

Decision **PROPOSED DECISION OF ALJ BEMESDERFER**  
**(Mailed 3/30/2020)**

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

Application for Order Authorizing  
California-American Water Company  
(U210W) to Purchase Bellflower  
Municipal Water System's Assets and  
for Related Approvals.

Application 18-09-013

**DECISION DENYING APPLICATION****Summary**

We deny the application of California-American Water Company for an order authorizing it to purchase the assets of the Bellflower Municipal Water System for \$17 million and to include the entire purchase price in its rate base.

**1. Background****1.1. History of the Transaction**

On May 9, 2016, the city of Bellflower (Bellflower or City), acting through its city council, voted to issue a request for proposals (RFP) to purchase the Bellflower Municipal Water System (Bellflower Municipal). The RFP was distributed to 14 potential buyers. Four Class A water companies including California-American Water Company (Cal-Am) were the only respondents. After holding public hearings and reviewing the competing proposals, the City accepted the Cal Am proposal. It was placed on the ballot at the next election

and approved by the voters.<sup>1</sup> Cal Am and the City then sought Commission approval of the proposed transaction.

## **1.2. Procedural Background**

On September 14, 2018, Cal Am filed its initial application. On October 29, 2018, the Commission's Office of the Public Advocate (Cal Advocates) filed a protest of the application. On November 19, 2018 Cal Am replied to the protest. On November 20, 2018, Cal Advocates filed a motion to require Cal Am to pay for Cal Advocates' consultant and the City filed a motion for party status. On December 5, 2018, Cal Am responded to Cal Advocates' motion to require Cal Am to pay for Cal Advocates' consultant.

On January 7, 2019, a prehearing conference (PHC) was held at which the presiding officer, Administrative Law Judge (ALJ) Karl Bemederfer, denied Cal Advocates' motion to have Cal Am pay for its consultant. On January 22, 2019, Cal Advocates filed a motion for reconsideration of the ALJ's ruling denying its payment request, together with a brief on certain threshold issues including, among others, the question of whether Cal Advocates had made a prima facie showing that the proposed purchase price is unreasonable.

On January 22, 2019, Cal Am filed an amended application. On February 6, 2019, Cal Am filed a response to Cal Advocates' motion for reconsideration of the ALJ's ruling denying Cal Advocates' request to have

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<sup>1</sup> See [https://www.bellflower.org/depts/water/potential\\_sale\\_of\\_the\\_mws.asp](https://www.bellflower.org/depts/water/potential_sale_of_the_mws.asp) (as of July 11, 2019); see also Exh. CAL AM-08, *Direct Testimony of Jeffrey L. Stewart*, dated September 14, 2018 (Stewart Direct), Bellflower City Manager, Q/A 11 served with the Application in this proceeding.

Cal Am pay for Cal Advocates' consultant. On February 15, 2019, Cal Am filed its reply to Cal Advocates' brief on threshold issues. On March 6, 2019, the ALJ ruled that Cal Advocates had not made a prima facie showing that the proposed purchase price is unreasonable.

On March 22, 2019, Cal Advocates filed a motion for reconsideration of the ALJ's ruling on the threshold issues, together with a motion for issuance of a scoping memo. On April 8, 2019, Cal Am filed responses to both of Cal Advocates' March 22, 2019 motions.

On April 11, Cal Am filed a motion to compel Cal Advocates to provide substantive discovery responses. On April 12, 2019, the assigned Commissioner issued a scoping memo. On April 22, 2019 Cal Advocates filed its response to Cal Am's motion to compel. To date, the ALJ has not ruled on Cal Am's motion to compel.

On May 29, 2019, the Commission held a public participation hearing (PPH) in Bellflower. At the PPH, several city officials from other parts of Cal Am's service territory supported Cal Advocates' position arguing that they should not have to bear the burden of the increased rates that they would have to pay if the acquisition goes forward. On June 5 and 6, 2019 the Commission held evidentiary hearings at its San Francisco hearing rooms. The parties filed opening briefs on July 12, 2019 and reply briefs on July 31, 2019, at which time the proceeding was submitted for decision.

## 2. Issues Before the Commission

Although the scoping memo identifies fourteen issues for decision, the threshold questions, as listed in the scoping memo, are<sup>2</sup>:

- Scoping Memo issue 1: Whether the Transaction should be approved and, if so, whether it should be approved with conditions.
- Scoping Memo issue 2: Whether the Transaction benefits both Cal Am's and Bellflower Municipal's customers.
- Scoping Memo issue 10: Whether Code of Civil Procedure (CCP) § 1263.320(a) or § 1263.320(b) should be used to determine the FMV of a public utility.
- Scoping Memo issue 12: If the Transaction is approved, whether the full purchase price (\$17 million) paid by Cal Am is the FMV and, if so, whether the Commission should establish the rate base for Bellflower Municipal as less than or equal to this FMV. In this regard, we note that although Public Utilities Code Sections 2718 et. seq. were enacted precisely to give larger water companies an incentive to acquire smaller water companies in spite of the adverse implications of such acquisitions on the rates paid by existing customers of the acquiring companies, Section 2720(d) preserves our authority to deny an application if

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<sup>2</sup> Of the 14 issues initially identified for decision, two were removed from the scope by a March 6, 2019 ruling by the ALJ. In the scoping memo, the assigned Commissioner reversed the ALJ's ruling and included all 14 of the original issues in the scope.

we find that the purchase price is unfair and unreasonable.<sup>3,4</sup>

### **3. Discussion and Analysis**

#### **3.1. Standards for Determining Fair Market Value**

Public Utilities (Pub. Util.) Code Section 2720(a)states:

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

- (1) For purposes of this section, “public water system” shall have the same meaning as set forth in Section 116275 of the Health and Safety Code.
- (2) For purposes of this section, “fair market value” shall have the same meaning as set forth in [S]ection 1263.320 of the Code of Civil Procedure.

Health and Safety Code Section 116275(h) defines “public water system” as follows:

- (h) “Public water system” means a system for the provision of water for human consumption through pipes or other constructed conveyances that has 15 or more service connections or regularly serves at least 25 individuals daily at least 60 days out of the year. A public water system includes the following:

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<sup>3</sup> “But if the resulting potential rate impact was unfair and unreasonable, the Legislature left the Commission authority under Pub. Util. Code §§ 851 and 852 to deny the applications.” D.01-01-018 at 5 (2000). *Accord* D.99-09-030

<sup>4</sup> We discuss other issues as necessary throughout this decision.

- (1) Any collection, treatment, storage, and distribution facilities under control of the operator of the system that are used primarily in connection with the system.
- (2) Any collection or pretreatment storage facilities not under the control of the operator that are used primarily in connection with the system.
- (3) Any water system that treats water on behalf of one or more public water systems for the purpose of rendering it safe for human consumption.

California Code of Civil Procedure Section 1263.320 provides two options for determining the fair market value of property taken in eminent domain proceedings:

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

Pub. Util. Code § 2720(b) sets the criteria for including in rate base some of the excess of a purchase price agreed to between seller and buyer of a public water system over the system's reproduction cost new less depreciation (RCNLD):

- (b) If the fair market value exceeds reproduction cost as determined in accordance with Evidence Code

Section 820, the commission may include the difference in the rate base for ratemaking purposes if it finds that the additional amounts are fair and reasonable. In determining whether the additional amounts are fair and reasonable the commission shall consider whether the acquisition of the public water system will improve water system reliability, whether the ability of the water system to comply with health and safety regulations is improved, whether the water corporation by acquiring the public water system can achieve efficiencies and economies of scale that would not otherwise be available, and whether the effect on existing customers of the water corporation and the acquired public water system is fair and reasonable.

Finally, Section 820 of the Evidence Code states the criteria for determining reproduction cost:

When relevant to the determination of the value of property, a witness may take into account as a basis for his opinion the value of the property or property interest being valued as indicated by the value of the land together with the cost of replacing or reproducing the existing improvements thereon, if the improvements enhance the value of the property or property interest for its highest and best use, less whatever depreciation or obsolescence the improvements have suffered.

### **3.2. What is the Fair Market Value of Bellflower Municipal?**

Cal Am and the City argue that (i) the fair market value of Bellflower Municipal for inclusion in the rate base of Cal Am as the acquiring corporation is found by applying the “willing buyer-willing seller” standard of C.C.P. §1263.320(a) to this transaction and (ii) as measured by that standard, the fair

market value of Bellflower Municipal is the price agreed on by the parties, \$17 million.

Cal Advocates argues that fair market value should be determined by applying C.C.P. §1263.320(b) because there is no relevant comparable market. Special purpose properties such as utilities tend to present unique factual situations affecting their value, a fact known by the legislature when it wrote the Consolidation Act and defined “fair market value” by reference to the Code of Civil Procedure. The legislative history of C.C.P. §1263.320 makes this explicit:

The phrase “in the open market” has been deleted from the definition of fair market value in subdivision (a), and subdivision (b) has been added to the definition because there may be no relevant market for some types of special purpose properties such as schools, churches, cemeteries, parks, *utilities*, and similar properties.)<sup>5</sup> [Emphasis supplied.]

The Consolidation Act thus points in two opposite directions, on the one hand accepting any value agreed between one water company and another water company by applying the willing buyer/willing seller standard while, on the other hand, preserving the Commission’s power to deny proposed acquisitions with valuations that we find to be excessive or unreasonably burdensome on the ratepayers of the acquiring company. The result is that each proposed acquisition must be evaluated based on its specific facts and the resulting valuation, regardless of which statutory standard is applied, must fall within a range of reasonableness.

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<sup>5</sup> West’s 7Ann. Cal. Code Civ. Pro. §1263.320



In this case, when all the evidence is considered, it is certain that the fair market value of Bellflower Municipal is substantially less than the price agreed to by the City and Cal-Am and that we cannot approve the acquisition at that price. In other words, judging the transaction by applying the “willing buyer/willing seller” standard of C.C.P. §1263.320(a) leads to an unreasonable and excessive price. Nor can we approve the transaction by applying the “just and equitable method” standard of C.C.P. §1263.320(b) to determine fair market value. When all the facts and circumstances are considered, the result is a significantly negative value for Bellflower Municipal, as shown on the table at the end of this section.

Bellflower Municipal owns two types of assets, tangible and intangible. The tangible assets include the land, buildings, pipes, pumps, tanks, meters, and other facilities and equipment necessary to treat and deliver water to the customers. The intangible asset is the right to draw up to 700 acre-feet of water per year from the Central Basin aquifer. It is part of 938 acre-feet of Central Basin groundwater rights previously owned by Peerless Water Company that were acquired by the City from Peerless in 2007. While Cal Advocates, citing Health and Safety Code Section 116275(h), argues that the Bellflower Municipal water system does not include the water rights, we believe the better view is that when, as is the case here, a public water system is sold as a “going concern” a necessary implication is that the system includes all elements required for it to deliver

water to its customers.<sup>6</sup> The record does not indicate whether Cal Am independently owns any Central Basin water rights, but it is a fair implication of Cal Am's intention to purchase Bellflower Municipal as a "going concern" that Cal Am would not purchase Bellflower Municipal without the water rights. Accordingly, we believe that the fair market value of Bellflower Municipal for ratesetting purposes includes the value of the 700 acre-feet of Central Basin drawing rights.

The water rights are valued by the parties at \$9.1 million, a valuation based on prices paid in an active market for such rights<sup>7</sup> that is not disputed by Cal Advocates. Simple arithmetic (\$17 million [proposed purchase price of Bellflower Municipal] minus \$9.1 million [value of intangible asset] implies a value of \$7.9 million for the tangible assets.

In this case, there is substantial evidence in the record to question the value assigned to the tangible assets by this calculation. The \$7.9 million value assigned to the tangible assets is supported by the RCNLD valuation prepared for Cal Am, which showed a value of just under \$21 million for Bellflower Municipal including the water rights, implying a value of \$11.8 million for the tangible assets. The 2015 RCNLD valuation done for the City by AKM

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<sup>6</sup> By "going concern" we mean that Bellflower Municipal is being purchased as an ongoing operating business rather than a collection of assets. In accounting terms, Cal-Am is purchasing both sides of Bellflower Municipal's balance sheet, not merely the right side.

<sup>7</sup> The Central Basin is an aquifer in which water drawing rights are frequently bought and sold in an active, adjudicated market.

Consulting Engineers (AKM Valuation),<sup>8</sup> valued the tangible assets at \$6.9 million.<sup>9</sup>

On the other hand, evidence introduced by Cal Advocates established that Bellflower Municipal is currently facing more than \$25 million in deferred repair and maintenance expenses.<sup>10</sup> These current liabilities are an offset to the value of the tangible assets and the value of Bellflower Municipal, *including the water rights*, is therefore significantly negative no matter which RCNLD valuation is used. This conclusion is summarized in the following table:

	RCNLD of Tangible Assets	Value of Water Rights	Current Repair & Maintenance Obligations	Value of Bellflower Municipal [Tangible Assets + Water Rights – Current Repair and Maintenance Obligations]
CAL AM	\$11.8 million	\$9.1 million	(\$25.7 million)	(\$4.8 million)
AKM	\$6.9 million	\$9.1 million	(\$25.7 million)	(\$9.7 million)

Testimony from Cal Advocates identifies other reasons for concluding that the proposed transaction significantly overstates the value of Bellflower Municipal. Cal Advocates argued that:

- 71% of Bellflower Municipal's pipes are comprised of obsolete material (asbestos cement);<sup>11</sup>
- Bellflower Municipal's asbestos cement pipes break at approximately twice the rate of asbestos cement pipes

<sup>8</sup> Exhibit Cal PA-1A, Attachment 3-13 (AKM Valuation)

<sup>9</sup> \$700,000 value of land + \$6.2 million, value of other assets

<sup>10</sup> *Ibid.*, Chart, at 3-257.

<sup>11</sup> Exhibit Cal PA-1 at 14, lines 3-5.

in other municipalities around the United States and Canada;<sup>12</sup>

- Cal Am substituted PVC pipe, which has a longer useful life and lower break rates, for asbestos cement pipe in its RCNLD evaluation;<sup>13</sup>
- All four entities that submitted bids in response to the City's request for proposals for acquisition of Bellflower Municipal were water utilities protected by rate of return regulation;<sup>14</sup>
- Bellflower Municipal's earnings are inadequate to meet present and forecasted capital needs and are insufficient to support the proposed purchase price;<sup>15</sup> and
- The proposed purchase price is more than double that of other recently proposed acquisition prices on a per-connection basis.<sup>16</sup>

In support of the reasonableness of the \$17 million purchase price, Cal Am and the City argue that the price was arrived at by arm's length bargaining and that there is no justification for going behind that price. They further point out that the negotiations were conducted openly and were subject to final approval by the voters. But as the above discussion of system valuation illustrates, their argument for measuring the value of Bellflower Municipal by applying the "willing buyer-willing seller" standard of C.C.P. § 1263.320(a) to this situation

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<sup>12</sup> Exhibit Cal PA-3 at 15, line 3.

<sup>13</sup> Exhibit Cal PA-1 at 14, lines 7-9.

<sup>14</sup> Cal-PA Opening Brief at 8-9.

<sup>15</sup> Exhibit Cal-PA 4 at 4.

<sup>16</sup> Exhibit Cal-PA 1A at 60, Attachment 1-4.

depends crucially on ignoring the poor physical condition and the infrastructure repair obligations of Bellflower Municipal. Ignoring these facts leads to a valuation that is not just and equitable.

Cal Am also argues that its superior size, experience, financial stability, and access to capital will enable it to deliver better services more economically and maintain system performance better than Bellflower Municipal.<sup>17</sup> We agree that Cal Am is much better able than Bellflower Municipal to meet the future needs of customers, to upgrade and repair the physical assets, and to comply with present and future laws and regulations. Compared with Bellflower Municipal, Cal Am would improve water system reliability, improve compliance with health and safety regulations, and achieve efficiencies and economies of scale that would not otherwise be available. Indeed, bringing the benefits of larger scale operations to the customers of small water companies is a fundamental reason behind the passage of the Consolidation Act. But those benefits cannot come at an excessive and unreasonable cost to current ratepayers.

In this case, the excessive cost of acquiring those benefits for the 2,000 current customers of Bellflower Municipal would be passed on to existing customers of Cal Am who would receive much higher water bills. For example, if the excessive cost was allocated between the General Office and the Los Angeles Division of Cal Am, as the utility proposes,<sup>18</sup> the Commission's Water

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<sup>17</sup> Cal Am Opening Brief, 14-21. *See also* Exhibit Cal Am 03, Morse Direct, *passim*.

<sup>18</sup> Cal Am proposes to allocate 53.44% of the acquisition prices to its Los Angeles Division and 45.56% to its General Office which will be allocated across all Cal Am customers including those in the Los Angeles Division.

Division estimates that typical residential customers in the Los Angeles Division would see average increases of approximately 10 percent in their water bills. As we noted at the beginning of this opinion, it was concern about this possibility that led representatives of other Los Angeles area communities served by Cal Am to appear at the PPH in support of the Cal Advocates.

#### **4. Conclusion**

For the above reasons, we conclude that (i) the fair market value of Bellflower Municipal should be determined by applying the method of valuation in C.C.P. §1263.320(b); (ii) the fair market value of Bellflower Municipal is between (\$4.8 million) and (\$9.7 million); (iii) the benefits of the proposed acquisition to customers of Bellflower Municipal do not outweigh the burdens of the proposed acquisition on existing Cal Am customers; and (iv) the proposed purchase price of \$17 million is unreasonable.

#### **5. Assignment of Proceeding**

Clifford Rechtschaffen is the assigned Commissioner and Karl J. Bemesderfer is the assigned ALJ in this proceeding.

#### **6. Comments on the Proposed Decision**

The proposed decision of ALJ Karl J. Bemesderfer in this matter was mailed to the parties in accordance with Section 311 of the Pub. Util. Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on \_\_\_\_\_ by \_\_\_\_\_. Reply comments were filed on \_\_\_\_\_ by \_\_\_\_\_.

**Findings of Fact**

1. The fair market value of Bellflower Municipal includes the value of its tangible assets plus the value of its groundwater rights.
2. The City of Bellflower owns rights to draw 938 acre-feet of water per year from the Central Basin aquifer.
3. The 700 acre-feet of groundwater rights included in the proposed sale to Cal Am have a fair market value of \$9.1 million.
4. Bellflower Municipal currently faces at least \$25 million of repair and maintenance expenses.
5. The fair market value of Bellflower Municipal is significantly negative.
6. Cal Am has offered to purchase the Bellflower Municipal distribution system including the 700 acre-feet of water rights for \$17 million.
7. After accounting for current repair and maintenance obligations, the highest fair market value of Bellflower Municipal is (\$4.8 million).
8. The purchase price of \$17 million is \$21.8 million more than the highest fair market value of Bellflower Municipal.
9. The proposed transaction would produce improved service for customers of Bellflower Municipal.
10. The proposed transaction would unreasonably increase water rates for existing Cal Am customers.

**Conclusions of Law**

1. The proposed transaction should be evaluated by applying the criteria of C.C.P. §1263.320(b) to determine the fair market value of Bellflower Municipal.
2. The purchase price of \$17 million is unreasonable.
3. The proposed transaction is not in the public interest.
4. The application should be denied.

**O R D E R**

**IT IS ORDERED** that:

1. The application of California-American Water Company to purchase Bellflower Municipal Water System for \$17 million and to include the entire purchase price in rate base is denied.
2. The motion of California-American Water Company to compel responses to data requests is denied.
3. Application 18-09-013 is closed.

This order is effective today.

Dated \_\_\_\_\_, at San Francisco, California.