

ALJ/KWZ/JMO/gp2/lil **PROPOSED DECISION**

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Ratesetting

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Decision **PROPOSED DECISION OF ALJS WATTS-ZAGHA AND
MCKINNEY (Mailed 6/9/2021)**

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Joint Application of
California-American Water Company
(U210W) and East Pasadena Water
Company (U331W) for an Order
Authorizing East Pasadena Water
Company to Sell and
California-American Water to Purchase
the Water Utility Assets of East
Pasadena Water Company.

Application 20-04-003

**DECISION APPROVING THE SALE OF EAST PASADENA
WATER COMPANY UTILITY ASSETS TO CALIFORNIA-AMERICAN
WATER COMPANY INC.**

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**DECISION APPROVING THE SALE OF EAST PASADENA
WATER COMPANY UTILITY ASSETS TO CALIFORNIA-AMERICAN
WATER COMPANY INC.**

Summary

This decision approves and authorizes the purchase of the water utility assets of East Pasadena Water Company (East Pasadena) by California-American Water Company, Inc. (Cal-Am) for a purchase price of \$34,000,000, and we authorize the same value to be used for ratemaking purposes as the rate base of the acquired system.

This decision authorizes the transfer of asset ownership from East Pasadena to Cal-Am and modifies Cal-Am's Certificate of Public Convenience and Necessity to incorporate the East Pasadena service area into Cal-Am's Los Angeles County District.

Additionally, this decision denies the request to create The East Pasadena Acquisition Contingency Memorandum Account but grants the request to create The East Pasadena Transaction Cost Memorandum Account, limited to any eligible costs incurred after the date of this decision. This decision also authorizes the inclusion of the service territory acquired from East Pasadena in Cal-Am's existing Memorandum Account for Environmental Improvements and Compliance issues for Acquisitions.

Finally, this decision grants Cal-Am's request for interim rate relief and closes the proceeding.

1. Background**1.1. Procedural Background**

On April 6, 2020, the California American Water Company (Cal-Am) and East Pasadena Water Company (East Pasadena), collectively, the Joint Applicants, filed Application (A.) 20-04-003. On May 11, 2020, the Public

Advocates Office timely filed a Protest. On May 29, 2020, a Prehearing Conference was conducted by the assigned Administrative Law Judge (ALJ).

On June 19, 2020, the assigned Commissioner issued a Scoping Memo setting forth all issues of law and fact to be determined in this proceeding, setting out a schedule of proceeding events, and designating the assigned ALJ as the proceeding's Presiding Officer.¹

The Commission held two Public Participation Hearings (PPHs) on August 3, 2020. Due to the state's shelter-in-place restrictions in response to the coronavirus, the PPHs were held remotely and included both telephone and internet access. On August 19, 2020, ALJ Jeanne McKinney was co-assigned to the proceeding. Evidentiary hearings were held on September 14, 2020. Concurrent Opening Briefs were filed on October 14, 2020. Concurrent Reply Briefs were filed on October 28, 2020, and the matter was submitted at that time.

The record of this proceeding consists of all filed documents, testimony received into evidence, and the transcripts of the evidentiary hearings.

The Commission's PPHs were held to solicit comments from ratepayers. Fifteen customers spoke at the PPHs and additional individuals commented on the public input section of the docket card.² All those who spoke or wrote opposed the transaction because they believed that it will cause rate increases with no benefits discernable to them as customers in the other Cal-Am districts. The scope of this proceeding was not altered by any input from the PPHs.

¹ A second ALJ was subsequently co-assigned but was not also designated as a Presiding Officer.

² As of January 18, 2021, a total of 33 individual comments had been received.

1.2. Joint Applicants

The Joint Applicants are East Pasadena and Cal-Am. East Pasadena is a California corporation, and its primary shareholder is Mr. Anton Garnier. East Pasadena is currently a Class B Commission-regulated water utility serving the cities of Temple City, Arcadia, San Gabriel and an unincorporated area of Los Angeles County southeast of the City of Pasadena.

Cal-Am, a California corporation, is a subsidiary of American Water Works Company, which is the largest publicly traded water utility in the United States, serving approximately 16 million people in North America. As a Class A California water utility, Cal-Am serves approximately 630,000 customers in 50 communities, spread across approximately 10 districts. The Commission sets rates for each of these districts in regularly scheduled GRCs. In terms of customers served, Cal-Am increased six-fold over the last twenty years. Most recently, Cal-Am acquired Oxbow Mutual Water Company and Dunnigan Water Works in 2015, Adams Ranch, Meadowbrook³ and Geyserville Water Works in 2016, Rio Plaza,⁴ Hillview,⁵ and Fruitridge Vista⁶ in 2019. Cal-Am's GRC application for 2021 is pending before the Commission.⁷ In it, Cal-Am includes the rate impacts of its 2019 acquisitions.

1.3. Application and Proposed Acquisition Terms

The Joint Applicants request Commission authority for Cal-Am to acquire nearly all the assets of East Pasadena and assume the public utility operations of

³ D.16-12-014.

⁴ D.19-04-015.

⁵ D.19-04-015.

⁶ D.19-12-038.

⁷ A.19-07-004.

East Pasadena, as described in the purchase agreement between Cal-Am and East Pasadena, dated August 19, 2019 (Purchase Agreement). Through this sale, Cal-Am would acquire the East Pasadena water distribution system which consists of four groundwater wells (two operating and two on standby), one monitoring well, eight booster stations, four water storage tanks, three interconnections with other water systems that include manual valves and a flow meter, and other plant and equipment. The sale also includes the water rights owned by East Pasadena: 1,708 acre-feet in the Main San Gabriel Basin and 515 acre-feet in the Raymond Basin, of which only 360.5 acre-feet is available for withdrawal. Through this system, East Pasadena serves a population of approximately 10,000 people, through approximately 2,200 residential connections and 800 commercial or industrial connections.⁸

Cal-Am also proposes to consolidate East Pasadena into Cal-Am's Los Angeles County District⁹ in two steps. First, the East Pasadena system would be immediately consolidated into the Los Angeles County District for operational purposes. Then, in 2024, East Pasadena would be consolidated for ratemaking purposes in Cal-Am's next scheduled general rate case (GRC). East Pasadena would cease to exist as a separate water utility. Its former customers would be served by Cal-Am under Cal-Am's Certificate of Public Convenience and Necessity (CPCN) and Cal-Am's CPCN would be modified by this decision to encompass the territory formerly served by East Pasadena.

⁸ According to East Pasadena's 2019 Annual Report it serves a population of 9,979. It reports 3,024 total meters, of which 1,111 are the smallest size and 936 are the next smallest size.

⁹ Cal-Am has a pending request to combine, for ratemaking purposes, its Los Angeles County District with its Ventura and San Diego Districts, into what would become the Southern District in its pending GRC. See Application at 21.

The Joint Applicants contend that the \$34 million purchase price represents the fair market value of the utility-related assets of East Pasadena and seeks Commission approval of that value. These assets currently have a book value of approximately \$4 million and constitute East Pasadena's rate base for ratesetting purposes. As discussed below, current law allows Cal-Am to include the fair market value of the assets in its rate base for ratesetting purposes. Thus, as proposed, this transaction would add \$30 million to the combined rate base of Cal-Am. The difference between the rate base valuation before and after acquisition is known as the "acquisition premium."

1.4. Public Advocates Office Objects to the Application

The Public Advocates Office argued that the Joint Applicants' proposals are not in the public interest and therefore would harm the ratepayers if the Commission approves the application. The Public Advocates Office argued the transaction would be in the public interest only if a portion of the sale proceeds are reserved for the East Pasadena ratepayers, and further argued that the Commission's gain-on-sale rules should apply to apportion the sale proceeds between East Pasadena shareholders (the seller) and the ratepayers of the former East Pasadena service area rather than all of the proceeds accruing to the seller.

2. Issues Before the Commission

The issues before the Commission are:

- A. Would permitting Cal-Am to purchase the water utility assets of East Pasadena be in the public interest?
- B. How does the proposed transaction comport with Public Utilities (Pub. Util.) Code §§ 851-854 and §§ 2718-2720?
 - (1) Is the total final purchase price representative of the fair market value as defined by Pub. Util. Code § 2720?
 - (2) Should the Commission authorize rate base equal to the total final purchase price?

- (3) Should the Commission approve the terms and conditions of the asset purchase agreement between Cal-Am and East Pasadena, entered into on August 19, 2019?
- C. When and how should Cal-Am consolidate the East Pasadena service area with Cal-Am's existing service area, for ratemaking and operational purposes?
- D. Will the effects on Cal-Am and East Pasadena customers be fair and reasonable, in light of any benefits likely to accrue to customers of East Pasadena and Cal-Am?
- (1) Should Cal-Am be permitted to file standard Consumer Price Index for All Urban Consumers (CPI-U) increases for 2021, 2022 and 2023 until new rates established through the Cal-Am 2022 General Rate Case (GRC) become effective (presumably January 1, 2024)?
- (2) Should Cal-Am be permitted to track in a memorandum account the difference in revenues billed at current East Pasadena rates and revenues that would have been billed from the final rates authorized in Cal-Am's 2019 GRC including the integration of the East Pasadena system?
- (3) Should Cal-Am be permitted to create a memorandum account tracking the transaction costs? If not, how should transaction costs be treated?
- E. Should Cal-Am be permitted to expand its existing Memorandum Account for Environmental Improvements and Compliance Issues for Acquisitions to include East Pasadena?
- F. Should the Commission expand Cal-Am's Certificate of Public Convenience and Necessity and relieve East Pasadena of its public utility responsibilities following the completion of the transaction?

3. Applicable Legal Framework

As we review the Joint Applicant's proposed transaction,¹⁰ the Commission must find the proposed sale and asset purchase transaction to be in

¹⁰ The Joint Applicants have complied with the procedural requirements of §§ 851-854 and §§ 2718-2720, and filed the requisite supporting documents identified in Rule 3.6 of the Commission's Rules of Practice and Procedure and in Decision (D.) 99-10-064.

the public interest according to Pub. Util. Code §§ 851 *et seq.*, as illuminated by §§ 2718 *et seq.* We will also address §§ 451 *et seq.*, as applied to the proposed transaction.

3.1. Sections 851 *et seq.*

Section 851, in relevant part, requires Commission approval before a public utility may sell the whole or any part of its property or rights “necessary or useful in the performance of its duties to the public,” and § 854(a) requires Commission authorization before any person or corporation may acquire or merge with any public utility. The Commission has long interpreted these code sections to prohibit acquisitions, mergers, and transfers of control unless the Commission has found the proposed transaction to be in the public interest.

In addition, subsections (b), (c), and (d) of § 854 contain a list of public interest criteria for transactions involving electric, gas and telephone corporations.¹¹ Although these subsections, by their terms, do not apply to water utilities, the Commission has referred to these public interest criteria in its review of proposed water utility transactions to identify various aspects of the public interest.¹² Here, we reference the eight criteria in subsection (c) primarily to point out that the public interest is comprised of a mix of interests: ratepayer interests, shareholder interests, public utility employee interests, as well as local and statewide community interests.¹³

¹¹ § 854 subsection (d) applies only to electric and gas corporations.

¹² D.01-09-057, Conclusions of Law 8, 9.

¹³ Subsection (c) of § 854 contains a list of eight public interest criteria, as follows:

- (1) Maintain or improve the financial condition of the resulting public utility doing business in the state.
- (2) Maintain or improve the quality of service to public utility ratepayers in the state.
- (3) Maintain or improve the quality of management of the resulting

Subsection (e) of § 854 also applies here and provides, as follows:

When reviewing a merger, acquisition, or control proposal, the commission shall consider reasonable options to the proposal recommended by other parties, including no new merger, acquisition, or control, to determine whether comparable short-term and long-term economic savings can be achieved through other means while avoiding the possible adverse consequences of the proposal.

3.2. Sections 2718 -2720

In 1997, the Legislature enacted the Public Water System Investment and Consolidation Act as codified in §§ 2718 -2720 and which includes as policy:

- a) Public water systems are faced with the need to replace or upgrade the public water system infrastructure to meet increasingly stringent state and federal safe drinking water laws and regulations governing fire flow standards for public fire protection.
- b) Increasing amounts of capital are required to finance the necessary investment in public water system infrastructure.
- c) Scale economies are achievable in the operation of public water systems.
- d) Providing water corporations with an incentive to achieve these scale economies will provide benefits to ratepayers.¹⁴

public utility doing business in the state.

- (4) Be fair and reasonable to affected public utility employees, including both union and nonunion employees.
- (5) Be fair and reasonable to the majority of all affected public utility shareholders.
- (6) Be beneficial on an overall basis to state and local economies, and to the communities in the area served by the resulting public utility.
- (7) Preserve the jurisdiction of the commission and the capacity of the commission to effectively regulate and audit public utility operations in the state.
- (8) Provide mitigation measures to prevent significant adverse consequences that may result

¹⁴ § 2719.

The Public Water System Investment and Consolidation Act sets out a framework to incentivize acquisitions of small water systems by larger, more financially secure entities, while leaving intact the Commission existing “powers and responsibilities granted pursuant to Sections 851 and 852.”¹⁵ Significantly, § 2720, subsection (a) provides:

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.

The Public Water System Investment and Consolidation Act requires the Commission to include in the acquiring water company’s rate base the fair market value of the acquired assets.¹⁶ The fair market value is determined in accordance with § 2720(a), as the purchase price (below appraisal) agreed to by a willing buyer and willing seller. When the fair market value exceeds the reproduction cost of the acquired system, the Commission shall further determine whether fair and reasonable to also include the excess in rate base in accordance with § 2720(b). The difference between the book value of the assets prior to acquisition, and fair market value approved for inclusion in rate base is known as an acquisition premium.

Recovering the acquisition premium in rates provides an incentive for the larger companies to acquire the small water systems, but it does not create a legal presumption that any acquisition of a smaller water system by a larger entity is in the public interest. Rather, by referring to § 851, the Legislature indicated that the acquisition must first be determined to be in the public interest. In our consideration of the public interest, we employ relevant guidance from the

¹⁵ § 2720(d).

¹⁶ This transaction is governed by § 2720 (a). Subsection (b) to § 2720 becomes applicable when the fair market value exceeds reproduction cost, which is not the case here.

Public Water System Investment and Consolidation Act, specifically the part of § 2720(b) itemizing benefits anticipated in acquisitions of smaller water systems:

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.

3.3. Public Interest Review and Ratepayer Indifference Standard

Prior to the enactment of the Public Water System Investment and Consolidation Act, once the transaction was determined to be in the public interest according to § 851, the acquiring company's new rate base after the acquisition would have been the value that was on the acquired company's books. Now, however, we must look to the public interest considerations in §§ 851 *et seq.*, as illuminated by §§ 2718 *et seq.*

In weighing the public interest considerations, there is a large body of prior Commission decisions applying a “ratepayer indifference standard,” where no harm or adverse impact to the ratepayer is identified. There are also a few decisions applying a higher bar of “tangible ratepayer benefit,”¹⁷ as the standard. Here, both the Joint Applicants and the Public Advocates Office assert the

¹⁷ D.11-12-007 at 5-6 ultimately settled upon the “ratepayer indifference standard,” as did D.00-05-027 (*also see* Dissent), D.00-05-047 (*also see* Concurrence), D.10-09-012 at 8, D.15-12-029 at 11, D.16-12-014 at 12, D.15-11-012. In contrast, D.01-09-057 at 27, and D.19-12-038 at 7 apply the “net ratepayer benefits.”

“ratepayer indifference standard” should apply.¹⁸ The Public Advocates Office argued:

The [Public Water System Investment and Consolidation Act] creates incentives for larger water companies to acquire smaller water utilities, in order to better capitalize necessary infrastructure improvements and ensure regulatory compliance with water quality standards, by allowing fair market valuation of the acquired utility’s assets, and inclusion of the full purchase price in the purchaser’s rate base. These incentives, however, pose certain risks that the Commission must address to ensure that the transaction is in the public interest and no harm or negative effect on the ratepayer will result from the acquisition.¹⁹

In reviewing the proposed transaction, we are compelled by the legislatively declared public interests, as set forth the Public Water System Investment and Consolidation Act. And in keeping with the majority of prior Commission decisions considering public water utility transactions, we agree with the active parties in this proceeding, and we apply the “ratepayer indifference standard” to the proposed acquisition.

3.4. Post-Transaction Ratemaking Under Section 2720 and Sections 451 *et seq.*

Subsection (a) of § 2720 established the post-acquisition ratemaking for this type of transaction:

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.

The Commission must also ensure that subsequent rates are just and reasonable under § 451 *et seq.* While water utility sales and acquisitions generally

¹⁸ Application at 10.

¹⁹ Opening Brief of the Public Advocates Office at 4 - 5.

occur independent of GRCs, sales and acquisitions create new costs and savings, as does the statutory requirement in §2720 (a). Rate changes, driven by revenue requirements and cost allocation decisions, are made during a water corporation's GRC during which the Commission reviews the utility's total operations. Every water corporation is required to submit a GRC application every three years pursuant to § 455.2(c) and the Commission's currently in effect rate case plan for Class A companies which includes Cal-Am.

Because this acquisition is governed by the Public Water System Investment and Consolidation Act, an acquisition premium is permitted as long as the transaction is determined to be in the public interest, with reference to the guidance set forth in part of § 2720(b):

... 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.

Such premium will ultimately result in an increase in the utility's revenue requirement and corresponding increase in customer rates. Though this transaction occurs outside of the normal GRC review, we must remain alert to the impacts on ratepayers when evaluating the public interest.

4. Discussion

The threshold issue is whether the proposed sale and asset purchase transaction is in the public interest. As discussed below, we find that the proposed sale and asset purchase transaction is in the public interest and consistent with §§ 851 *et seq.* and §§ 2718 *et seq.*

4.1. Purchase Price as the Fair Market Value

As discussed below, the total final purchase price of \$34 million represents the fair market value as defined by Pub. Util. Code § 2720. We therefore authorize the inclusion of the total final purchase price in rate base.

Here, we must establish the fair market value of the proposed acquisition because that value would be used as the rate base for subsequent ratesetting proceedings. The Public Water System Investment and Consolidation Act defines the fair market value of the water system as a transaction between a “willing seller-willing buyer” consistent with California Code of Civil Procedure Section 1263.320.²⁰

Joint Applicants argue that East Pasadena willingly entered into the contract with Cal-Am and the seller was under no pressure or obligation to agree to the sale.²¹ Cal-Am and East Pasadena asserted that they arrived at the agreed upon contract purchase price of \$34 million after arm’s length bargaining.

The proposed purchase price was supported by the Joint Applicants’ appraisal, which was based on the replacement cost new less depreciation method. The appraisal valued the East Pasadena system assets at \$42.9 million,²²

²⁰ Subsection (a)(2) of § 2720 adopts the same meaning of “fair market value” set forth in Section 1263.320 of the Code of Civil Procedure, which in turn sets forth two options for determining fair market value – (a) the highest price on the date of valuation that would be agreed to by a seller, being willing to sell... and a buyer, being ready, willing and able to buy...with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available, and (b) [for property taken for which there is no relevant, comparable market] the value on the date of valuation as determined by any method of valuation that is just and equitable.

²¹ EPWC - 1 (Morales Direct) at 4.

²² The appraisal value of \$43.2 million presented in CAW-5 (Zanni Direct), was corrected and updated in CAW-11 (Zanni Rebuttal) to reflect a change in the economic obsolescence conclusion.

consisting of tangible property assets of \$9.3 million, real estate and vehicles of \$7.2 million, and water rights of \$26.7 million.

The Public Advocates Office presented its own appraisal valuation of \$38.5 million and noted that the proposed purchase price of \$34 million is actually lower than either appraisal provided by Cal-Am or the Public Advocates Office.

The Public Advocates Office had no objection to the purchase price amount and the Public Water System Investment and Consolidation Act definition of the fair market value (“willing seller-willing buyer” standard of California Code of Civil Procedure Section 1263.320). Nevertheless, the Public Advocates Office argued that such an approach to fair market value could be potentially abused or lead to an over-inflated purchase price.²³ The Public Advocates Office did not offer any evidence of abuse or over-inflation by the Joint Applicants in this proceeding.

We acknowledge that transactions authorized under the Public Water System Investment and Consolidation Act, like this one, may lead to rate increases but will also likely lead to other important ratepayer benefits envisioned by the Public Water System Investment and Consolidation Act. As stated in D.01-09-057, “[a]pplying Section 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.”²⁴ That is by design to incentivize these transactions to “achieve these scale economies will provide benefits to ratepayers”²⁵ as well as other legislatively imputed public interests, set forth in statute.

²³ Public Advocates Office Opening Brief at 7.

²⁴ D.01-09-057 at 28.

²⁵ § 2719 (d).

Based upon the evidence and the controlling authorities, we are persuaded that the purchase price is the fair market value. Moreover, the two appraisals valued the water system well above the final purchase price. We therefore find the final purchase price of \$34 million represents the fair market value as defined by Pub. Util. Code § 2720 -- a transaction between a "willing seller-willing buyer" consistent with California Code of Civil Procedure Section 1263.320.²⁶ We therefore authorize rate base equal to the total final purchase price of \$34 million as the fair market value of the East Pasadena's used and useful utility assets. The incentive that results from using the purchase price as the new rate base, was estimated by Cal-Am to result in \$1.945 million more in revenue requirement annually.

4.2. Rate Impacts of the Purchase Price in Rate Base

As discussed throughout this decision, our finding of purchase price as the fair market value for the proposed transaction provides an incentive, termed an "acquisition premium," to Cal-Am. The Public Water System Investment and Consolidation Act provides that an acquisition premium shall be included in the acquiring water company's rate base. This premium refers to the difference between the book value of the assets prior to acquisition, and the actual price at which the assets are purchased. Here, Cal-Am will realize an acquisition premium of \$30 million, the difference between the purchase price of \$34 million and the current East Pasadena assets' worth \$4 million.²⁷ Put another way, the

²⁶ Section 1263.320 of the Code of Civil Procedure sets forth two options for determining fair market value - (a) the highest price on the date of valuation that would be agreed to by a seller, being willing to sell... and a buyer, being ready, willing and able to buy...with full knowledge of all the uses and purposes for which the property is reasonably adaptable and available, and (b) [for property taken for which there is no relevant, comparable market] the value on the date of valuation as determined by any method of valuation that is just and equitable.

²⁷\$4 million is essentially the rate base of East Pasadena for ratemaking purposes. Acquisition premium=difference between fair market value and book value of East Pasadena assets=\$34

post-transaction rate base will be \$30 million greater than the current rate base for the stand-alone East Pasadena.

If the proposed acquisition is approved and immediately implemented for ratemaking purposes, Cal-Am's forecast of a \$689.9 million rate base in 2021²⁸ would change to approximately \$724 million. Joint Applicants estimate the corresponding revenue requirement increase of the \$34 million increase in rate base would be \$1.945 million and claim that this \$1.945 million in new revenue requirement would result in a 0.71 percent increase per bill for each customer of the Los Angeles County District (including both existing customers and customers from the newly acquired East Pasadena system).²⁹ The new revenue requirement of \$1.945 million is net, after accounting for the revenues that East Pasadena customers will bring, and the cost savings and synergies from economies of scope and scale.³⁰ Therefore, of the \$34 million, only \$16.39 million new rate base is associated with the \$1.945 new revenue.

The proposed \$34 million addition to Cal-Am's consolidated rate base would be composed of both assets that are depreciable for ratemaking purposes, and other assets such as land and water rights, which are not depreciable, but retain their full value for as long as they remain in rate base. For those assets that

premium=difference between fair market value and book value of East Pasadena assets=\$34 million-\$4 million=\$30 million.

²⁸ A.19-07-004.

²⁹ Note that Joint Applicants estimate of a 0.71 percent rate increase is illustrative as it is based upon the unlikely assumption of immediate consolidation for ratemaking purposes. In fact, Joint Applicants propose collection of the increases estimated before 2024 through a memorandum account review and surcharge, and not through rates.

³⁰ See Attachment 1 to CAW - 2 (Owens Direct Errata), showing the proposed allocation of \$34 million as \$16.39 million to customers of the newly consolidated district, offset by operational savings and new revenues, and the remaining \$17.61 million to all Cal-Am customers, including the former East Pasadena customers.

depreciate annually, rate base decreases over time and the utility would recover that depreciation in rates. The increase in rate base associated with land and water rights, however, would be a permanent component of rate base. Cal-Am requests the purchase price be attributed to depreciable and non-depreciable assets in the same proportion as valued by the appraisal.³¹ The appraisal values presented by Cal-Am allocates the non-depreciable assets at 62 percent of the rate base.³²

The Commission last reviewed East Pasadena's revenue requirement and associated rates to meet its revenue requirement in a GRC in 2015.³³ This 2015 GRC adopted \$3,959,034 as East Pasadena's rate base on which investors have the opportunity to earn a 9.74 percent return, and the adopted overall revenue requirement was \$3,135,976.³⁴ East Pasadena residential customers' average monthly bill in April 2020 was \$68, consisting of a fixed meter charge and a quantity rate for each unit of water.³⁵ Residential, commercial, and industrial customers pay the same quantity rate but different fixed charges. The quantity charge does not vary based on water usage, so that high consuming customers pay the same price per unit of water as low consuming customers.

³¹ CAW - 2 (Owens Direct Errata) at 9.

³² CAW - 2 (Owens Direct Errata) at 9 and CAW - 11 (Zanni Rebuttal) at 2. Witness Owens' 62 percent water rights figure in Direct Testimony was based on a total appraisal value of \$43.2 million which Cal-Am's witness corrected in Rebuttal to \$42.9 million but this correction does not change the percentage calculation of water rights as 62% of total appraised value of the assets.

³³ The Commission last approved East Pasadena's revenues and rates in Commission Resolution W-5039 (Resolution W-5039).

³⁴ Resolution W-5039.

³⁵ Attachment 2 to CAW-2 (Owens Direct Errata).

The Commission's Water Division historically reviewed East Pasadena's rates annually following its standard practice applicable to a Class B Water utility.³⁶ Accordingly, East Pasadena customer rates increased 2.10 percent in 2016,³⁷ 2.10 percent again in 2017,³⁸ and 1.90 percent in 2018,³⁹ with a 6.75 percent expense offset as well.⁴⁰

If the Joint Applicants' proposal is approved and adopted, East Pasadena would be consolidated within the newly formed Cal-Am Southern District⁴¹ immediately for operational purposes, and in 2024⁴² for ratemaking purposes. For 2021, Cal-Am forecasts a revenue requirement of \$272,624,200 and a rate base of \$689.9 million on which investors will have the opportunity to earn a 7.61 percent return. The average bill of Cal-Am's customers in the Los Angeles County District ranged from \$83 - \$90 in April 2020, for an amount of water approximately at or above East Pasadena's average amount of water.⁴³ Cal-Am's residential tariffs show an inverted conservation rate structure, which means the price per unit of water varies based on consumption, so that high consumers pay a higher per unit of water than low consumers.⁴⁴

³⁶ Standard Practice Manual U-27-W revised April 16, 2014 at 65.

³⁷ AL 96.

³⁸ AL 98.

³⁹ AL 105.

⁴⁰ AL 103.

⁴¹ In its current GRC, Cal-Am requests approval to consolidate for ratemaking purposes its Los Angeles County District with the Ventura and San Diego Districts, to form a Southern District.

⁴² 2024, or after Cal-Am's GRC subsequent to the A.19-07-004 GRC.

⁴³ Attachment 2 to CAW-2 (Owens Direct Errata).

⁴⁴ A conservation focused rate design has increasing prices for higher consumption to encourage reduced consumption. Otherwise, a rate design might tend to have lower prices if there are economies of scale which reduce the average cost of incremental units.

The Public Advocates Office argued that the rate increase associated with the acquisition would constitute a harm to ratepayers and claimed that the proposed acquisition put “burdens on [existing] Cal Am ratepayers statewide as well as former [East Pasadena] customers and Cal Am ratepayers in [its current] Los Angeles service area” and would be unfair and unnecessary.

We find that the Public Advocates Office failed to incorporate the benefits to the transaction and therefore argued without merit that ratepayers would be treated unfairly.

On balance, we find that there are sufficient benefits in the transaction to offset any resultant rate increase. In fact, East Pasadena customers can expect a lower cost of service for the same or better water quality and reliability. Cal-Am quantified some of these savings from economies of scale expected in one year in its projections for 2021.⁴⁵ The Joint Applicants asserted, and we agree, such economies of scale for East Pasadena customers will grow over time. Additionally, in the short-term, East Pasadena customers will gain access to a number of Cal-Am programs and services not offered by East Pasadena, including:

- Nearby locations for expanded customer service and more effective assistance in emergency situations;⁴⁶
- Self-service options over the internet, paperless billing, translation in several languages;⁴⁷
- Low-income assistance for qualifying customers;⁴⁸ and

⁴⁵ Attachment 1 to CAW – 2 (Owens Direct Errata).

⁴⁶ CAW – 2 (Owens Direct Errata) at 30.

⁴⁷ CAW – 2 (Owens Direct Errata) at 30.

⁴⁸ CAW – 2 (Owens Direct Errata) at 29.

- More robust conservation programs.⁴⁹

Cal-Am expects the long-term synergies from the acquisition to offset any rate increases to customers of the former East Pasadena, stating:

While initial increases to the revenue requirement under California American Water appear to be slightly higher than they would if East Pasadena continued to operate the system, East Pasadena customers should experience the benefits of lower overall costs going forward.⁵⁰

Cal-Am also described the benefit of this transaction for all its customers statewide as the spreading of the fixed costs of the system across the additional 3,000 customers of East Pasadena.⁵¹

The Public Advocates Office objected and argued that benefits will only accrue to existing East Pasadena customers.⁵² And, as proposed, the transaction is not in the public interest, despite any benefits it may provide to East Pasadena

⁴⁹ CAW – 2 (Owens Direct Errata) at 28, 30.

⁵⁰ CAW – 2 (Owens Direct Errata) at 16.; One of the first applicable Commission decisions following the implementation of §§ 2718 – 2720 was D. 01-09-057, authorizing Cal-Am to acquire the water utility assets and public utility operations of Citizens Utilities Company of California. In this decision, the Commission explains the conundrum of how an increased rate base, with a likely increase in rates to follow, is beneficial to ratepayers of the acquired company “.....that if it were to include the full acquisition premium directly in rate base at the time of transfer under Section 2720(a), the revenue requirement for the former Citizens districts would be driven up and rates would follow in the short term. Economies of scale would begin to develop almost immediately, however, and after the early years the synergies savings from consolidation would overcome the effects of including the acquisition adjustment in rate base. Rates could then begin to drop to below what they would have been for the stand-alone operation.”

⁵¹ CAW – 2 (Owens Direct Errata) at 16, 26.

⁵² While the Public Advocates Office referenced an unreasonable rate increase for customers of the newly formed Los Angeles District in its Reply Brief at 3, this statement is in the context of scenario that will not occur: where the newly formed Los Angeles District would absorb the entire acquisition premium with no offset. The Public Advocates Office Reply Brief at 3 – 4 argued Cal-Am ratepayers statewide would subsidize the purchase price with no tangible benefit.

customers.⁵³ The Public Advocates Office argued there would be an unreasonable impact on Cal-Am customers in other parts of the state outside of the proposed Los Angeles District (including East Pasadena) currently under review in Cal-Am's pending GRC:

Imposing additional rate burdens on captive ratepayers who will have none of the benefits described in Pub. Util. Code § 2719 is not merely unfair, but also conflicts with a key premise of the statute that ratepayers will benefit from the transaction.⁵⁴

We find that the short and long term benefits of this transaction for East Pasadena customers, Cal-Am's existing customers in its Los Angeles District and all of Cal-Am's customers statewide sufficiently outweigh the anticipated rate increase. The Joint Applicants have adequately established that benefits will likely occur for all customers subject to the acquisition, sufficient to justify an overall revenue increase of approximately \$1.945 million annually.

We need not decide the question of whether the Los Angeles District will be realigned in the pending GRC and the placement of East Pasadena in that district is reasonable. Rates for East Pasadena customers or for existing Cal-Am customers will not change beyond the usual annual attrition adjustments, until Cal-Am has litigated its next 2024 GRC.

4.3. Allocation of Rate Base

The Joint Applicants proposed an allocation of the rate base designed to minimize the rate increase necessary to collect the new \$1.945 million in revenue.⁵⁵ Minimizing the rate increase is achieved by spreading rate impacts

⁵³ Public Advocates Office Opening Brief at 4.

⁵⁴ Public Advocates Office Reply Brief at 4. Also see PAO - 1 (Public Advocates Office Direct) at 1-9.

⁵⁵ CAW-2 (Owens Direct Errata) at 11:13-18.

equally over the largest number of customers possible (all Cal-Am customers statewide).⁵⁶ Furthermore, the Joint Applicants' proposed allocation necessarily depends upon a number of assumptions: Commission approval of new rates proposed by Cal-Am in its application, Commission approval to consolidate the Cal-Am Los Angeles County District with San Diego and Ventura into a Southern District, timing, and that synergies from operational consolidation materialize in the amounts estimated.⁵⁷ We defer consideration of Cal-Am's proposal to allocate the rate base between the proposed new consolidated district and its Corporate Office, which would impact all Cal-Am's ratepayers statewide, to the next 2024 GRC. Cal-Am already planned to defer ratemaking consolidation until its next GRC, so it is unnecessary, to set an allocation in this decision. With our approval of immediate operational consolidation discussed in the next section, we expect cost savings from synergies should begin to occur in time for consideration in Cal-Am's next GRC.

There is some guidance in § 854(e), to avoid adverse consequences of the transaction if an alternative to capturing savings can be found. No parties, including the Public Advocates Office, proposed any alternate allocation recommendation. Nevertheless, the Public Advocates Office maintained the transaction, as proposed, is unfair, primarily to the Cal-Am's ratepayers, in districts other than the newly consolidated district.⁵⁸ Moving the allocation decision closer to the time when new rates will take effect, and better estimates can be made, enhances the prospect of understanding rate impacts and apportioning impacts most fairly.

⁵⁶ Reporter's Transcript of Evidentiary Hearing September 14, 2020 at 160:1-6.

⁵⁷ CAW-2 (Owens Direct Errata) at 15:5-23.

⁵⁸ Public Advocates Office Opening Brief at 8, 16.

In the absence of a viable alternative analysis now, we defer addressing the allocation and its rate impacts to the next GRC, where the outcome of the district reorganization will be known. At that time, Cal-Am and the Public Advocates Office will have an opportunity to fully analyze the correct basis for setting rates in all of Cal-Am's districts including the possible new Southern District which will include the former East Pasadena customers.

The East Pasadena customers continue to be served at present rates, subject to the same interim attrition rate adjustments that would have been available to East Pasadena under the current ratesetting regime, until there is a decision in the next GRC where Cal-Am will have East Pasadena consolidated into its overall operations.

By deferring this issue to the 2024 GRC, we can also have the parties examine in depth the question of how to address the long-term ratemaking consequences of the intangible assets acquired by Cal-Am including the water rights held by East Pasadena before the sale. East Pasadena did not have a value on these rights in its current rate base. Cal-Am, however asserted that 62 percent of the value should be allocated "non-depreciable" assets, i.e., intangible assets which would include water rights. The Public Advocates Office offered a different valuation. In its opening comments on the proposed decision, Cal-Am requested the Commission resolve now the ratemaking treatment of water rights to give the company certainty and clarity, and characterized the water rights issue as one of "outsized importance." We agree with this characterization. Precisely for this reason, we require the examination of the ratemaking treatment of water rights within the overall context of Cal-Am operations, during Cal-Am's next GRC.

Based on the foregoing, it is reasonable to direct the parties to address the long-term ratemaking options and consequences of the intangible assets in the 2024 GRC.

4.4. Operational Consolidation of East Pasadena Service Area with Cal-Am's Existing Service Area

Cal-Am proposed an immediate consolidation of the East Pasadena service area with Cal-Am's existing service area for operational purposes. However, for ratemaking purposes, Cal-Am proposed postponing consolidation until the implementation of its 2024 GRC.

The Public Advocates Office did not oppose the proposed immediate consolidation for operational purposes and agreed the operational and public benefits from the acquisition begin immediately.

For ratemaking purposes, the Public Advocates Office argued for deferring consolidation for many years. This is not persuasive because it was based on the Public Advocates Office's erroneous assertion that sale proceeds should be returned to East Pasadena ratepayers.

There is no compelling reason to defer operational consolidation; thus, we approve the proposed immediate operational consolidation. Section 451 requires rate changes in the context of a GRC, and as noted above we defer ratemaking consolidation of the East Pasadena service area to the subsequent Cal-Am 2024 GRC.

4.5. Certain Specific Gain-On-Sale Rules are Not Applicable to the Proposed Transaction

Under the terms of the transfer, East Pasadena will receive approximately \$34 million in exchange for the East Pasadena assets used and useful to provide water service as a regulated public utility. For East Pasadena, the transaction would produce a \$30 million gain-on-sale, *i.e.*, the difference between its current

rate base value of \$4 million and the purchase price. The Commission has previously established specific treatment for a gain-on-sale involving certain types of utility assets.⁵⁹

The Public Advocates Office argued that the gain-on-sale for this transaction should be allocated between shareholders and ratepayers in accordance with certain prior gain-on-sale decisions, however, the cited decisions only apply to the sale of utility assets that are no longer used and useful, i.e., those assets that are not in rate base and not currently used for utility operation. The Joint Applicants asked the Commission to reject the Public Advocates Office's proposal and argued that the proposed allocation would "turn the State policy favoring consolidation of small water systems on its head."⁶⁰ The Joint Applicants argued the gain-on-sale decisions cited by the Public Advocates Office did not change Commission policy which generally permitted shareholders to retain the full proceeds when the transfer results in the total liquidation of an acquired utility operation. Here, the Joint Applicants argued, the transaction is for all of the used and useful water utility assets of East Pasadena, and they would be purchased by Cal-Am and continue to be used to provide water utility service to the former customers of East Pasadena.

The Commission opened Rulemaking (R.) 04-09-003 to consider generally how to allocate gains from the sales of utility assets no longer used and useful, between ratepayers and shareholders. The final decisions mandate profits of real property, which is another term for non-depreciable property, be allocated 50-50 between shareholders and ratepayers.⁶¹

⁵⁹ See, D.06-05-041, as modified by D.06-12-043, the principal gain-on-sale decisions.

⁶⁰ Joint Applicants Reply Brief at 6.

⁶¹ D.06-05-041 FoF 2, 3.

For public water utilities in particular, the controlling authority on the gain-on-sale of no longer used and useful utility non-depreciable assets was previously established by statute, the Public Water Utility Infrastructure Improvement Act of 1995, §§ 789 *et seq.* (Infrastructure Act). Non-depreciable assets are typically land and intangibles such as water rights. When a water utility sells real property no longer used and useful, the Infrastructure Act requires the “net proceeds” of the sale accrue neither to ratepayers or shareholders but instead are invested in water system infrastructure that is necessary or useful for utility service.⁶² The Joint Applicants ~~emphasized that~~ emphasized that applying the Commission’s gain-on-sale decisions (which are applicable only to no longer used and useful assets) to transactions involving assets currently used and useful, and which are subject to the Public Water System Investment and Consolidation Act, would extinguish the incentive to sell and make the transaction unviable.⁶³

In fact, the Commission has previously determined that applying gain-on-sale rules to used and useful water system asset sales would directly conflict with the Public Water System Investment and Consolidation Act.⁶⁴ When utility ownership is transferred completely to a new owner any gain (or loss) realized by the former ownership structure belongs to that former owner.

In its opening comments on the proposed decision, the Public Advocates Office pursues its ~~misguided~~ argument.

In D.06-05-041, the Commission states that allocation rules for gain-on-sale “shall apply to water utility sale assets, *except* where the

⁶² D. 06-05-024 at 61.

⁶³ Joint Applicants Opening Brief at 11, Reply Brief at 9. CAW - 9 (Stephenson Rebuttal), EPWC - 2 (Morales Rebuttal), EPWC - 3 (Solvik Rebuttal).

⁶⁴ D.16-11-014.

asset sold is real property *that is no longer used and useful.*”[footnote 11: D.06-05-041, Ordering Paragraph 20 (emphasis added).] The PD erroneously concludes the opposite, stating that the gain on sale requirements do not apply to the present transaction because East Pasadena’s assets are currently used and useful. [footnote omitted] Precisely because this transaction involves the sale of currently used and useful assets, the rules established in the Gain on Sale Decisions apply to this transaction and the PD errs in declining to apply them.[footnote omitted]⁶⁵

The Public Advocates Office misconstrues Ordering Paragraph 20⁶⁶ regarding water utility sales, by suggesting an exclusion of real property no longer used and useful implies the inclusion of real property used and useful. The exclusion in Ordering Paragraph 20 is for real property, and the inclusion for depreciable property.

The Public Advocates Office argument is contrary to the context of the entire gain-on-sale proceeding. As noted above, D.06-05-041 considers at length prior relevant statutory direction, the Infrastructure Act. Yet D.06-05-041 omits reference to the prior statutory direction of the 1997 Public Water System Investment and Consolidation Act, and the Commission’s implementation in D.99-10-064, despite the obvious impact D.06-05-041 would have made on fair market value and the acquisition premium.⁶⁷

We are not persuaded by the Public Advocates Office’s argument. The gain-on-sale decisions do not apply to the East Pasadena asset sale where

⁶⁵ Public Advocates Office Opening Comments on the Proposed Decision at 3-4.

⁶⁶ Ordering Paragraph 20, with supporting discussion found at 61-66, of D.06-05-041.

⁶⁷ If buyers and sellers of water utilities were to negotiate a purchase price and concomitant acquisition premium with 50 percent of the gain assumed allocated to ratepayers of the acquired water utility, such credit to ratepayers of the acquired utility would be funded by ratepayers of the acquiring utility

Cal-Am applied to acquire all of the currently used and useful assets which would continue to be used for utility service.

~~The Commission's decisions on gain on sale and the attendant gain on sales rules are inapposite, as discussed above, and we decline to apply them to this transaction.~~

4.6. The Proposed Transaction is in the Public Interest

Cal-Am argued that this transaction would bring greater economies of scale, greater resources and expertise, to the management and operation of East Pasadena. Cal-Am listed benefits such as ensuring East Pasadena customers' long-term access to safe and reliable water services at affordable prices. Cal-Am also noted that East Pasadena's economically disadvantaged customers would be eligible for Cal-Am's already existing the low-income assistance program.

East Pasadena described the decision to sell the utility to Cal-Am as a sound management strategy that will provide long-term sustainability for the current East Pasadena ratepayers.

The Public Advocates Office argued that the rate increase associated with the acquisition would constitute a harm to ratepayers. We are not persuaded by this argument by the Public Advocates Office, nor their remedy of incorrectly allocating a portion of the gain to ratepayers.

In general, the parties' consensus, including the Public Advocates Office, was that East Pasadena is a well-run public water utility under its current ownership and management and no immediate threats to water quality or reliability have been identified.

Evidence in this case shows that, over time, California's stricter water quality standards, water supply issues and the need to develop new water conservation strategies could cause rate increases to East Pasadena's 3,000

customers beyond a level they could absorb. In fact, East Pasadena Wells 7 and 8 have been shut off for many years. Well 7 has been shut off since 2013 because it exceeded state limits for Gross Alpha and Uranium. Well 8 has been shut off since 2018 because it exceeded state limits of 1,2,3-Trichloropropane. In both cases, the necessary treatment system would be a high cost for ratepayers to bear. East Pasadena's witness further described how careful management, conservation, and lower demand currently allowed East Pasadena to reliably serve their customers without Wells 7 and 8. However, East Pasadena's witness testified that demand will steadily increase and therefore returning the wells into service would become more essential. The witness also asserted that Cal-Am's acquisition of East Pasadena would lessen ratepayer impacts of the infrastructure investment that would eventually be required, stating:

The decision to sell stems directly from East Pasadena's sound management strategy. We are looking 3 to 5 years down the road and it is far better to transition to a much larger and more capable company now than to wait, which would only pass on greater compliance costs to our [stand-alone] ratepayers in the future.

Similarly, Cal-Am's witness testified that East Pasadena is likely to face financial and operational challenges in the "near future."

Cal-Am's witness testified that by combining Cal-Am and East Pasadena's groundwater rights through this transaction East Pasadena customers' water demand can be met without costly over-pumping from the Main water basin, where East Pasadena currently must over-pump. With regard to Cal-Am ratepayers, Cal-Am provided testimony that acquiring East Pasadena's water rights in the Raymond and Main water basins would similarly give Cal-Am and its customers access to the lowest-cost water supplies available.

Cal-Am's witness estimated \$1.475 million in annual cost savings and further testified that Cal-Am's lower authorized rate of return (compared to East Pasadena's) would save East Pasadena ratepayers approximately \$35,000 for every million dollars of invested capital. Cal-Am's witness also noted additional unquantified potential cost savings for material purchases, contracts for engineering projects, and use of in-house engineers.

In addition, Cal-Am contended that it has better access to capital at lower costs than East Pasadena. For example, the Commission authorized Cal-Am to issue up to \$359 million in long-term debt in D.18-07-013, and Cal-Am is also a part of a financial services agreement with its parent company that applies to all of its subsidiaries. This would suggest that Cal-Am is far more capable than East Pasadena to finance future infrastructure needs. The resulting improvement in access to capital to invest in East Pasadena's water system infrastructure is consistent with the policy objective of the Public Water System Investment and Consolidation Act.

Finally, Cal-Am argued that its "size, position in the industry and association with parent company American Water, will allow California American Water to meet water quality, reliability and customer service standards efficiently."

We note, the Public Advocates Office did not contest the above evidence on the public interest benefits of the transaction; its main objection was the likely rate impact on all customers.

In summary, we apply the "ratepayer indifference standard," as we weigh the above public interests furthered by the proposed acquisition. We find that the rate impact of this proposed transaction cannot be eliminated, but those ratepayer impacts are one of several components comprising the public interest

driven by an increase in rate base determined to be fair and reasonable. In view of the compelling evidence of public interest benefits that will result from the proposed transaction, we find that on balance the proposed transaction promotes the legislatively declared post-transaction public interest objectives and meets the “ratepayer indifference standard.”

4.7. New and Modified Memorandum Accounts

The Joint Applicants ask the Commission to establish for Cal-Am two new memorandum accounts: (i) The East Pasadena Acquisition Contingency Memorandum Account⁶⁸ (Contingency Account), which would track alleged lost revenue from all affected entities until the acquisition could be integrated for ratemaking purposes in the 2024 GRC; and (ii) The East Pasadena Transaction Cost Memorandum Account (Transaction Account) which would track any potential costs necessary to complete the transaction, such as legal, engineering, surveying, appraisal, noticing, and other professional activities not otherwise included in the application.

As discussed below, we deny the request to create the Contingency Account and approve the Transaction Account subject to the limits as discussed

⁶⁸ A memorandum account is a regulatory tool that, when authorized, allows a utility to record off the balance sheet any costs which are defined but unknown in terms of amount or justification. These defined costs are not yet authorized as recoverable in rates. In a subsequent proceeding the utility must (1) justify why the costs should be recoverable from ratepayers and then it must (2) justify the costs were reasonably incurred (*e.g.*, costs were as low as possible, etc.) Thus, a memorandum account is a promise to consider recovery, not a promise of recovery in subsequent rates. The creation of a memorandum account avoids the legal prohibition on retroactive ratemaking. By contrast, a balancing account has a regulatory decision authorizing future recovery where the costs may be volatile and not readily forecast for inclusion in rates, and therefore the utility must subsequently justify the reasonableness of the actual expense in a formal proceeding. Memorandum accounts do not appear on the balance sheet because they are not yet authorized for current or future recovery, whereas balancing accounts are reported on the balance sheet as an asset or liability depending on the balance. Balancing accounts typically have a forecast rate in current rates which offset actual costs as they are incurred, and therefore can be over- or under-collected over time.

below; and we approve the inclusion of East Pasadena in Cal-Am's existing Memorandum Account for Environmental Improvements and Compliance.

4.7.1. The East Pasadena Acquisition Contingency Memorandum Account

The Joint Applicants' estimate of revenues that may be lost during the years 2021, 2022 and 2023 should be the same as the revenues calculated for illustrative purposes if the acquisition were to close immediately, which is \$1.945 million, annually.

The Public Advocates Office opposed the requests to establish both new memorandum accounts, disputing that the Commission's criteria for establishing memorandum accounts apply to the facts of this proceeding, and points to a recent Cal-Am acquisition as precedential, where Cal-Am acquired Hillview Water Company.⁶⁹

Cal-Am failed to make a unique case for the Contingency Account to show that it could be materially harmed. If, as Cal-Am states in opening comments of the proposed decision, East Pasadena's larger size increases the variability of regulatory risk as well as the magnitude of risk, so does East Pasadena's larger size increase the potential for reward. Cal-Am is subject to a regular cycle of rate proceedings including the GRCs and attrition filings which adjust rates in between GRCs. We discount the Public Advocates Office's reliance on a single recent decision, because the Commission is not rigidly bound to precedent but must instead consider each proceeding on its own merits as well as recent prior decisions.

Cal-Am entered into the purchase of East Pasadena as an experienced and competently run utility subject to this Commission's regulatory regime and

⁶⁹ D.19-11-003 in A.18-04-025.

should have fully understood and considered the ratesetting cycle as one of many factors affecting its decision to acquire the company. We could not approve the acquisition of East Pasadena, if we did not believe that Cal-Am was a competent entity to operate East Pasadena in place of the seller. As a competent entity Cal-Am should have recognized that the price it would pay would include the attendant risks and opportunities offered by East Pasadena's current and near-term operations and revenue stream as well as the open-ended opportunity for a future revenue stream as a part of Cal-Am's overall operations.

We therefore find that there is no "contingency" or other circumstances that warrant the creation of the proposed Contingency Account.

4.7.2. The East Pasadena Transaction Cost Memorandum Account

The Transaction Account would track the costs of activities necessary to complete the transaction, such as legal, engineering, surveying, appraisal, noticing, and other professional activities. The Joint Applicants argue that they have spent approximately \$290,000 in transaction costs as of October 2020.⁷⁰ In support of their requests for both memorandum accounts, the Joint Applicants argued the requests (for both the Contingency Account and Transaction Account) meet the Commission's criteria for creating memorandum accounts and are consistent with recent Commission decisions approving Cal-Am's other acquisitions.

The Public Advocates Office opposed granting the Transaction Account as well as the Contingency Account, above.

As noted above, Cal-Am is a sophisticated party that has purchased other water systems and is well able to consider its risks and rewards by entering into

⁷⁰ CAW - 7 (Owens Rebuttal) at 9.

the agreement to buy East Pasadena's operations and it has had every opportunity to include in this application all foreseeable costs in addition to the purchase price. Additionally, Cal-Am is a sophisticated operator of water systems and should have carefully and fully examined East Pasadena's operations before entering into a transaction. Spending over \$290,000, as of last November, is not a small sum even for Cal-Am. The Public Advocates Office is well within its remit to be concerned that these costs may be unnecessary or excessive.

No costs incurred before the creation of a memorandum account may be included in this account. To do so would violate the prohibition on retroactive ratemaking.⁷¹ Cal-Am's concern that limiting the Transaction Account to costs going forward would disincentive future water system consolidations is speculative. As in this case, the statutory incentive may suffice.

Based on the foregoing, we authorize the Transaction Account subject to review by the Commission in a subsequent proceeding. We remind all parties that this is a Memorandum Account. As such there is no presumption that the costs will be found necessary or reasonable and, instead, they may not be recoverable. Merely spending the money does not justify future recovery in rates. Cal-Am bears the full burden of proof for both the necessity of these costs and their reasonableness. "Necessity" means that these costs benefit the customers by improving or maintaining the system in a reasonable manner to provide safe and reliable water service. Conversely, any costs incurred that serve to protect or benefit Cal-Am's shareholders would not meet this definition.

⁷¹ The Commission sets rates on a prospective basis not on the recovery of actual historical costs. This is why we set rates on a GRC forecast test year and why we authorize balancing accounts for justifiable but uncertain costs. Memorandum accounts lack findings on justification and reasonableness.

4.7.3. Inclusion of East Pasadena in the Existing Memorandum Account for Environmental Improvements and Compliance Issues for Acquisitions

Cal-Am's request to expand the currently authorized memorandum account entitled "The Memorandum Account for Environmental Improvements and Compliance issues for Acquisitions" is unopposed and should be granted. This is consistent with decisions in prior acquisitions and is in the public interest. Like all memorandum accounts, it is subject to review before any recovery is included in rates.

5. Interim Rate Relief Until the Next GRC

As an interim rate relief, until Cal-Am has its next 2024 GRC, Cal-Am requested permission to file for the annual cost-of-living rate increases the Commission would have permitted for East Pasadena had the acquisition not occurred. Cal-Am's request for interim rate relief is granted. We find that the impact of the annual cost-of-living rate increases on East Pasadena customers is reasonable because these filings would have occurred in the absence of the acquisition.

6. Certificate of Public Convenience and Necessity

Upon completion of the acquisition, East Pasadena will cease to operate⁷² and Cal-Am will replace it as the service provider for the current customers of East Pasadena. Consequently, we must simultaneously cancel East Pasadena's CPCN and modify Cal-Am's CPCN to include the new service territory and customers. Upon completion of the transaction both East Pasadena and Cal-Am shall file Tier 1 compliance advice letters to implement these respective changes.

7. The California Environmental Quality Act

⁷² This decision does not terminate the corporate entity of East Pasadena because this transaction is an asset purchase not a merger of two companies.

Pursuant to Public Resources Code § 21080 *et seq.* (the California Environmental Quality Act (CEQA)) and pursuant to Rule 2.4 of the Commission’s Rules of Practice and Procedure, the Commission must consider the environmental consequences of projects that are subject to our discretionary approval. The CEQA Guidelines state that a proposed “activity [that] will not result in a direct or reasonably foreseeable indirect physical change in the environment” is exempt from CEQA.⁷³ Similarly, where “it can be seen with certainty that there is no possibility that the [proposed] activity in question may have a significant effect on the environment, the activity is not subject to CEQA.”⁷⁴

Based on the record before this Commission, we find that the proposed transaction is not subject to CEQA as it can be seen with some certainty that there is no possibility that the transaction in question may have a significant effect on the environment. Alternatively, the proposed transaction qualifies for exemption from CEQA, under CEQA Guideline § 15061(b)(3) as having no significant impact upon the environment. Here, the proposed acquisition is merely the control and ownership of existing utility assets, and there is nothing in the record to demonstrate or imply any change in purpose or manner from the present distribution of water. The parties both agreed that this transaction requires no CEQA review from this or any other agency. Further, there is no evidence in the record that this transaction requires CEQA review from this or any other agency. Therefore, we find that a CEQA review is not required.

8. Safety Considerations

⁷³ CEQA Guideline § 15060(c)(2)

⁷⁴ CEQA Guideline § 15061(b)(3).

The proposed transaction does not appear to cause any change in any aspects of safety as to the operation of the East Pasadena service area. To the contrary, Cal-Am asserted, without opposition, that there are more likely to be improvements in safety issues and concerns.⁷⁵ Consequently, it is reasonable to conclude that safety is not negatively impacted by this transaction, and so it is in compliance with § 451, which requires, in part, that utilities are operated to promote the safety of the public.

9. Comments on Proposed Decision

The proposed decision of ALJs Camille Watts-Zagha and Jeanne McKinney in this matter was mailed to the parties in accordance with Section 311 of the Public Utilities Code and comments were allowed under Rule 14.3 of the Commission's Rules of Practice and Procedure. Comments were filed on June 29, 2021, by Cal-Am and the Public Advocates Office, and reply comments were filed on July 6, 2021, by Cal-Am, East Pasadena and the Public Advocates Office. Corrections and clarifications have been incorporated throughout this decision as appropriate.

10. Assignment of Proceeding

Genevieve Shiroma is the assigned Commissioner and Camille Watts-Zagha and Jeanne McKinney are the co-assigned ALJs in this proceeding. Pursuant to § 1701.3(b) and Rule 13.2(b), ALJ Watts-Zagha was designated as the Presiding Officer.

Findings of Fact

1. Cal-Am is a Class A public water utility subject to the jurisdiction of this Commission. Cal-Am is a California corporation and it is a subsidiary of

⁷⁵ Cal-Am Application at 15, 17.

American Water Works Company, the largest publicly traded water utility in the United States.

2. Cal-Am has a CPCN to operate as a regulated Class A public water utility company and serves approximately 630,000 customers in 50 communities.

3. East Pasadena is a Class B public water utility subject to the jurisdiction of this Commission.

4. East Pasadena has a CPCN to operate as a regulated Class B public water utility serving approximately 3,000 customers in the cities of Temple City, Arcadia, San Gabriel, and an unincorporated area of Los Angeles County southeast of the City of Pasadena.

5. Cal-Am and East Pasadena adequately notified their customers of the proposed acquisition of East Pasadena's utility assets.

6. Commission Resolution W-5039 has previously established East Pasadena's rate base of \$3,959,034 with a revenue requirement of \$3,135,976.

7. Cal-Am currently has a GRC, A.19-07-004, pending, and it is scheduled to file its next GRC on July 1, 2022, for test year 2024.

8. East Pasadena's principal owner voluntarily entered into an agreement to sell the utility's assets to Cal-Am in an arm's-length negotiated contract at a mutually agreeable price of \$34 million, with minor adjustments at closing the transaction, for all of East Pasadena's water system related assets used to operate as a Class B water public utility.

9. The proposed purchase price is \$34,000,000, plus or minus any adjustment amounts within the purchase agreement, and inclusive of East Pasadena's water rights.

10. The Public Water System Investment and Consolidation Act provides that an acquisition premium may be included in the acquiring water company's rate

base. This acquisition premium is the difference between the book value of the assets prior to acquisition, and the fair market value of the assets at the time they are purchased.

11. As long as the transaction is found to be in the public interest, the Public Water System Investment and Consolidation Act permits inclusion of the acquisition premium in the acquiring company's rate base.

12. Section 2720(b) provides, in part:

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.

13. The rate impacts associated with the estimated \$1.945 million increase in revenue requirement are reasonable in view of the compelling evidence of public interest benefits that will result from the proposed transaction.

14. East Pasadena can be operationally included in Cal-Am's current Los Angeles County District which itself may be included in a new Southern District in the pending Cal-Am GRC.

15. East Pasadena's rates for its current customers, including any allowable rate increase, remain in effect until Cal-Am's test year 2024 GRC decision.

16. The proposed transaction will result in efficiencies and economies of scale which would benefit the existing East Pasadena and Cal-Am ratepayers, including benefits from consolidating the East Pasadena service area into the currently existing Cal-Am Los Angeles County District.

17. The proposed purchase price was supported by the Joint Applicants' appraisal, which was based on the replacement cost new less depreciation method. The appraisal valued the East Pasadena system assets at \$42.9 million, consisting of tangible property assets of \$9.3 million, real estate and vehicles of \$7.2 million, and water rights of \$26.7 million.

18. The Public Advocates Office presented its own appraisal valuation of \$38.5 million and noted that the proposed purchase price of \$34 million is actually lower than either appraisal provided by Cal-Am or the Public Advocates Office.

19. As a large Class A water utility, Cal-Am is in a superior position to achieve economies of scale, resources, and has knowledge to better service the water needs of the East Pasadena service area compared to East Pasadena's current operations.

20. Cal-Am has no need for a new East Pasadena Acquisition Contingency Memorandum Account.

21. Cal-Am needs a new East Pasadena Transaction Cost Memorandum Account for potential recovery of costs incurred after the effective date of this decision.

22. Cal-Am needs to include East Pasadena in an existing Memorandum Account for Environmental Improvement and Compliance Issues for Acquisitions.

23. The cost allocation and rate design impacts of the acquisition can be deferred to the 2024 GRC.

24. The transaction will enhance the health and safety of East Pasadena customers.

25. The transaction will have no reasonably foreseeable impact on the environment.

26. The transaction is not subject to CEQA as it can be seen with some certainty that there is no possibility that the transaction in question may have a significant effect on the environment.

27. The transaction qualifies for exemption from CEQA, under CEQA Guideline § 15061(b)(3) as having no significant impact upon the environment.

Conclusions of Law

1. The Commission should authorize East Pasadena to sell, and Cal-Am to purchase, all of East Pasadena's assets listed the Asset Purchase Agreement, entered into on August 19, 2019, including East Pasadena's entire water system, water rights and all of its assets.

2. The total final purchase price of \$34 million, plus or minus any adjustment amounts within the purchase agreement, represents the fair market value as defined by Pub. Util. Code § 2720.

3. The Commission should authorize post-transaction rate base equal to the total final purchase price.

4. Approving Cal-Am's proposed purchase of the water utility assets of East Pasadena is in the public interest and consistent with §§ 851 *et seq.* and §§ 2718 *et seq.*

5. The Application and the proposed acquisition promote the legislative and public interest goals of Public Water System Investment and Consolidation Act, §§ 2718 *et seq.*

6. It is reasonable to direct the parties to address the long-term ratemaking options and consequences of the intangible assets in the 2024 GRC.

7. Consideration of Cal-Am's proposal to allocate the rate base between the proposed new consolidated district and its Corporate Office, which would impact all Cal-Am's ratepayers statewide, should be deferred to the next 2024 GRC.

8. Cal-Am's proposed immediate consolidation of the East Pasadena service area with Cal-Am's existing service area (Los Angeles County District or Southern District), for operational purposes, should be authorized.

9. Cal-Am's request to consolidate East Pasadena into its Los Angeles County District for ratemaking purposes in Cal-Am's next GRC, effective January 1, 2024, is reasonable, and should be granted.

10. The ratesetting allocation of the rate base addition should be deferred to the 2024 GRC.

11. The ratemaking allocation of its acquisition premium between Cal-Am's rate districts and the East Pasadena service area should be deferred to the 2024 GRC.

12. The long-term ratemaking treatment of the acquired intangible assets should be deferred to the 2024 GRC.

13. Until Cal-Am files its next GRC, the rates in the East Pasadena service area should remain in effect subject to existing authority to file for rate increases using the Commission's advice letter process.

14. Cal-Am's request for authorization to establish an East Pasadena Transaction Memorandum Account to record all of its future transaction costs consistent with this Decision should be granted.

15. Cal-Am's request for authorization to establish an East Pasadena Acquisition Contingency Memorandum Account should be denied.

16. Cal-Am should be authorized to add East Pasadena to its existing Memorandum Account for Environmental Improvement and Compliance Issues for Acquisitions.

17. The Commission's decisions on gain-on-sale and the attendant gain-on-sales rules ~~are inapposite and should do~~ not ~~be applied~~ apply to this transaction.

18. The transaction complies with and is consistent with § 451, which requires, in part, that utilities are operated to promote the safety of the public.

19. CEQA review should not be required before approving the transaction.

20. This proceeding should be closed.

O R D E R

IT IS ORDERED that:

1. East Pasadena Water Company (East Pasadena) is authorized to sell, and California-American Water Company is authorized to purchase, all of East Pasadena's assets listed in the Asset Purchase Agreement, entered into on August 19, 2019, including East Pasadena's entire water system, water rights and all of its assets.

2. California-American Water Company's (Cal-Am's) Certificate of Public Convenience and Necessity is modified to incorporate the East Pasadena Water System service area into Cal-Am's Los Angeles County District.

3. California-American Water Company (Cal-Am) is authorized to include the \$34,000,000 purchase price, plus or minus any adjustment amounts within the purchase agreement, of East Pasadena Water Company in Cal-Am's rate base in a subsequent 2024 general rate case proceeding. Cal-Am shall address the long-term ratemaking treatment of the acquired intangible assets in that proceeding.

4. California-American Water Company, in its next 2024 general rate case, shall consolidate East Pasadena Water Company in its tariffs for ratemaking purposes.

5. California-American Water Company's (Cal-Am's) proposed immediate consolidation of the East Pasadena Water Company service area with Cal-Am's existing service area (Los Angeles County District or Southern District), for operational purposes, is authorized.

6. Existing rates for customers of the East Pasadena Water Company shall remain in effect until subsequently modified by this Commission.

7. California-American Water Company shall file within 10 days of this decision a Tier 1 Advice Letter to establish an East Pasadena Transaction Cost Memorandum Account and to include East Pasadena in its existing Memorandum Account for Environmental Improvement and Compliance Issues for Acquisitions.

8. California-American Water Company's request to create a new East Pasadena Acquisition Contingency Memorandum Account is denied.

9. Until California-American Water Company files its 2024 general rate case proceeding, the rates in the East Pasadena Water System service area shall remain in effect subject to existing authority to file for rate increases using the Commission's advice letter process.

10. California-American Water Company's request for authorization to establish an East Pasadena Transaction Memorandum Account to record all of its future transaction costs consistent with this Decision is granted.

11. Within 10 days of the completion of the sale by the East Pasadena Water Company (East Pasadena) to California-American Water Company (Cal-Am) of all of the assets included in the Asset Purchase Agreement, Cal-Am and East

Pasadena shall notify the Commission's Water Division that the sale has been completed.

12. This proceeding, Application 20-04-003, is closed.

This order is effective today.

Dated _____, at San Francisco, California.

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