC's ability to pump the full Peerless water rights from the Central Basin, whereas Peerless has been unable to operate several of its own wells due to the location of a plume of contaminants. At no time will SCWC request rates for current Peerless customers that are higher than those in effect at the same time for customers in its Metropolitan District.

SCWC believes the increases for the Peerless customers are justified because of the tangible and intangible benefits of the merger. While it is difficult to quantify the benefits of being part of a larger system, SCWC believes it is clear that there are such benefits. As a large publicly traded company, SCWC has access to more and lower cost financing, as evidenced by the different returns on rate base authorized by the Commission. This will benefit Peerless customers, not only on existing investments, but for all future capital projects as well. SCWC would anticipate replacing Peerless' purchase of high cost water from Park Water Company ($833/AF) with lower cost MWD purchases ($478/AF) at some point in the future. SCWC will provide more efficient operations and higher quality of service. By combining with SCWC, Peerless customers will enjoy the benefits of a staff of water quality experts, improved system pressure following the completion of the proposed capital improvement program, and a customer service center that operates twenty-four hours per day, seven days a week.

If Peerless remains a stand-alone water company, somehow makes the same improvements as SCWC proposes, and maintains its current rate of return on rate base, Peerless' rates will exceed the projected rate level of SCWC's ME-1 tariff in 2005, assuming ME-1 rates increase an average of 6.65% annually. Pursuant to the Settlement, SCWC will make these capital improvements at a

savings to Peerless customers in comparison to what the cost would be if Peerless were to proceed on its own. Moreover, Peerless' stand-alone rates are projected to continue to be higher than SCWC's ME-1 rate into the future.

Lastly, the merger between SCWC and Peerless ensures that the current Peerless system is maintained under Commission regulation and oversight. Peerless' current customers will continue to be protected by Commission regulation from unjustified rate increases due to unnecessary capital investments or operating expenses.

SCWC also contends that its current SCWC customers will benefit from approval of the Settlement. There are approximately 98,000 customers in SCWC's Metropolitan District, so one might think the addition of 2,000 Peerless customers might have little impact. However, current SCWC customers will benefit by the acquisition of the water rights, and also in the future by the spreading of fixed costs of service over a larger customer base.

SCWC has also analyzed the tangible costs and savings of the merger under the terms of the settlement agreement. (Exh. 2-Tab J.) SCWC indicates those savings to SCWC customers which will result from the merger, those savings to Peerless customers which will result from the merger, and those costs which will be shared by both groups (that will be reflected in a Metropolitan District general rate case filed some time after the merger has been completed). This analysis is not intended to be a precise forecast of future water rates, but is an example to illustrate the relative impacts of the merger.

The tangible and identifiable benefits available due to the integration of Peerless into the Metropolitan District include:

1. Elimination of salary expense of $278,731.

2. Elimination of rent for office space of $10,000.

3. Elimination of expense for outside services and contract work of $19,065.

4. Reduced supply expense of $146,175.

5. Reduction in return on rate base and depreciation expense of $68,395. This saving is based on the lower CPUC-adopted depreciation accrual rate (2.89% vs. 3.09%) for SCWC.

6. Eliminate the cost for general liability insurance of $20,555. SCWC will add the Peerless system to its operations without any impact to SCWC's insurance expense.

7. Peerless will have a net shifting of cost recovery from SCWC's customers to Peerless customers for operation costs.

On the other hand, costs that Peerless customers will incur as a result of the integration of Peerless into SCWC's Metropolitan District include:

1. Zastrow consulting contract to pay a retainer for his services $115,000 per year, less dividends received from ASW stock (which actually are expected to exceed $115,000 each year). This cost is estimated at $0.

2. Lost water lease revenues of $86,800. Peerless currently leases out a portion of its water rights that it is unable to use for itself. SCWC will pump these rights in the future and therefore these revenues will be lost (but offset by the greater savings noted above).

3. Federal Income Tax of $9,058. Because of the small taxable income of Peerless, it is taxed at a 15% federal rate. When this system becomes a part of SCWC, the taxable income will be subject to the higher 35% federal rate. To value this cost, SCWC multiplied the 20% tax rate difference times the 1999 Commission-adopted Taxable Income for FIT ($45,290).

4. Premium paid over rate base of $441,414+$11,728+ $39,345. Because the purchase price to be recorded in rate base is at fair market value ($4,039,850 less goodwill of $190,607) while the Peerless rate base ($422,119) reflects original recorded costs, the premium paid ($3,427,124) will be reflected in SCWC's rate base. The return component reflecting a 12.88% before-tax RORB is $441,414; the annual amortization (40 years excluding non-depreciable water rights) is $11,728; and the property tax is $39,345.

SCWC identifies one other quantifiable cost of the merger, Zastrow's supplemental work agreement. In addition to his retainer, Zastrow will be compensated at the rate of $75/hour worked, plus his expenses, an amount which is currently unknown.

SCWC extended its analysis through the year 2025. SCWC applied a 3% inflation factor to most items. In general, SCWC contends the 25-year total net benefits are positive on both a nominal dollar ($13,589,833) and real dollar ($3,873,055) basis. In the first year, there is a net cost as a result of the merger, which is not passed on to ratepayers, but a net benefit in all subsequent years.

SCWC provides rate base calculations to show the impact of the merger. SCWC starts with the purchase price of $4,039,851, less goodwill of $190,607 ($3,849,244) and less the existing Peerless rate base ($422,119), to arrive at the premium paid ($3,427,125). SCWC amortized this premium (an intangible asset), less water rights ($2,958,000, a non-depreciable asset) over 40 years (Uniform System of Accounts treatment) to arrive at the net rate base addition ($3,421,261) in year 2001. This rate base addition resulting from the merger would be reflected in rates, through rate of return and depreciation, after the Commission resolves SCWC's post-merger general rate case.

SCWC made a second calculation for some of those necessary plant additions, as determined by SCWC engineers who inspected the Peerless system.

The improvements for the first five years reflect the projects identified in the

settlement agreement (line 32). SCWC reduced the additions to $195,500 per year thereafter to complete the remainder of the projects identified by SCWC engineers. Increasing the rates to existing Peerless customers by 10% each year from 2002 and 2005 will provide some of these funds. Depreciation expense was calculated using SCWC's adopted 2.89% accrual rate. SCWC contends these plant additions are necessary, and should be done regardless of whether Peerless remains a stand-alone utility or merges into SCWC.

Finally, if Peerless remained a stand-alone utility, it would require additional capital expenditures, such as upgrading their administrative office ($100,000); replacing two trucks, a backhoe, and an air compressor ($125,000); and replacing the computer system ($22,000). Such expenditures can be avoided by this merger.

SCWC plans to serve Peerless customers in its Central Basin East Office, located at 12013 E. Firestone Blvd. in Norwalk. The office is about seven miles from Peerless' existing administrative office and is accessible to Peerless customers for walk-in service. It can handle customer inquiries, complaints, and emergency calls both in person and, to the extent not handled by the centralized customer service center, by telephone. SCWC customer service representatives in this office will be capable of handling all customer inquiries during normal working hours, including requests for turn-on or shut-off, billing inquiries, collection activities, leak reports, meter reading, conservation and public relations, and other local matters. In addition, SCWC has customer service offices in Bell Gardens, Culver City and Carson that may be convenient for some customers to visit during their work day.

ORA's Initial Opposition and Later Support of Merger

ORA initially concluded the application should be denied because the total purchase price is 857% greater than the amount currently in the adopted rate base of $422,119, and this disparity would cause Peerless' revenue requirement to increase by $329,000 per year. (ORA Report, Exh. 9.) ORA agreed that certain savings in expenses of operation would occur as a result of the merger. However, the largest savings is the use of Peerless' water rights to pump additional water instead of purchasing water for the Metropolitan District. There are also savings in operation expenses, since SCWC can provide service to Peerless without incurring additional expense. Offsetting these savings would be the loss of revenue for leasing unused water rights, the amortization expense for the purchase price and increased property taxes.

In sum, ORA initially conceded the expense reductions ($565,600) are greater than the increases ($307,100), resulting in annual cost savings initially projected by SCWC ($258,500). However, when the higher revenue requirement for increased rate base is added, the result is a net increase in costs, which would result in higher rates ($119,163) and would represent a 15.4% increase to Peerless customers. (*Ibid.*, pp. 6-7.)

ORA would disallow goodwill ($190,607) and plant funded by contributions ($6,969) as not properly borne by Peerless' ratepayers. ORA's Report concluded that Peerless customers would pay lower rates if it remained independent, assuming that it made all the improvements proposed for the next five years and experienced normal inflation.

After the PPH, SCWC revised its proposal as summarized earlier. (See above, "Modified Terms per Settlement Agreement.") In addition, ORA became convinced that Peerless could not finance the necessary improvements, and that

therefore, it was better to merge Peerless with SCWC to obtain financing. Based upon this new information, SCWC's recalculation of savings, and SCWC's acceptance of ORA's recommended disallowances, ORA changed its position to recommend approval of the merger.

Opposition of Cities

The three cities who protested the application also filed comments opposing the settlement agreement as unreasonable, unlawful and not in the public interest.

City of Bellflower

Three witnesses, Michael J. Egan, City Administrator, Dan Koops, President of Bellflower Somerset, and M. Kabirr Faal, a consultant employed by Kane, Ballmer & Berkman, testified for the City of Bellflower (Bellflower). (Exh. 10, 17, and 20.) In general, these three witnesses say the Bellflower City Council unanimously opposes the proposed merger because Bellflower considers the request to adversely affect its residents by increasing rates, decreasing customer service, causing unnecessary and unreasonable capital expenditures and creating the potential for the taking of private property to build wells.[2]

Egan makes diverse contentions: that the merger creates no specific operational efficiencies, and the cost savings are speculative and insubstantial; that SCWC has no office in Bellflower and does not propose one, whereas Peerless has an office there; that connecting service to Bellflower Somerset would eliminate the need for new wells; and that the size of SCWC's proposed wells is

[2] These potential well projects would be subject to requirements of the California Environment Quality Act (CEQA), compliance with which is not shown in the application, Bellflower argues.

excessive. Egan testified that Bellflower has succeeded in reducing water purveyors in the city from 20 to 5, in furtherance of its Master Water Plan. (Exh. 14.) Egan indicated SCWC has made overtures to operate a consolidated water system with Bellflower. Thus, he believes SCWC seeks to expand its territory regardless of the effect on customers or the community, while Bellflower seeks to remove redundant service costs.

Egan notes that Bellflower is currently selling its water system to Bellflower Somerset and has authorized the use of city property for a well site because the city is built out. However, Bellflower will not do the same for SCWC, and Egan contends SCWC will need to acquire private property for well sites which may not meet CEQA.

Egan points out that Bellflower Somerset is the largest water purveyor in the city and has the most cost effective service. It has merged with smaller water companies over the years and succeeded in improving service while keeping costs low, contrary to SCWC's proposal. Bellflower Somerset's rates are 60% lower than SCWC's and 40% lower than those of Peerless. Thus, Bellflower Somerset's acquisition of Peerless is better for the community.

Koops rebuts Zastrow's testimony. He contends Zastrow's testimony, viz., that Peerless was formed in 1941 after Bellflower Somerset had denied service to certain houses, is not accurate, as Bellflower Somerset was not in existence at that time. Koops believes Zastrow intended to state that one of the predecessors to Bellflower Somerset, either Somerset Mutual Water Company or Bellflower Mutual Water Company, which merged in 1988 was the entity which purportedly denied service to the referenced homes. Second, Koops contends Zastrow misunderstands the structure of a mutual water company such as Bellflower Somerset. Peerless' customers would become shareholders in

Bellflower Somerset should the mutual purchase Peerless. Customers would then each have a voice in the operation of Bellflower Somerset and in the election of its directors. Lastly, Koops contends that contrary to Zastrow's testimony, the operating and capital costs associated with needed improvements to Peerless' distribution system ultimately will be passed on to Peerless' customers through significantly increased rates proposed in this proceeding, and not borne by SCWC's investors.

Koops refutes Zastrow's statement that Bellflower Somerset would rely on serving new Peerless customers through water purchased from member agencies of the MWD. Koops states that any required infrastructure improvements would be financed by payments by Peerless' present customers at their existing rates, as a result of the significant spread that exists between Peerless' rates and the rates charged by Bellflower Somerset to its existing customers. In addition, Peerless' customers would continue to be served in large part by groundwater produced by Bellflower Somerset's wells. In contrast, the proposed merger with SCWC would necessitate the costly refurbishment of Peerless' existing wells solely because SCWC does not operate a system contiguous to Peerless' system and, therefore, Peerless' existing customers could not be integrated into SCWC's existing system. Over one-half of the projected capital improvement costs relate solely to the refurbishment of those wells or installation of treatment facilities. According to Koops, much of those costs could be avoided if those customers received water from Bellflower Somerset and its existing wells and treatment facilities.

Koops contends that Bellflower Somerset has not experienced the adverse impacts of the purported toxic plume and related water quality issues to the extent Peerless has for two reasons. First, Bellflower Somerset's wells are

deeper than those of Peerless and therefore produce higher quality water. Secondly, and most telling, Bellflower Somerset's distribution system is very well-maintained, as profits are used for maintenance of existing facilities and necessary capital improvements, rather than being distributed to shareholders. Because its distribution system is well maintained, Bellflower Somerset's water does not exhibit the secondary problems of discoloration and odor that Peerless has experienced, which in part results from the accumulation over time of material in Peerless' mains.

Koops explained that Bellflower Somerset has planned to install a new connection with MWD. However, outside funding for the cost of that connection has been received, and those costs will not in any manner whatsoever be passed onto any Bellflower Somerset shareholder or existing Peerless customer.

Koops testified that Bellflower Somerset remains willing and financially able to acquire Peerless at the $4 million price promised by SCWC. (Exh. 22.) Four of the eight Peerless "islands" of non-contiguous service territory are contiguous to Bellflower Somerset. No new wells would be needed, and the replacement of mains could be accomplished without increasing rates. In fact, rates would drop for 20 ccf bi-monthly from the current $43.73 to $29.50 after acquisition and improvement costs are paid. Koops contends the use of Peerless pumping rights by SCWC's Metropolitan District customers will increase import and other costs, and thus increase the rates of Peerless customers. Currently, Park Water Company leases 496 AF of these rights partly to serve Bellflower residents. Therefore, the water rights benefit local customers, who will lose this benefit after the proposed merger, and the water rights are used for SCWC's Metropolitan District.

Faal contends the proposed merger will result in significant rate risks, which would be unfair and unreasonable to impose on ratepayers. He argues that the benefits of consolidation and potential cost savings are both exaggerated and outweighed by the ultimate burdens and risks for Peerless' ratepayers. He contends that Peerless' capital and operating requirements can be fulfilled with less burdensome ratepayer impacts. Faal sees the primary, if not sole, beneficiaries of the proposed merger as the shareholders of each company, Peerless and SCWC. Therefore, Faal concludes the proposed merger should not be approved because it is not in the public interest and is, in fact, harmful to the ratepayers.

Faal notes that, currently, Peerless' rates are 18% lower than rates in SCWC's Metropolitan District, but are 48% higher than those of Bellflower Somerset, 61% higher than those of Paramount and 69% higher than those of Lakewood. Under the settlement, Peerless rates would remain unchanged until January 2002, then they would rise 10% annually until 2005, then they would increase an additional 28.6%[3] when the former Peerless service area is consolidated with SCWC's Metropolitan District. These increases total over 80% in four years. Faal forecasts that by 2005, the rates would be 66% higher than Bellflower-Somerset, 89% higher than Paramount and 97% higher than Lakewood.

Faal says that by including roughly $3 million for the purchase of water rights in rate base, SCWC is severing and "monetizing" water rights dedicated for public use. Faal believes this treatment of water rights is economically

[3] SCWC disputes the amount of this percentage and contends it is closer to 16%.

harmful. Faal presents a chart of recent Commission acquisition cases to support his contention that this price is an unprecedented increase in rate base resulting from a utility merger. (Exh. 18.) Faal interprets the Public Water System Investment and Consolidation Act (Pub. Util. Code §§ 2718-2720) as prohibiting mechanisms to allow shareholders of merging companies to generate unreasonable profits and earnings by merely changing corporate control or ownership. Faal describes the intent of that statute to improve water system reliability, and to achieve efficiencies and economies of scale not otherwise available, not to increase the net book value by nearly 1,000%.

Faal challenges the alleged cost savings and contends that SCWC should guarantee these savings to immunize the ratepayer from ramifications of overly optimistic projections. Further, he believes the proposed improvements are unnecessary. He says the improvement plan fails to consider viable, less costly alternatives.

City of Paramount

The City of Paramount (Paramount) sponsored testimony by Harry L. Babbitt, its Director of Public Works, and William C. Pagett, its City Engineer. Paramount serves 7,256 water customers. Babbitt testified regarding alternatives to this merger which would better serve those 98 Paramount residents who are served by Peerless. Pagett testified to inconsistencies in the applicants' analysis of merger benefits.

Paramount believes the merger does not serve the public interest because it will, ultimately if not immediately, increase the bi-monthly average bill for all SCWC customers, and will not clearly improve the quality of service to customers, since it may take longer for the Peerless system to be upgraded.

Paramount does not believe SCWC's ownership will necessarily improve the quality of service to Peerless customers. SCWC serves 300 accounts in Paramount, which receives complaints from these SCWC customers about water outages, dirty water, low flows and service issues when customers do not receive a response from SCWC's technicians.

Paramount estimates that upgrading the Peerless system will take longer than SCWC contends. The facilities serving each city are isolated. The

Peerless System in the city of Paramount is served by only one well that produces low quality water and low pressure at peak hour demand. Should this sole source of water fail, Peerless customers would be without service until Paramount turns on Peerless' emergency connection to the Paramount water system. SCWC's system within Paramount also needs an upgrade to increase water pressure and fire protection flow. Interconnecting with Paramount's system can immediately increase water pressure and volume, and provide higher quality water to the 98 Peerless customers.

Paramount contends it can serve Peerless customers in Paramount within five minutes of a transfer to Paramount's system. Compared to SCWC, Paramount contends it provides better quality water, and increased water pressure and volume. Connecting to Paramount will reduce the average bi-monthly costs to Peerless customers from $73.51 as of June 30, 2000, to $45.77, and Paramount can upgrade the portion of the system in its city limits within approximately one year, but no more than three years, without having to increase its water rates. In contrast, Peerless customers' bi-monthly bill would increase to $84.01, if the merger is approved.

Paramount also has a positive track record for operations, as evidenced by the outcome of its acquisitions of the Paramount County Water District, Park Water District, Van Diest Water Company, Century Center Mutual Water Association, Community Water Service, County Water Company, Century City Mutual Water Company, and Midway Gardens Mutual Water Company. Pagett managed the transition in the last four acquisitions, and in all of those cases Paramount was able to complete all necessary capital improvements for the newly integrated systems within one to three years.

Paramount contends it can provide better service to Peerless customers within the city because, unlike Peerless' system, the city's system is completely interconnected into a loop monitored by computer. Paramount maintains this state-of-the-art system by regular maintenance and upgrades. It also meets or exceeds standards for fire flow, and it would install more fire hydrants in the former Peerless service area. Paramount has multiple sources of water available to ensure constant and immediate water flow. In addition, the City has two wells, two Central Basin Municipal Water District connections, and emergency ties to the City of Long Beach system.

Paramount contends the alleged benefit of additional pumping rights will not accrue to Peerless customers, since it will be used to supply SCWC's Metropolitan District. Paramount contends this dispersion of Peerless' water rights will minimize any cost savings claimed to result from the merger.

City of Lakewood

Peerless currently serves 105 accounts in the City of Lakewood. Lakewood itself provides water service to 20,112 customers. Lakewood sponsored James B. Glancy, its Director of Water Resources.

Glancy testified that the application proposes significant improvements to the portion of Peerless' system in Lakewood, and that the existing Peerless customers would pay for these improvements. He contends there are alternatives to the merger that are more beneficial to Peerless customers. Lakewood currently provides water service to its residents, and could serve those Peerless customers in its service territory with little or no effort through the transfer of the Peerless system to the city. Lakewood contends it provides better quality water, and increased water pressure and volume at lower cost. Specifically, it will reduce the average bi-monthly water costs to those Peerless

customers from $63.40 to $37.60. Lakewood can make the necessary connections to the Peerless system without a need to increase the water rates.

Lakewood estimates that the transition of the 105 Peerless customers to the city's water system could be accomplished in a matter of a few weeks. The transition would be paid from Lakewood's Capital Improvement Program funds. Lakewood does not believe there is a need to perform any immediate capital improvements after the 105 customers are transferred to its system. Based upon an inspection of the Peerless customers' service area, Lakewood concluded there are sufficient fire hydrants, however, some lines may need to be replaced. Lakewood estimates it would spend $350,000 after several years to replace all pipelines and all service lines up to and including the meter, and provide new fire hydrants. These costs would be part of Lakewood's budgeted capital improvements program.

In addition, Glancy, believes SCWC's estimated $11 million cost of Peerless improvements is extremely high, due in part to an unreasonable number of new wells.[4]

Lakewood recommends that Lakewood and Paramount acquire the portions of Peerless within their cities. Each city has its own water system capable of serving the respective areas Peerless now serves. These cities could provide this service at lower cost than what is being paid now. The acquisition

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[4] According to Glancy, modern supply wells in this basin typically provide 2,500 to 3,000 gallons of water per minute. If you divide the total customer base of approximately 2,000 Peerless customers by five water wells, that is one well for about 400 customers. Currently, Lakewood has sixteen water wells for 21,000 customers, or roughly 1,300 customers per well. Thus, per Glancy, SCWC's proposal of five wells for only 2,000 customers is excessive, costly, and unreasonable.

costs would not be borne by the Peerless customers, and unless there were some extraordinary expenses for improvements, they would be completed at no additional cost to the customer. Lakewood has sufficient well capacity, having completed drilling two new wells in the past five years.

Discussion

We deny the proposed merger because the burdens imposed significantly outweigh the benefits gained. We base this conclusion on our analysis of the facts under criteria applicable to settlements and mergers.

The proposed settlement is opposed by three parties; as a practical matter, therefore, this is a hotly contested proceeding in which some of the parties (the applicants and ORA) ultimately presented a joint position. Our standard for review of settlements is in Rule 51.1 of the Commission's Rules of Practice and Procedure. This rule requires that a settlement be reasonable in light of the entire record, serve the public interest and not contrary to applicable law. Regarding the public interest aspects of a merger, our test for approval is that the merger is not adverse or injurious to ratepayers. (*Re Merger of California Water Service, Dominguez, Kern Valley and Antelope Water Companies,* D.00-05-027, affirmed on application for rehearing in D.00-09-042, p. 5.)

Furthermore, whether or not a proposed merger is embodied in a settlement, the operator of the combined utility system must have the technical, managerial, and financial capability to run the system. Finally, specific criteria for a water utility merger have evolved in our interpreting the Public Water Systems Investment and Consolidation Act of 1997. The stated purpose of the statute is to provide incentives for acquisition of water systems where the acquisition would help the system to replace or upgrade its infrastructure to meet increasingly stringent state and federal safe drinking water laws and fire

flow standards. (See Pub. Util. Code § 2719.) The means by which the statute would accomplish this purpose is to allow into rate base the full "fair market

value" of utility property, when "fair market value" is paid as the purchase price. In effect, an amount in excess of the book value of the purchased plant may be used as rate base for ratesetting purposes as an incentive for taking on the responsibility of upgrading an inadequate, troubled water system. (See Pub. Util. Code § 2720.) However, we have noted a limit to the reasonableness of this type of incentive. In *Pine Flat and Pine Mountain Water Companies*, D.00-01-018, we concluded that when a new rate base amount is unreasonable and unfair as a result of applying the new "fair market value" standard considering the future benefits received, we retain authority to deny a merger.

In the motion to approve the settlement, applicants and ORA contend the settlement meets all required criteria. In responses opposing approval, the cities contend the settlement would result in unreasonable rates and unnecessary improvements, contrary to the public economic interest and to various statutes, such as CEQA. They also contend that the acquiring company often does not respond to customer complaints, and therefore fails the criterion of managerial competence. Thus, the cities are saying the merger meets none of the criteria, i.e., that it is not reasonable, lawful, or in the public interest. We agree with the cities that the sale of Peerless to SCWC is not in the public interest and thus should be denied. We address each of these criteria below.

Reasonableness

Peerless' current total rate base is $422,119. Adjusting the rate base to reflect almost the entire purchase price (about $4 million), per the settlement, results in a net increase in rates of $119,163, or 15.4%, solely attributable to the merger. This 857% increase in rate base raises a serious question over whether the effect of the merger on Peerless' existing customers is fair and reasonable. (See Pub. Util. Code § 2720(b).) As Bellflower's witness Faal notes, the highest

recent increase in rate base as a result of a merger is 81.8%. Customers would have to pay the pay the authorized return on this increase. We have previously concluded that where rate base "write-ups" lead to unreasonable rate increases without commensurate benefits, we have the authority to deny the merger. (*Re Merger of California Water Service, Dominguez, Kern Valley and Antelope Water Companies,* D.99-09-030, p. 5, Conclusions of Law 4 and 5.)

We consider these purchase price-related and Merger Plan increases to be unreasonable. Moreover, when coupled with the potential further increase of 16-28% when Peerless is merged with SCWC's Metropolitan District, the cumulative increase in rates is extraordinarily onerous.

The appraised value of the water rights in December 1996 was $2,700 per AF. (Exh. 2, Tab G-Perry Appraisal, p. 1.) More recent water transaction have ranged as high as $3500 per AF (Exhibit 2, p. 3 and Exhibit 2, Tab E.) These transactions indicate that a valuation of $3000 per AF is reasonable.

SCWC indicated that it will use the excess water rights belonging to Peerless to serve Metropolitan District customers, since once the merger is approved these water rights belong to all SCWC customers. If roughly half of the water rights are used for Metropolitan District customers at no cost, this is not a benefit for Peerless customers but rather a burden. It effectively places the 2,000 Peerless customers in the position of subsidizing the water supply of 98,000 Metropolitan District customers before the districts are consolidated. This is unreasonable.

SCWC contends the merger would provide important non-quantifiable benefits, such as the ability to finance needed improvements. SCWC proposes to finance $ 2.64 million in improvements within 5 years and $11.5 million in improvements eventually. With only 2000 current connections, this

improvement plan would result in stunningly high per-connection investments. However, the cities provide persuasive evidence that the Peerless system is mostly in satisfactory condition. While it is true that five operating wells are inactive due to contamination, there are five operating wells and others used for emergencies. No party presented evidence that current water quality is in violation of DHS primary standards or threatens to be so in the future. Complaints regarding secondary standards, coloration, leaks and low pressure, were investigated and traced to customer plumbing, not Peerless' pipes. Moreover, in the last 6-7 years, DHS has inspected the entire system and declared it to meet all existing standards. DHS reports of the Peerless system show that it has few leaks or customer complaints, and has adequate capacity to meet customer demand. In 1994 and 1999, DHS reported that Peerless was meeting all obligations to provide safe, potable water. (Exh. 4 and 5.) This is persuasive evidence that this system is not in such poor condition that we need be concerned with immediate financing for major improvements. Thus, Peerless is not the type of utility contemplated by § 2719 as needing timely merger strategies in order to provide safe, adequate service. Moreover, Zastrow is selling the company because he is retiring, not because he is unable to run and maintain it.

City engineers provided persuasive evidence that some of the proposed improvements are not needed, or are significantly inflated. In fact, all of the cities believe the needed improvements in their respective cities could be paid within their existing budgets, each of roughly $500,000 per year.

We also find the need for new wells to replace contaminated wells could be eliminated by connecting Peerless to the cities' systems, which due to their deeper wells are not experiencing contamination. Moreover, if the

problems of discoloration and low pressure are attributable to old customer pipes, as Peerless complaint investigations and DHS reports indicate, spending $11 million on improvements to Peerless' system will not alleviate these problems. Thus, the record shows that SCWC's proposed improvements are unnecessary, and rate increases to support those improvements are unreasonable.

In summary, the proposed rate base increases, need for improvements and estimate for improvements are unreasonable. Peerless is not a troubled water system in need of rescue, and the large rate increase due to the merger and capital improvement plan dwarfs any economies that the merger might provide. In particular, the capital improvement plan, inseparable from this proposed merger, would lead to extremely high per customer investment levels. Even though SCWC would eventually average these new investments and resulting revenue requirements into its larger Metropolitan District, this serves only to hide the economic impracticality of the merger and investment plan proposed by SCWC and Peerless. Moreover, as we discuss later, economies of scale may be realized by alternative means, without the large rate increase due to the merger.

Consistency with Applicable Law

SCWC contends that the well construction it proposes will have no significant impact on the environment because it already has numerous existing wells, implying an exemption from the requirements of CEQA because it will build near these facilities, or on the same sites. However, Bellflower contends there is no assurance that sites near present wells can or will be obtained. We need not address or resolve these environmental issues at this time since we conclude the proposed merger must be denied.

What we do resolve now is that the proposed merger and capital improvement plan would lead to a per customer rate base attributable to former Peerless' customers that greatly exceeds any previously found reasonable for a

water company. It will greatly increase rates without adequate benefits to offset the increases. Consequently, we cannot find the resulting rates to be just and reasonable, as § 451 requires, nor can we find the proposed merger meets the criteria set forth in § 2720(b). We conclude the merger is inconsistent with applicable law.

Public Interest

Public policy, as set forth in statute and Commission decisions, favors acquisition of technically or financially challenged water utilities by other providers with adequate resources and the potential to realize economics of scale. We have already found that Peerless is not a troubled water system, but to the extent that transfer of ownership is desirable, other suitable providers appear ready, able, and willing to acquire Peerless.

Three cities in Peerless' service territory request to acquire the Peerless facilities in their respective cities. Negotiations between one city, Bellflower, and Peerless failed because the owner of Peerless was not motivated to sell to this city. These cities request an opportunity to connect to Peerless and provide service at cheaper rates immediately upon acquisition.

Each city has existing physical connections to Peerless for emergency purposes. Lakewood and Paramount already operate water systems with few customer complaints, and have city engineers with the technical expertise to successfully operate Peerless. The same can be said of the mutual water company in Bellflower. These water providers also have the financial means to acquire and maintain Peerless. (Exh. 27, 31, and 32.) Connecting with any one or all of these three cities will immediately result in lower rates to the Peerless' customers.

Zastrow's concern that the acquisition of Peerless by Bellflower Somerset would require customers to purchase shares in the mutual was adequately addressed. As Koops testified (Exh. 21), this requirement may be met by charging each customer as little as $1, and may be collected in the regular customer bill. Therefore, any requirement to purchase shares in a mutual water company is not a deterrent for low-income or fixed-income customers.

Bellflower also indicated that capital improvements are not financed by a mutual water company through special assessments, which increases rates, as Zastrow presumed. Such improvements are financed from city budgets, retained earnings and city loans. Therefore, they do not affect rates.

The advantages of connecting with one or all of these cities are obvious, especially when considered in light of the proposed merger and investment plan. Under this plan, rate base will immediately increase from approximately $420,000 to $4 million. Over the next five years, a capital improvement plan will lead to another $2.64 million in investments. This will eventually rise to $11.5 million, an enormously costly investment program to provide water service to approximately 2000 customers. We find that it is wasteful for numerous purveyors to construct duplicate facilities and connections throughout these cities. It is clear that operating the water system as proposed by SCWC is extremely costly. In counterpoint, we note that Bellflower has successfully reduced this number of purveyors from twenty to six in its city within recent years. To grant SCWC's acquisition of Peerless does nothing to reduce the number of purveyors. However, since we have no authority to force Peerless to sell to one or all of these cities, we only note that such a sale would greatly benefit the Peerless customers and lead to a rationalization of water service.

Accordingly, we find the merger is not in the public interest. If the current ownership of Peerless wishes to transfer the utility, it must do so under terms and conditions that better fit the public interest as set forth in this decision.

Comments on Proposed Decision

The proposed decision of Administrative Law Judge Bennett in this matter was mailed to the parties in accordance with Pub. Util. Code § 311(d) and Rule 77.1 of the Rules of Practice and Procedure. Comments were filed on October 25, 2001 and reply comments were filed on October 30, 2001.

The comments of SCWC and Peerless assert that the merger will result in savings, not costs for ratepayers, and that the initial capital investment program is only $2.64 million, not the $11.5 million identified by SCWC engineers and cited in the proposed decision of the presiding officer. SCWC and Peerless further assert that a valuation of water rights at $3000 per AF is reasonable. In addition, SCWC and Peerless argue that as a matter of policy, the Commission should not exhort Peerless to "break apart its service territory." SCWC and Peerless conclude by urging the Commission to accept the January 26, 2001 ORA, SCWC, and Peerless merger settlement.

ORA asserts that the settlement is fair and reasonable because "Peerless has neither the financial nor the technical ability to make necessary improvements to its system." ORA concludes that the settlement is fair to consumers and that the acquisition of Peerless' water rights "would reduce the expense of purchasing water for customers in SCWC's Metropolitan District."

Bellflower, Lakewood, and Paramount jointly offered opening clarifying comments.

In reply comments, Paramount and Lakewood assert that the "cost saving projections are inherently speculative and insubstantial." Paramount and

Lakewood point out that the $2.64 million initial capital investment program is part of an $11.5 million capital improvement program. They note that their "state of the art water systems" could serve those customers of Peerless within their cities with integration requiring only modest investments. Finally, they note that in contrast to speculative costs savings, rate increases are certain and large.

In reply comments, Bellflower points out that under the merger settlement, Peerless' customers are "guaranteed a minimum increase of 62% from existing rates by 2005." Bellflower notes that this increase results in large part from the large investment plan proposed by SCWC. Bellflower characterizes this plan as unnecessary, whether we consider the 5-year $2.64 million plan or the eventual $11.5 million plan. Similarly, Bellflower points out whether water rights are valued at $2700 per AF or $3000 per AF is not material to the reasonableness of the proposed merger plan and the resulting rate increases.

Finally, Bellflower argues the SCWC is simply wrong in its claim that denying the merger is bad public policy. Bellflower points out that despite the allegations of SCWC, the Bellflower-Somerset Mutual Water Company is substantially regulated by federal and state health agencies and by an elected board of directors.

We have weighed the comments of all parties carefully and have revised the decision at various points to insure its conformity with the record and facts of the case. Nevertheless, the central findings of the proposed decision remain unchanged. The findings stand because the merger and proposed investment plan result in an immediate $3.6 million or 857% increase in rate base, and $2.64 million in new investments over 5 years. This requires rate increases of 62% over the next five years. Subsequently, investments will rise another $8.9 million to a

post-acquisition total of $11.5 million. With only 2000 customers, the per customer investment resulting from this merger and improvement plan is clearly excessive. The subsequent blending of this costly acquisition into the larger Metropolitan District serves only to disguise the fact that this acquisition plan has costs so high that operations are not sustainable without cross subsidies from other ratepayers. In this context, determining whether $2700 per AF or $3000 per AF is the appropriate assessment of water rights remains immaterial to our analysis of the merger. We conclude that approving this merger leads to unreasonable rates and investments, and is not in the public interest.

Findings of Fact

1. SCWC requests authority to acquire control and ownership of Peerless by a tax-exempt stock exchange for $4,039,851, which includes water rights, land, and infrastructure, less any amount of debt owed by Peerless to the owner, J. William Zastrow, on the closing date.

2. The water rights, valued in the merger agreement at $2,958,000, consist of 986 AF of allocated water pumping rights in the Central Basin in Los Angeles County, pursuant to the Judgment of Los Angeles Superior Court (Case No. 786656, dated October 11, 1965). These water rights are not currently in rate base.

3. The water rights are appraised for $2,700 per AF in December 1996. More recent transactions indicate that a value of $3,000 per AF is not unreasonable.

4. The land being sold is six parcels of real property, on which are located active wells. The total appraised value of these well sites is $226,380. The market value of this land exceeds Peerless' current book value of the parcels, which is $8,693.

5. The remaining assets include 13 wells, 83,670 linear feet of cement and welded steel mains, approximately 2,000 meters, and service connections. They

had a net book value of $285,029 at year-end 1999 and a market value that exceeds the appraised value of $855,470. In addition, goodwill is appraised at $190,607.

6. Other major terms of the merger agreement are: $115,000 annual consultant fees to William Zastrow, Peerless' owner, for transition services, plus $75 per hour for any other work; purchase land personally owned by Zastrow for $104,000 not to be used in utility service; within five years perform specified improvements estimated at $2.64 million, with rates increased 10% per year to pay the return on rate base for these improvements; place Peerless on the higher tariff of Metropolitan District upon merger approval. Subsequently, another $8.9 million will raise total post merger investments to $11.5 million to serve only 2000 connections.

7. The Cities of Bellflower, Paramount and Lakewood filed protests to the application. They are ready, willing and able to provide service to the Peerless customers in their cities at rates lower than existing and proposed rates, including needed improvements.

8. The overwhelming majority of Peerless customers oppose the proposed merger.

9. ORA and applicants entered into a settlement agreement and filed a motion to approve it. The settlement agreement modifies the terms of the merger agreement to exclude goodwill, and to record water rights as intangible assets amortized over 40 years. They also agree that: Peerless' rates should be frozen at their current level through 2001; SCWC guarantees it will make specified improvements to Peerless' system over the next five years; SCWC should be allowed to request an increase in Peerless' rates for a maximum of 10% annually, provided scheduled improvements are completed; and Peerless

customers will join SCWC's Metropolitan District in 2005, provided the specified improvements have been completed.

10. Bellflower, Paramount and Lakewood oppose the settlement agreement for the same reasons they protested the application.

11. The increase in rate base that would result from the proposed merger is 857%, which is significantly greater than the increases authorized in recent water merger cases.

12. The proposed merger would effectively place Peerless customers in the position of subsidizing water supply to SCWC's Metropolitan District for the years until Peerless is consolidated with the district.

13. Lakewood, Paramount, and Bellflower have demonstrated that the size of the proposed wells is inflated by at least 50%.

14. Peerless received reports from DHS in 1994 and 1999 that the system meets all state requirements for water supply and quality. Therefore, Peerless is not a system intended to qualify for special incentives to acquire.

Conclusions of Law

1. The fair market value of land, facilities, and water rights proposed by applicants approximates reproduction cost new less depreciation.

2. The proposed post-acquisition investment program leads to per connection investment levels that are unreasonable.

3. The proposed merger as proposed and as revised by the settlement agreement is unreasonable, not in the public interest, and contrary to existing law.

4. The proposed merger is injurious to Peerless customers.

5. The motion to approve the settlement agreement between applicants and ORA, which would authorize the proposed merger, should be denied.

6. This order should be made effective immediately, so that Peerless can promptly begin discussions regarding the ultimate disposition of its water system.

O R D E R

IT IS ORDERED that:

1. The motion to approve a settlement agreement is denied.
2. The request to approve the proposed merger is denied.
3. This proceeding is closed.

This order is effective today.

Dated November 29, 2001, at San Francisco, California.

LORETTA M. LYNCH
President
HENRY M. DUQUE
RICHARD A. BILAS
CARL W. WOOD
GEOFFREY F. BROWN
Commissioners