

Decision 01-11-070

November 29, 2001

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

Application of Citizens Utilities Company Of California (U-87-W), a California corporation, and California American Water Company (U-210-W), a California corporation, for each of the following orders:

1. Authorizing Citizens Utilities Company of California to sell and transfer all of its water utility assets and indebtedness to California-American Water Company; Authorizing California-American Water Company to acquire all of the water utility assets and indebtedness of Citizens Utilities Company of California and thereafter to engage in and carry on the water utility business and service to the Customers of Citizens Utilities of California;
2. Authorizing Citizens Utilities of California to withdraw from the water utility business; and
3. For related relief.

A.00-05-015  
(Filed May 16, 2000)

A.00-05-016  
(Consolidated)

**ORDER DENYING APPLICATION FOR REHEARING  
OF THE OFFICE OF RATEPAYER ADVOCATES  
AND APPLICATION FOR REHEARING AND REQUEST FOR STAY  
OF THE MONTARA SANITARY DISTRICT OF DECISION 01-09-057**

**I. SUMMARY**

On September 24, 2001, Decision (D.) 01-09-057 which we issued on September 20, 2001, was mailed. The decision became immediately effective upon its issuance.<sup>1</sup> On October 4, 2001, the Commission's Office of Ratepayer Advocates (ORA)

<sup>1</sup> Pub. Util. Code, § 1731.

and the Montara Sanitary District (MSD), both parties in the underlying proceeding, timely filed applications for rehearing of D.01-09-057. MSD also filed a request for stay of that portion of D. 01-09-057 that pertains to the Montara District.<sup>2</sup> Responses to the MSD and ORA applications were filed by Citizens Utilities Company of California (Citizens) on October 9, 2001 and by California-American Water Company (CalAm) on October 12, 2001. This order disposes of both applications for rehearing of D. 01-09-057, and denies MSD's request for a stay.

## II. BACKGROUND

D.01-09-057, among other things, authorizes the acquisition of all of the water utility assets of Citizens and its California Safe Drinking Water Bond Act Loan indebtedness by CalAm. Subject to certain conditions, including use of an alternative sharing proposal in future ratesetting proceedings concerning the assets at issue, the decision authorizes CalAm to immediately acquire all of Citizens' California water utility assets pursuant to the terms set forth in the Asset Purchase Agreement of October 1999 and assume all of Citizens' public utility obligations concerning water service. It also relieves Citizens of its water public utility obligations. Among those assets which CalAm is authorized to acquire from Citizens are those in the Montara District in San Mateo County, as well as in the Larkfield District in Sonoma County, the Felton District in Santa Cruz County and various areas in Sacramento County. For purposes of the joint application all four California districts are considered as one asset and are valued at \$161.33 million. The total purchase amount for all assets that CalAm is acquiring from Citizens is \$835 million. (Asset Purchase Agreement (October 15, 1999), § 2.6.1.) The

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<sup>2</sup> "MSD is a public agency providing sanitary service to the unincorporated communities of Moss Beach and Montara and surrounding communities. In 1992 voters agreed to give the sanitary district the additional powers of a county water district that may do any act necessary to furnish sufficient water for present or future use, including storage and conservation of water, or to appropriate, acquire, and conserve water and water rights for any useful purpose." (*In the Matter of the Application of Citizens Utilities Company of California for Approval of its Water System Master Plan Update for its Montara District* (2001) \_\_\_ Cal.Puc.2d \_\_\_, D.01-09-055, at 6-7 (A.00-10-049).)

acquisition premium for the California assets is valued at \$64.7 million. The acquisition premium includes \$1.2 million related to acquisition related costs.

### **III. DISCUSSION**

ORA contends the decision is unlawful on two grounds: 1) Citizens and CalAm failed to meet their burden of proof, and 2) the benefits the decision allocates to ratepayers are illusory.

MSD has raised the following allegations of legal error in reference to D. 01-09-057: 1) failure to consider all relevant factors and failure to adequately explain the basis for the decision; 2) failure to provide separately stated findings of fact and conclusions of law on all material issues in violation of statutory requirements; 3) failure to comply with Public Utilities Code section 2720; 4) authorization of a discriminatory ratemaking mechanism in violation of statutory law; 5) failure to establish just and reasonable rates in violation of statutory law; 6) failure to minimize long term costs of reliable water service in violation of Public Utilities Code section 701.10; and 7) failure to adequately consider whether the purchase of utility property at issue in the underlying matter is in the public interest in violation of provisions of the Public Utilities Code.

As discussed below, neither applicant has established that the decision contains legal error and there is no cause to order a rehearing in this matter or to stay the decision.

#### **ORA Issues**

ORA contends that the applicants, Citizens and CalAm, have not met their burden of proving that the merger is justified. ORA does not argue what the legal standard of evidence is that applicants failed to meet but it appears from its argument that ORA does not believe that applicants have established their case by even a preponderance of the evidence. A person or corporation seeking to merge, acquire, or control any public utility operating in California has the burden of proof and must

demonstrate by a preponderance of the evidence that the requirements of subdivisions (b) and (c) of Public Utilities Code section 854 are met. (Pub. Util. Code, § 854(e).) ORA argues that the applicants have not proven that the alternative sharing proposal (the ratesetting mechanism) adopted by the decision will likely result in any net merger benefits to ratepayers. In our decision, we reviewed the estimated net benefits to ratepayers at pages 31-33 (Tables 2 and 3) and determined that "... ratepayers would receive a benefit equivalent to 67%, 54%, or 51% of the synergies savings in this comparison [through 2041]..." and that under the net present value of the total net benefits, ratepayers would receive 41% to 55% of the total benefits. Moreover, the record shows that although ORA did not agree with CalAm entirely on its calculation of the likely net benefit to ratepayers, nor on the likely synergies benefit calculation, it did agree that ratepayers would receive net benefits of at least 43%. We cannot reconcile ORA's position during the proceeding that ratepayers would receive net benefits, with its position on rehearing that ratepayers will not receive any benefits.

ORA initially took issue with much of what was presented in CalAm's synergies analysis. It later came to closure with CalAm on its late-proceeding estimate of achievable synergies, agreeing that estimate is appropriate for the purpose of evaluating the acquisition. Apparently relying largely on CalAm's synergies analysis and its own net present value calculations, ORA estimated that under CalAm's alternative sharing, ratepayers could receive about 43% and Applicants 57% of the approximately \$101 million in net present value attributable to the acquisition. ORA concluded that the share offered to ratepayers was inequitable and/or not sufficient to overcome the risk that the projected synergies may not materialize, and recommended the Application be denied. ORA did not present a quantitative analysis that addressed what an equitable allocation of the benefits due to the synergies in this case would be.... (D.01-09-057, at 31.)

ORA has argued that the evidence CalAm produced and upon which we based our determination is not supportable because it includes "stayout benefits,"

something we rejected as a benefit to ratepayers.<sup>3</sup> ORA raised this issue during the proceeding as well. We discuss the calculations upon which we base our determination of the benefits of this acquisition in the challenged decision at pages 29-33 and the various calculations are set forth in the three tables therein.

In the challenged decision we note that “the largest share of the quantifiable benefits from the Application sharing proposal [which is not the mechanism we adopted] were said to be about \$25 million in stayout benefits...;” and we rejected the concept that the stayout benefits should be given weight as a quantifiable benefit. (*Id.*, at 34.) As noted in the decision, certain of the calculations in Tables 1,2 and 3 include stayout benefit calculations. (*Id.*, at 35.) Nonetheless, we specifically stated: “In each case the stayout adjustments, while significant, do not change the conclusions we reach from those tables. Ratepayers stand to receive a smaller amount if the stayout benefits are disregarded, but still an amount approaching one-half of the net benefits generated by the acquisition.” (*Id.*) Thus, although the stayout benefits were included in the tables, their inclusion does not constitute legal error justifying rehearing since we took this into consideration in making our determination as to the likely benefits ratepayers will receive. Regardless of whether the stayout benefits had been included or not, the outcome would have been the same. ORA’s argument that applicants “have failed to prove that the mechanism used to allocate merger benefits between shareholders and ratepayers will likely result in any net merger benefits to ratepayers” is not supported by the record.

### **MSD Issues**

Although MSD raises numerous issues, they all concern essentially two themes: 1) that the unique history of service problems and high rates plaguing the Montara District over the decades are material issues in this proceeding, and 2) the likely

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<sup>3</sup> Stayout benefits are “those benefits arising from CalAm’s commitment to forego filing general rate case applications for increases effective through 2005.” (*Id.*, at 33.)

rates that will result from our adoption of the alternative sharing mechanism will be unjust and unfair to Montara District ratepayers. By D.01-09-057 we approved the acquisition of Citizens' California water utility assets by CalAm, and CalAm's alternative sharing mechanism, which is a ratesetting method to be used in future ratemaking proceedings concerning these assets. The Montara District is one of the four California assets at issue, the issue before us concerned the acquisition of all of Citizens' California water utility assets, including those in the Montara District. Although MSD repeatedly sought to make Montara District a principal issue in this proceeding, most of the issues MSD raised were addressed in Citizens' application proceeding (A.00-10-049) for approval of its Water System Master Plan Update for the Montara District, which was held concurrently with the underlying proceeding. (We rejected MSD's March 2001 request to consolidate the two proceedings,<sup>4</sup> and we issued D.01-09-055 in A.00-10-049 on the same day as the challenged decision.)<sup>5</sup>

We did not approve Citizens' Master Plan in A.00-10-049, and by D.01-09-055, we approved a revised Master Plan of Improvement for the Montara District, "estimated to increase rates by slightly less than one-half the requested amount." (D.01-09-055, at 2.) Further, in D.01-09-055, we rejected MSD's contention that the resulting rates for the Montara District from the improvement plan would be excessive. (*Id.*, at 28.)

The absolute level of a rate under the law does not make it either reasonable or unreasonable. The reasonableness of a rate depends upon whether it will provide the utility with a reasonable opportunity to recover all of its prudent costs and to earn a reasonable return, and at the same time provide the customer with reasonable service. We herein conclude, based on the record, that the modified Master Plan and corresponding revised estimated costs are reasonable. In the future when Citizens requests to place projects

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<sup>4</sup> D.01-09-057, at 59.

<sup>5</sup> D.01-09-055 was mailed on September 25, 2001. No applications for rehearing of D.01-09-055 have been filed.

into rate base, it must demonstrate that its implementation of the plan was reasonable and must justify any cost overruns. The Commission will establish rates only after the completion of the Master Plan projects, at which time MSD, ORA, and others may challenge allowance in rates of overruns or other costs incurred imprudently. (*Id.*)

As noted, MSD has not challenged D.01-09-055. In this proceeding, as in A.00-10-049, it argues that the Montara District should be consolidated with other districts “to share common administrative and general services to minimize the rate impact of the improvements,” which would have a similar effect as single-tariff pricing. (See e.g., D.01-09-055, at 21.) In A.00-10-049, Citizens indicated that it would explore district consolidation so that Montara District’s costs could be spread over a larger group of ratepayers, and MSD has not provided any information suggesting that CalAm is adverse to this consideration. (D.01-09-055, at 27.) In *Greyhound Lines, Inc. v. Public Utilities Com.* (1967) 65 Cal.2d 811, the California Supreme Court declared: “Every issue that must be resolved to reach that ultimate finding is ‘material to the order or decision,’ and findings are required of the basic facts upon which the ultimate finding is based. [Citations.]” (65 Cal.2d, at 813.) Issues concerning the possible future rates of the Montara District are not necessary for us to resolve in this proceeding concerning approval of the acquisition of Citizens’ assets. “[T]his is not a proceeding to set rates; the specific level of rates and quality of service in Montara are not at issue except to the extent that the acquisition itself could have a positive or negative impact on them.” (D.01-09-057, at 59-60.) MSD’s Montara District-specific issues are not material issues in this underlying proceeding. The ratemaking issues of concern to MSD belong in the next Montara District ratesetting proceeding; at this point they are premature.

Acquisitions of public utility assets are governed by Public Utilities Code section 851, *et seq.* Although the provisions of Public Utilities Code section 854(b) and (c) are not applicable in the case of water utilities, pursuant to an ALJ ruling each of the section 854(c) criteria was at issue in this proceeding. (D.01-09-057, at 51.) MSD appears to take issue with certain of the section 854(c) criteria, as they pertain to the

Montara District. Many of the issues raised by MSD particularly regarding section 854(c) issues were, as discussed above, the same issues it raised in A.00-10-049. The record shows that although we resolved these issues differently than MSD had hoped, they were adequately addressed. (D.01-09-057, at 56-62.)

MSD also contends that the challenged decision violates Public Utilities Code section 2720 by failing to make required findings regarding market value. The challenged decision states: “[s]ince CalAm proposes an alternative ratemaking method, the [s]ection 2720(b) provision regarding market value in excess of reproduction cost is not at issue.” (D.01-09-057, at 25.) Nonetheless, MSD argues that the decision fails to make a determination that the fair market value is just and reasonable. Public Utilities Code section 2720 does not contain any provision requiring the Commission to make any particular type of findings without the Commission first exercising its discretion regarding reproduction costs. It does require use of the “fair market value” standard set forth in Code of Civil Procedure section 1263.320 for ratesetting purposes, but it does not require the Commission to find that the fair market value is fair and reasonable except under one particular circumstance. In the event that the “fair market value exceeds reproduction cost, as determined in accordance with [s]ection 820 of the Evidence Code, the [C]ommission may include the difference in the rate base for ratesetting purposes if it finds that the additional amounts are fair and reasonable.” (§ 2720(b), emphasis added.) If the Commission exercises this discretionary option and includes the difference in the rate base, then in determining whether the additional amounts are fair and reasonable the Commission is mandated to take the following four factors into consideration:

- 1) whether the acquisition of the public water system will improve water system reliability;
- 2) whether the ability of the water system to comply with health and safety regulations is improved;
- 3) whether the water corporation by acquiring the public water system can achieve efficiencies and economies of scale that would not otherwise be available; and

- 4) whether the effect on existing customers of the water corporation and the acquired public water system is fair and reasonable. (§ 2720(b).)

By the challenged decision we determined that the entire purchase price of \$835 million that CalAm will pay to Citizens, not only for its California water corporation assets, but also for its regulated and unregulated water and wastewater assets in five other states was the result of arms-length negotiations, and represents the fair market value for those assets. (D.01-09-057, at 25 and 64-65, Finding of Fact, No. 1.) A little over nineteen percent of that total amount, or \$161.32 million, is the portion allocated to the California assets. In Finding of Fact No. 2, we stated that the “method of allocating the purchase price to California is reasonable, and the resulting \$161.32 million price allocated to California assets represents fair market value of those assets.” (*Id.*, at 65.) We also stated that “[a]fter taking into account the book value of Citizens’ assets and the portion of the premium attributable to unregulated assets, the parties generally agree the acquisition premium for California regulated assets would be 64.553 million.” (*Id.*, at 25.)

The Commission is obligated to make the four findings required by section 2720(b) only if the fair market value exceeds reproduction costs and the Commission includes that amount in the ratebase. As can readily be seen from the record, the question of whether the fair market value exceeded reproduction costs (i.e., the cost of replacing or reproducing the existing improvements on the land at issue), was not at issue.

MSD asserts that the Commission failed to undertake an independent analysis of the fair market value of Citizen’s California water utility assets. Nothing in section 2720 requires the Commission to undertake an independent analysis and it appears from the record that the parties did not contest the purchase value of the assets. (*Id.*) MSD has not provided any calculations or other specific information as to the correctness of the value, and has not established that the value is erroneous. MSD’s

assertion that the Commission was obligated to make the findings required by section 2720 and failed to do so is without merit.

MSD also contends that the challenged decision is erroneous because it violates state policy set forth in Public Utilities Code section 701.10, by approving a ratemaking mechanism that will permit CalAm to set rates above the cost of service for the next 40 years. It further argues that the Commission did not clearly articulate its basis for adopting the ratemaking mechanism; however, the decision is replete with references to our basis for adopting the alternative sharing proposal. As we stated many times in many ways in D.01-09-057:

... CalAm's alternative sharing proposal is more favorable to ratepayers in terms of reducing revenue requirement than the '§ 2720 Return On Only' and '§ 2720 Return Of and On' alternatives, and far better than the No-Acquisition alternative.... CalAm's alternative sharing proposal delivers to ratepayers roughly half the synergies savings generated by the acquisition and is far better for ratepayers than the No-Acquisition alternative.... Of the three [s]ection 2720-compliant acquisition ratemaking treatments, CalAm's alternative sharing proposal is best because it is the only one which does not increase rates at any time, yet it provides comparable rate decreases for the indefinite future." (*Id.*, at 62.)

Adoption of the alternative sharing proposal is within our discretion and the record demonstrates that it violates neither law nor public policy. MSD does not disagree with Conclusion of Law No. 12 that "CalAm's acquisition of Citizens' water utility assets is in the public interest," but contends that the Commission failed to evaluate on an individual district-to-district basis whether the acquisition of the Montara system (or any individual system) serves the public interest. (MSD application, at 7 and 28; see also, D.01-09-057, at 72.)

MSD further argues that approval of a ratemaking mechanism that permits CalAm to recover its acquisition premium equally from ratepayers in all four of the districts it acquires by the challenged decision is harmful to Montara District ratepayers because their circumstances are different than those in the other districts. For example,

MSD argues that Montara District ratepayers have a history of services problems, as well as rates in excess of those set in the other districts CalAm is acquiring. MSD also believes that Montara District rates are likely to increase in the future because of capital improvements authorized in A.00-10-049. Finally, MSD contends that there is no evidence that CalAm paid any acquisition premium for the Montara District facilities, and, without citing to the record, it believes that there is “substantial and compelling evidence that no such premium was paid or can fairly be allocated to Montara District facilities.” (MSD application, at 23.)

MSD is correct that the challenged decision does not evaluate the acquisition of the Montara District on an individual basis, and while this is an accurate assertion, it does not constitute legal error. As discussed above, this proceeding was not about the numerous issues raised by MSD in A.00-10-049 and/or those that are more properly the subject of a rate proceeding for the Montara District.

MSD points out that Montara and the other three districts are considered separate entities for ratemaking purposes and for this reason “there is no way for the Commission to fairly or accurately assess public interest considerations affecting ratepayers in the different districts involved without carefully considering the particular facts and circumstances pertaining in each such district on an individual basis.” (MSD application, at 28.)

In addition, it argues that the Commission is also required to determine whether the transaction at issue offers ratepayers some equitable share of the benefits the transaction will generate, and cites page 28 of the challenged decision, presumably as proof the decision fails to do this. (*Id.*) However, at page 28 of D.01-09-057 we stated:

We find that a transaction subject to [s]ection 2720 should offer some equitable share of the benefits the transaction will generate. This is entirely consistent with [s]ections 2719(c) and (d) .... Reflecting an ‘equitable sharing of benefits’ standard does not speak to whether those benefits should be entirely quantifiable, entirely non-quantifiable, or some combination of both.

Applying [s]ection 2720 places a cost on ratepayers: that of supporting a rate base higher than it would otherwise be because it is set at fair market value. CalAm's [s]ection 2720-compliant alternative sharing proposal similarly places a cost on ratepayers: that of paying through rates a return of and on the acquisition premium... CalAm, however, represents its alternative sharing proposal as providing benefits to ratepayers that more than offset all costs it places on them from whatever source.[] (D.01-09-057, at 28-29.)

Indeed, at page 50 of the challenged decision we stated: “[g]iven that there are substantial non-quantifiable and non-monetary benefits [in addition to the ratepayers likely receiving more or less half of the net benefits] as well, the Commission should approve the [a]pplication rather than risk losing this deal and its substantial expected benefits without reason to believe that a better deal is forthcoming.” (D.01-09-057, at 50; see also, *id.*, at 69, Finding of Fact No. 25; and at 70, Conclusions of Law Nos. 8-12.) The record does not support MSD's allegation that the Commission neglected to adequately determine whether the transaction at issue offers ratepayers some equitable share of the benefits the transaction will generate.

Finally, as part of its application, MSD sought a stay of the challenged decision as it pertains to the Montara District, until disposition of its application for rehearing. MSD did not establish good cause for granting its request for stay of D.01-09-057.

#### **IV. CONCLUSION**

For the reasons stated above, we deny the ORA's and MSD's applications for rehearing, as no legal error has been shown.

**THEREFORE, IT IS ORDERED** that:

1. The Application for Rehearing of Decision 01-09-057 filed by the Office of Ratepayer Advocates is denied.
2. The Application for Rehearing of Decision 01-09-057 filed by the Montara Sanitary District is denied.

3. The Request for Stay of Decision 01-09-057 filed by the Montara Sanitary District as part of its Application for Rehearing is denied.

4. 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