

APPENDIX A:
Proposed Framework and Analysis

A Revised Framework for Water Utility Acquisitions

STAFF WHITE PAPER

RECOMMENDING AN ORDER INSTITUTING
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Executive Summary

The California Public Utilities Commission (Commission) is dedicated to ensuring clean, safe, and reliable water service at reasonable rates. The Commission currently regulates 91 investor-owned water utilities (Water IOUs) which serve roughly 15% of California’s population.

For the past two decades, the Commission’s guiding framework¹ regarding water utility acquisitions has primarily sought to achieve economies of scale by incentivizing the acquisition of smaller water systems by larger investor-owned utilities. This remains an important goal, and the Commission has approved dozens of acquisitions under this framework. However, there are many questions that the existing framework leaves unanswered, and many acquisition proceedings remain contentious, especially on the issues of the valuation of water systems and the effects of acquisitions on ratepayers—customers of both the acquiring system and the system being acquired. Due in part to unanswered questions with the existing framework, some acquisition proceedings have exceeded the timeline prescribed by the existing framework to arrive at a conclusion and have often put the Commission’s policy goals of affordability and ensuring safe, clean, and reliable water service at odds as described in this paper.

Furthermore, developments since the Legislature acted in 1997² to incentivize acquisitions have the potential to influence Commission policy regarding acquisitions in the near term and in the future. In September of 2012, California established the Human Right to Water.³ In February of 2019, the Commission adopted its first Environmental and Social Justice Action Plan, which addresses the rights for clean, safe, reliable, and affordable access to water to communities that have been underserved. Finally, in April of 2021, the State Water Resources Control Board (SWRCB) released its first Human Right to Water Needs Assessment as part of its Safe and Affordable Funding for Equity and Resilience (SAFER) program, highlighting approximately 620 at-risk or failing water systems across the state. Some of these systems may be seen as opportunities for consolidation by Commission-regulated utilities, and as more acquisitions come before the Commission, it will need to continue to balance the benefits of acquisitions with the inherent risks.

In light of the complexities faced in recent acquisition proceedings, as well as the development of the state’s policy goals, Water Division recommends the Commission open an Order Instituting Rulemaking (OIR) to create a revised framework for water utility acquisitions. This rulemaking could explore the Commission’s acquisitions policy broadly, as well as specifically address:

- available options for the valuation of water systems;
- how to evaluate an acquisition’s impact on ratepayers, including the ratemaking method used to allocate costs to the acquiring utility’s customers;

¹ Decision (D.) 99-10-064.

² Legislature’s passage of Senate Bill (SB) 1268 as the Public Water System Investment and Consolidation Act of 1997

³ Water Code, Section 106.3.

- how to best coordinate acquisition policies with the State Water Resources Control Board;
- the role of grant funding in acquisitions;
- the procedural timeline for processing acquisitions;
- the appropriate standard for reviewing acquisition proceedings; and
- how to address gains on sale or potential cost sharing between ratepayers and shareholders.

This white paper begins by summarizing the historical and regulatory framework that governs water system acquisitions at the Commission. It then explores each of the above issues in more detail in the context of the existing framework's problems and in specific case studies. Finally, the white paper poses questions that the Commission may consider with the opening of a new Rulemaking.

Summary of the Existing Framework

Governing Statutes

The Public Water System Investment and Consolidation Act of 1997 (Act) sought to achieve economies of scale in public water systems, given the increasing amounts of capital required to finance necessary investments.⁴ Specifically, the Act established Sections 2718 through 2720 of the Public Utilities Code (PU Code)⁵.

PU Code Section 2720(a) incentivizes water corporations to acquire other water systems by setting the fair market value of the acquired system as the standard when establishing rate base.⁶ Subsection 2720(b) allows for the inclusion in rate base of an acquisition premium—the difference between the fair market value and the reproduction cost⁷ of the acquired system—if certain conditions are met. The conditions to be considered are: 1) whether the acquisition of the public water system will improve water system reliability; 2) whether the ability of the water system to comply with health and safety regulations is improved; 3) whether the water corporation by acquiring the public water system can achieve efficiencies and economies of scale that would not otherwise be available; and 4) whether the effect on existing customers of the water corporation and the acquired public water system is fair and reasonable. Therefore, in evaluating those conditions for each acquisition, the Commission has the authority and responsibility to determine if the acquisition is ultimately in the public interest.

Section 1263.320 of the Code of Civil Procedure (CCP) provides two possible pathways for the determination of fair market value in acquisitions. The first defines fair market value as the highest price agreed upon by a willing buyer and willing seller. The second, applying in special circumstances like utilities, provides for a “just and equitable” valuation in cases where no relevant, comparable market exists.

Acquisitions are also governed by Sections 851 through 854 of the PU Code. These sections establish the Commission’s authority to determine whether a proposed acquisition is in the public interest and Section 854 specifically lists criteria that can aid the Commission in doing so.⁸ These sections of the PU Code establish more specific administrative guidelines for processing of acquisitions, such as establishing that

⁴ D.99-10-064 concluded Rulemaking (R.) 97-10-045, which the Commission opened in response to the Legislature’s passage of Senate Bill (SB) 1268 as the Public Water System Investment and Consolidation Act of 1997.

⁵ This Code Section and relevant statutes can be found in Appendix B.

⁶ Fair market value is specifically defined in Section 1263.320 of the Code of Civil Procedure, discussed below.

⁷ “Reproduction cost” of a property is determined in accordance with Evidence Code Section 820, which also establishes a distinction between replacement cost and reproduction cost.

⁸ While these criteria are specifically applied to electrical, gas, and telephone companies, the criteria in 854 generally denote that ratepayer interest, shareholder interests, utility employee interests, and local & statewide community interests all constitute the public interest.

transactions valued above \$5 million require an application, while lesser-valued transfers may be processed via advice letters.

Also relevant to acquisitions of water systems is PU Code Section 10061, governing the sale or transfer of municipal systems. Section 10061 permits a city or county to sell the portions of its water system outside municipal boundaries by a resolution of its legislative body, while the water system located within city limits may only be sold by a majority of voters in a special election. Additional notice requirements are also required for a municipal sale and are described in this code section. Other statutes governing municipal water systems may add additional layers to the Commission's decision-making process. In particular, Government Code Section 37420.5 created specific provisions for the cities of El Monte, Montebello, and Willows to sell their water systems without being subject to the PU Code Section 10061 requirements regarding a public vote.

Background

The Commission opened Rulemaking (R.) 97-10-048 to address the need for changes in regulations surrounding the acquisition or merger of utility water systems, in relation to two significant events affecting the water industry at the time. Shortly after this proceeding was opened, the Legislature enacted Senate Bill 1268 to add Sections 2718-2720 to the PU Code, also known as the Public Water System Investment and Consolidation Act of 1997 (Act). With this Act, the Legislature declared that public water systems were “faced with a need to improve their infrastructure to meet increasingly stringent state and federal safe drinking water laws.”⁹ Thus, more capital to finance necessary investment in water systems would be needed. The Legislature declared that economies of scale were achievable in the operation of public water systems and desired to provide incentives for water corporations to seek these economies, which in turn would benefit ratepayers.¹⁰ The incentive provided by SB 1268 was to allow the fair market value as the standard for ratemaking purposes when a water system is acquired. Through this ratemaking practice, the acquiring utility would add the fair market value of the acquired system to its existing rate base, similar to a capital addition that increases the overall value of the utility and allows the utility to earn a return on its investment. In addition, if the fair market value exceeds the reproduction cost, the difference may be included in the acquiring utility's rate base provided the additional amount is found to be reasonable and will provide important benefits.¹¹

The second significant event at the time was the approval in the 1996 California general election of Proposition 218, which requires an affirmative vote by the public before a public agency water system is authorized to raise property-related fees or taxes and by extension, water rates. By allowing the public to vote on proposed water rate increases, this proposition fulfilled its purpose in giving the public an opportunity to have a say in rate increases; however, this voting process may have led to some unintended consequences. Voters may elect to not raise rates or their own utility bills, but this ultimately results in

⁹ PU Code Section 2719(a).

¹⁰ PU Code Section 2719(b) and 2719(c).

¹¹ PU Code Section 2720(b).

deferred maintenance and water system degradation from the absence of increased revenues needed to address water supply and capital improvements. For example, Paso Robles voters rejected a rate increase in 2009 to fund the Nacimiento Water Project constructing a pipeline that would provide an additional source of supply to the city.¹²

Faced with the rising costs of water system maintenance and operation in addition to the inability to raise sufficient revenue to cover those costs, municipally owned water systems may choose to sell or contract their systems to other municipal water systems, water districts or investor-owned water utilities. For example, the City of Montebello’s water system “has been operating at a significant deficit since at least 2007, due in large part to increased costs of imported water, operations, maintenance, and necessary capital improvements” and has been operated by San Gabriel Valley Water Company since 2013.¹³ Thus, many more such systems may present opportunities to achieve economies of scale and financial and operational efficiencies, increasing the likelihood of acquisitions and mergers with public water systems.

The Framework Decision

R.97-10-048 resulted in Decision (D.) 99-10-064 (“the Framework Decision”) which governs the Commission’s practice regarding acquisitions in the wake of both Proposition 218 and the Public Water System Investment and Consolidation Act of 1997. The Framework Decision adopted a Settlement Agreement¹⁴ that set forth schedules and other operating procedures for acquisition proceedings in accordance with PU Code Section 2718-2020.

Regarding PU Code Section 2720(a), the Framework Decision affirms that the purchase price is, in general, the indicator of fair market value (as specified in Section 1263.320 of the Code of Civil Procedure) and that the fair market value serves as the standard for establishing the rate base of the acquired system. Action by the Commission is required for an acquisition or consolidation to take place; the Commission must find rates to be just and reasonable before they are implemented in the newly acquired system. Each application is required to include certain elements to assist in the Commission’s review: an appraisal of the acquired system; the proposed rates;¹⁵ the purchase agreement; notice to customers; the service list, including expected interested parties; and, in the cases of mutual and governmental acquisitions, a service area map.

Beyond the basic incentives explicitly described in PU Code Section 2720, the Framework Decision provides additional incentives for the acquisition of inadequately operated and maintained small water utilities.¹⁶ Acquisitions of inadequately operated and maintained small utilities may be addressed via advice

¹² Strickland, Tonya. “Paso voters reject water rate increase to fund Nacimiento pipeline project.” San Luis Obispo Tribune, November 3, 2009. <https://www.sanluisobispo.com/news/local/article39110382.html>. Accessed December 17, 2021.

¹³ Application (A.) 20-10-004, p.13.

¹⁴ D.99-10-064, Appendix D.

¹⁵ D.99-10-064 does not clarify whether the proposed rates are those of the acquired utility, the acquiring utility, or both.

¹⁶ “Inadequately operated and maintained small water utilities” specifically refers to systems with fewer than 2,000 customers subject to orders from the Department of Drinking Water (known as the Department of Health Services when the Decision was issued).

letter rather than application.¹⁷ The acquiring utility of an inadequately operated and maintained small utility may: a) establish a memorandum account for expenses associated with unanticipated repairs; b) design rates to recover up to 100% of fixed costs in the service charge; c) file for an increase in rates based on the most recent increase in the Consumer Price Index for All Urban Consumers; and d) set rates based on rate of return for a Class C or D utility. In these types of acquisitions, the acquiring utility may also earn an acquisition premium: a return on the price paid plus 50 percent of the difference between book value and the price paid, in addition to any costs incurred to complete the acquisition.¹⁸

The Framework Decision sets forth three different schedules for acquisition proceedings, depending on whether the acquisition can be handled by application or advice letter; and in the case of an application, whether the acquired utility is Class A or B, or Class C or D utility.¹⁹ The schedules for consolidation applications should nominally conform to a 245-day timeline, though the schedule for larger utilities' consolidations provides for a longer timeline in the event of an independent appraisal.²⁰ Proposed acquisitions of a Class A or B utility are also preceded by a Notice of Intention, outlining how the consolidation would affect reliability, health and safety regulations, economies of scale, and customers. Acquisitions or consolidations that can be done by advice letter—such as those of inadequately operated and maintained small water utilities, or as specified in PU Code Section 851—should conform to a 100-day review timeline.

¹⁷ D.99-10-064, Appendix D, Section 3.02.

¹⁸ The acquisition premium is to be amortized over the average remaining life of the plant.

¹⁹ Per the Commission's General Order 96-B, Water Industry Rule 1.2, Class A utilities serve more than 10,000 service connections; Class B utilities serve between 2,001 and 10,000 service connections, Class C utilities serve between 501 and 2,000 service connections; and Class D utilities serve 500 service connections or fewer.

²⁰ In practice, many acquisitions have exceeded the prescribed timeline. This is discussed further in the sections below.

Issues with the Existing Framework

Price and Valuation

One of the most litigious issues in acquisition proceedings at the Commission is in determining the value of an acquired system. Pursuant to PU Code Section 2720 and CCP Section 1263.320, the Commission has interpreted those code sections to find that the fair market value of an acquired system—the amount to be added to rate base—is equal to the price paid by the acquiring utility.²¹ PU Code Section 2720(b) explicitly instructs the Commission to compare the fair market value to the system’s reproduction cost less depreciation, before permitting the acquiring utility to add the acquisition premium—the amount of the purchase price above the system’s assessed value—to rate base. However, CCP Section 1263.320 also maintains that “where no relevant, comparable market exists,” the fair market value can be determined by any “fair and reasonable method”. The legislative history of this code section explicitly notes acquisitions of utilities as an example of where this statute might apply, as utilities by nature have other factors that complicate the determination of fair market value.

In particular, utility acquisitions are unique in that the motivations of both buyer and seller are aligned to achieve the highest price possible. The motivations of the seller to achieve the highest price possible for their water system are clear, but the regulatory framework presents an unusual phenomenon on the buyer side. In a normal market-based transaction, the seller’s desire for the highest possible price competes with the buyer’s desire to pay the lowest price possible, such that a fair market value will be determined somewhere in the middle. However, as discussed, PU Code Section 2720 establishes that the fair market value (and its proxy, purchase price) are added to the acquiring utility’s rate base. As a result, in utility acquisitions, the buyer may *also* be incentivized to seek a higher price, acting contrary to the usual market forces.

According to the existing framework, acquisitions that come before the Commission through the formal application process should include an appraisal based on replacement cost net less depreciation (RCNLD).²² Beyond comparison of the RCNLD to the purchase price to determine the acquisition premium, the existing framework offers no additional guidance for how the appraisal is to be used. Of particular note, an important part of the discussion for acquisitions of water systems is the question of liabilities, such as debt, deferred maintenance, and income taxes. The RCNLD appraisals submitted with each acquisition application are required to include all of the acquired system’s assets but makes no mention of liabilities. The existing framework is silent on the question of how liabilities affect the fair market value of a system, particularly in the form of deferred maintenance costs. Any additional necessary plant improvements that the Commission does not consider in its review of the acquisition represents an additional cost to ratepayers later in time.

²¹ D.19-11-003; D.19-04-023; D.19-04-015.

²² D.99-10-064, Appendix D, p.2.

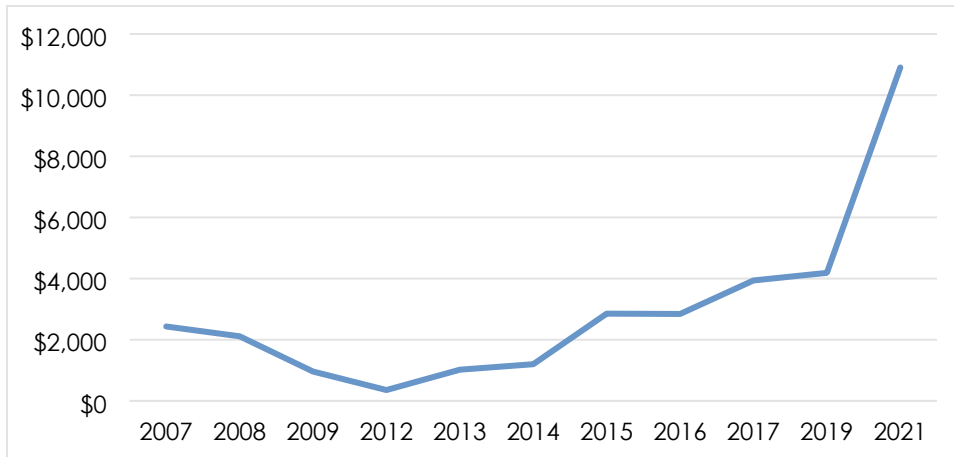


Figure 1: Average Purchase Price per Connection of Acquisitions, 2007-2021²³

While the Commission could consider other aspects of valuation in addition to the purchase price, the Commission often lacks the necessary data to provide in depth analysis. For example, purchase price per connection may be used as an indicator of the overall reasonableness of a system’s valuation. Figure 1 above shows a relatively steady increase in price per connection since 2012 and an exponential increase in 2021, but the Commission has limited insight into what factors might be driving the increase. Revising the framework offers the opportunity to enhance the reporting requirements involved in utility acquisitions so that the Commission can more holistically determine the true value of a system.

Case Study: City of Bellflower Water System

All of the abovementioned issues regarding valuation of an acquired system have played out in the proposed acquisition of the Bellflower Municipal Water System by California-American Water Company (Cal-Am)²⁴. Bellflower received four proposals with different valuations to acquire the system, all from Commission-regulated Class A water utilities. As seen in Table 1, the proposals ranged from \$3 million to \$17 million with Bellflower ultimately selecting Cal-Am, the highest bidder.

²³ Systems sold to Commission-regulated water utilities only. Not adjusted for inflation.

²⁴ A.18-09-013.

Water Utility	Proposal
California Water Service Company	\$3 million
Park Water Company (Liberty Utilities)	\$14.2 million
Golden State Water Company	\$14.5 million
California-American Water Company	\$17 million

Table 1: Proposals received by the City of Bellflower²⁵

Cal-Am submitted an appraisal as required by the existing framework in support of its proposed \$17 million purchase price. A competing valuation, brought into the record of the proceeding for historical purposes, offered a similar valuation for the system, but also described more than \$25 million of necessary improvements over the next 20 years. The Commission has not traditionally considered the physical condition of a system in determining its value, but the Administrative Law Judge (ALJ) in the Bellflower proceeding issued a proposed decision on March 30, 2020, rejecting the acquisition on the grounds that the necessary improvements to the system should be considered as liabilities that offset the value of Bellflower’s tangible assets and water rights.

However, the Proposed Decision was not adopted by the Commission due to concerns with the original valuation, and parties were “sent back to the drawing board” to consider a new valuation. Consequently, Cal-Am performed a new assessment of the Bellflower system’s physical condition, acknowledging that necessary improvements to a system could affect the value of a system beyond the purchase price. A settlement agreement was filed on November 23, 2021, which would approve the acquisition with the stipulation that the City make available \$5 million to Cal-Am for infrastructure improvements. The settlement agreement is still pending Commission action at the time of issuance for this white paper.

²⁵ Cal-Am’s presentation to the Commission July 25, 2018.

Water Rights

Another area where the existing framework gives no guidance on is the issue of water rights. The ultimate authority for water rights is held by the State Water Resources Control Board (SWRCB).²⁶ However, in areas where groundwater rights are contested, courts can adjudicate the groundwater supply, deciding who owns water rights, how much water they can extract, and how the water can be used.²⁷ Often, administration of an adjudicated basin is placed under the authority of a watermaster who can charge assessments and fees for over pumping. The finite quantity of water rights in a contested area means that water rights within adjudicated basins are particularly valuable; consequently, localized water markets to sell and trade water rights within the basin have emerged.

Water rights granted to a utility by SWRCB, an adjudication, or another court order do not usually make up a portion of the utility's rate base and the utility does not earn a return on them.²⁸ Because water rights are fundamentally a permit to use water, they were historically transferred along with the other assets of the system and not valued separately. However, the increased competition for water rights within adjudicated basins has changed how they are treated in acquisition proceedings. Starting with Cal-Am's acquisition of Adams Ranch Mutual Water Company in 2016²⁹, when a utility acquired a system with existing water rights, the water rights began to be valued as an asset on their own terms, separate from the purchase price. This inconsistency stems in part from the existing framework, which does not require separate review of water right issues except as part of the overall reasonableness of the acquisition.

With a lack of guidance from the existing framework, the Commission has had to review the separate valuation of water rights on a case-by-case basis with mixed results.³⁰ PU Code Section 2720 requires the fair market value (usually measured by purchase price) be the standard for the acquiring utility to establish the new rate base for ratemaking purposes. In prior Commission proceedings, the acquiring utility includes in its purchase price both the physical plant to be acquired and the water rights in determining the new value to add to its overall rate base as a result of the acquisition. As a result, the value of a system, the corresponding rate base, and the customer rates that follow can be dramatically altered just by a change of ownership. Further complicating the consideration of water rights is that water rights are an intangible asset that does not depreciate³¹. That is, when their value is added to rate base through a utility acquisition, it remains there indefinitely. This is in direct contrast to physical assets, like wells and pipes, which depreciate as they age and are ultimately replaced and removed from rate base at the end of their useful life.

²⁶ There are some exceptions, such as holders of water rights from prior to the SWRCB's existence.

²⁷ There are currently 29 groundwater areas considered adjudicated by the Sustainable Groundwater Management Act (SGMA).

²⁸ Water rights in California are also subject to a "beneficial use" clause defined as any use recognized by the state as being an appropriate use of water, and only for reasonable amounts of water.

²⁹ Resolution W-5080 approved the acquisition that includes the water rights purchase of \$1,600,000.

³⁰ Decision 19-04-15, which approved the acquisition of Rio Plaza Water Company by Cal-Am, did not allow water rights to be a separate asset value.

³¹ In Commission General Rate Case Proceedings, intangible assets are not considered a part of utility rate base.

Case Study: East Pasadena Water Company

The issue of water rights has come to the fore in the recent acquisition of East Pasadena Water Company by Cal-Am. In Cal-Am's testimony from this proceeding, East Pasadena's estimated 2021 rate base, in the absence of the acquisition, was approximately \$4.1 million. However, when the system came before the Commission in the proposed acquisition by Cal-Am with A.20-04-003, the system was valued by the applicants and Public Advocates Office at approximately \$42 million³² and \$36 million,³³ respectively. The water rights specifically made up 61.8%³⁴ of the value in Cal-Am's appraisal and 80.3%³⁵ of the value in Public Advocates Office's appraisal. Ultimately, the purchase price of \$34 million, which was lower than both appraisals, was presumed reasonable in the Proposed Decision. The Public Advocates Office contended that because of the variance between the ultimate purchase price and East Pasadena's original rate base, the difference should be treated as a gain on sale and returned to ratepayers. While the Commission did not ultimately adopt that gain on sale reasoning in the approved Decision, the point remains that acquisitions can create discrepancies in the value of a system when the ratemaking treatment of water rights is left undefined or are able to be freely transferred as assets.

Investor-owned utilities can acquire systems not just for their physical plant but also secure lower-cost sources of supply for all customers in the form of water rights, and the Commission should facilitate acquisitions that do so equitably. However, in the East Pasadena case, the change in ownership allowed the water rights to be converted from an intangible asset not in rate base to an asset that will never be removed from rate base. While water rights certainly have value, that water rights can be treated differently before and after a simple change in ownership is inconsistent and points to an oversight in the existing framework. Indeed, D.99-10-064 is silent regarding water rights and other intangible assets, and the development of a new acquisition framework offers the opportunity to define how water rights should be treated in a way that is fair to both utilities and customers of acquired and acquiring utilities.

³² A.20-04-003, Testimony of Kevin Zanni, Attachment 2, Exhibit 18, p.77.

³³ A.20-04-003, Public Advocates Office Testimony, p. 2-2.

³⁴ A.20-04-003, Testimony of Kevin Zanni, Attachment 2, Exhibit 18, p.77.

³⁵ A.20-04-003, Public Advocates Office Testimony, p. 2-2.

Acquisitions Involving Mutual or Publicly Owned Water Systems

The existing framework provides limited guidance on the acquisition of mutual³⁶ and publicly-owned water systems. Sections 852 and 854 of the PU Code apply specifically to Water IOUs but do not provide language regarding acquiring a publicly-owned utility. Furthermore, Section 2705 states that mutual water companies are not public utilities and are “not subject to the jurisdiction, control or regulation of the Commission.” The Commission has not determined, to date, whether the statute requires Commission authorization for an acquisition by a Commission-regulated Water IOU of a publicly-owned or mutual utility.

Water IOUs are, however, required to file an application for long-term financing of a particular acquisition according to the existing framework, or may rely on previous Commission authorization for long-term financing where applicable.³⁷ Furthermore, the existing framework instructs that the implementation of rates in newly acquired public or mutual systems be done through the Commission’s advice letter process, and the new rates must be the acquiring utility’s existing rates, the acquired system’s existing rates, or rates that are lower than either. The existing framework makes explicit that the Commission may approve or reject rates implemented via advice letter, depending on the reasonableness of the proposed rates.³⁸

Case Study: City of Montebello Water System

The lack of guidance around municipal acquisitions has complicated the acquisition of the City of Montebello System by San Gabriel Valley Water Company³⁹. San Gabriel recently came before the Commission seeking to acquire the Montebello system in accordance with Government (Gov.) Code Section 37420.5, which allowed the City to sell its water system without the statutory requirement of a public vote as required by PU Code Section 10061. The Public Advocates Office protested the acquisition in part because Gov. Code Section 37420.5 required the entirety of the city’s system to be located within city limits, while the Montebello system contained portions in the neighboring cities of Rosemead and Commerce. San Gabriel contested first that the Commission did not need to rule on whether or not the City had complied with the statutes, since the City is not under the Commission’s jurisdiction. San Gabriel also contended that the City could sell those portions of the system inside the City according to Gov. Code Section 37420.5, and the portions of the system outside the city according to PU Code Section 10061. The Commission’s Proposed Decision (PD) issued on July 2, 2021 agreed with Public Advocates Office that the Commission has a responsibility to ensure compliance with the governing statutes. The PD also determined that the acquisition did not properly comply with the statute and rejected the application without prejudice.

³⁶ For the purposes of this paper, a mutual water system is a company whose shareholders are the owners of the land served by the mutual. A mutual is not subject to Commission regulation if it provides water to its shareholders at cost. Mutuals are governed in part by Section 14300 of the Corporation Code and Section 2705 of the PU Code.

³⁷ The Settlement from the Framework Decision gives the example of a municipality selling its water system in exchange for annual payments from the acquiring utility but does not provide direction to the Commission for processing acquisitions of municipal and publicly-owned systems.

³⁸ D.99-10-064, p.10.

³⁹ A.20-10-004

On October 8, 2021, Governor Newsom approved AB 850, an act amending Gov. Code Section 37420.5 to remove the requirement that Montebello's assets be fully contained within the boundaries of the city. Four days later, the ALJ in A.20-10-004 issued a ruling withdrawing the PD and allowing the case to proceed on its merits. While the facts and the governing statutes of the Montebello acquisition are unique, the proceeding has highlighted that the additional regulations surrounding municipal systems can complicate otherwise straightforward acquisitions. A revised framework offers the opportunity to clarify the Commission's role and to provide guidance to the Commission on how the acquisition of municipal systems should proceed.

Different Standards for Evaluating Acquisitions

As discussed in the Existing Framework Section, the Commission’s authority under PU Code Section 851-854 requires it to determine if a transaction is in the public interest before an acquisition can proceed. Furthermore, an acquisition premium can only be included in the acquiring company’s rate base under PU Code Section 2720(b) if the Commission finds the premium to be “fair and reasonable.”

Thus, while the legislation is clear about the Commission’s responsibility to evaluate if an acquisition is in the public interest, the existing framework does not provide specific statutory guidance on how to conduct this public interest evaluation. The Commission has traditionally applied two different standards to determine if an acquisition is in the public interest⁴⁰. The first is the Ratepayer Indifference Test, under which the Commission requires that the sale of a utility should not have any net consequences that cause a ratepayer to prefer the seller to the buyer. Ratepayers should be unaffected with the quality and continuity of service.

The second standard is the Tangible Ratepayer Benefit which requires that an acquisition must deliver a net benefit to the ratepayer. D.01-09-057, authorizing the sale of Citizens Utilities Company to Cal-Am, found that “a transaction subject to Section 2720 should offer to ratepayers some equitable share of the benefits the transaction will generate.”⁴¹ This Decision recognized that the benefits in question may be some combination of quantifiable, such as economies of scale, and non-quantifiable or non-monetary, such as enhanced management and operational expertise. However, it also recognized that Section 2720 places the explicit cost of an acquisition premium on ratepayers, and that there are inherent risks to ratepayers in the form of overestimated benefits or possible service degradation. Ultimately, in determining whether to approve the acquisition, this Decision asks, is the “equitable share of the benefits” that ratepayers receive commensurate with the costs and risks that they incur?

Therein lies the complication between the two standards—the Commission has never firmly established the degree to which the benefits of an acquisition must match or outweigh the costs. As a result, the Commission has used a mixture, applying both standards in different situations.

⁴⁰ A recent example being Cal-Am’s acquisition of East Pasadena (D.21-08-002, p.11-12).

⁴¹ D.01-09-057, p.28.

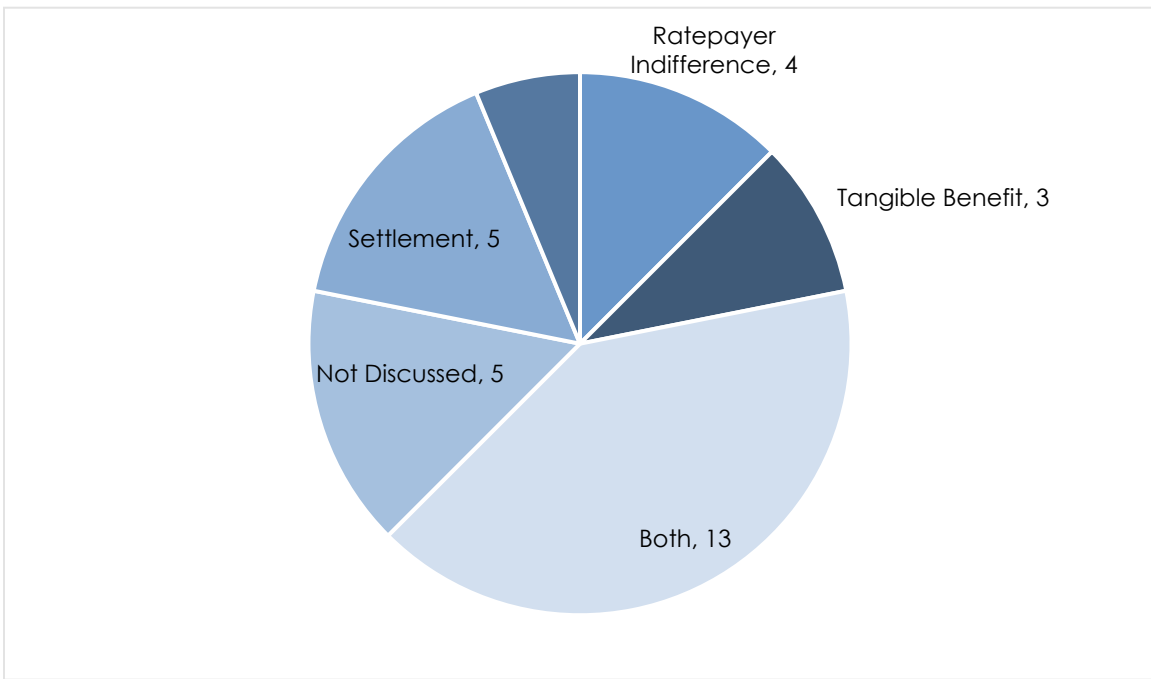


Figure 2: Standards Applied in Decisions on Acquisitions, 2007-2021⁴²

D.17-05-003, for instance, authorizing the sale of Benbow Water Company to Del Oro Water Company, stated “The Commission requires a test of ratepayer indifference when evaluating the sale of a public utility, and also requires the buyer to demonstrate that the buyer’s acquisition of the public utility yields a tangible benefit to the ratepayer.” In so doing, the Commission indicates that the two standards are not necessarily in competition, and both the Ratepayer Indifference Test and the Tangible Ratepayer Benefit may together decide if an acquisition is in the public interest. Figure 2 shows that there is no prevailing standard in evaluating acquisitions; using both standards together is most common, but not used in a majority of acquisitions.

Further complicating matters is that prior acquisitions have shown the two standards may become either secondary or overlooked in the Commission’s review of a proposed acquisition. Recent examples that demonstrate these two cases are the acquisitions of Mesa-Crest Water Company⁴³ by Park Water Company and Hillview Water Company⁴⁴ by Cal-Am. In the sale of Mesa-Crest, the two standards were considered during settlement discussions among the parties. However, when a settlement agreement was reached between the parties, the Commission applied a different standard for review of the settlement with its review of reasonableness for settlement agreements.⁴⁵ In the sale of Hillview, a relatively large purchase price and tax liability lead the Commission to address the issues of rate recovery causing the two standards to be omitted from discussion in the decision approving the acquisition. These two examples demonstrate

⁴² Systems sold to Commission-regulated only

⁴³ D.19-04-023

⁴⁴ D.19-11-003

⁴⁵ The standard of review for settlements are set out in the Commission’s Rules of Practice and Procedure Article 12.

that a re-examination of the Commission's acquisitions framework may provide beneficial guidance by affirming which standard, or a combination thereof, should be used in evaluating acquisitions, including those in which a settlement drives the final terms.

Effects on Customers

The existing framework also spotlights inadequately operated and maintained, or unsustainable, systems and raises the issue of how to improve water service to customers of those systems. The costs to improve the infrastructure of an unsustainable system, especially one with a small customer base, may be significant and may also result in large rate increases that a small customer base may not be able to support. Furthermore, to comply with PU Code Section 2719(d), the Commission developed four incentives to make acquiring inadequately operated and maintained water systems more attractive to Commission-regulated water utilities:

- Establish a memorandum account for expenses associated with unanticipated repairs;
- Design rates to recover up to 100% of fixed costs in the service charge;
- File for an increase in rates based on the most recent increase in the Consumer Price Index for All Urban Consumers; and
- Set rates on the basis of the applicable rate or return on rate base, or rate of margin permitted for a Class C or Class D water utility

The magnitude of all four of these incentives leads to additional rate increases passed on to customers, both from the acquired utility and the acquiring utility.

One solution to help mitigate large rate increases is to spread the potential costs to a larger customer base. This is commonly referred to as the socialization of costs and is often used to justify and support an acquisition.⁴⁶ From the perspective of a customer of an unsustainable water system, having the system acquired by a larger utility to generate economies of scale is beneficial as the pre-existing customer may end up paying a lower rate than if no acquisition had occurred. However, from the perspective of a customer from the larger or acquiring utility, rates would increase as a result of the acquisition to help cover the costs to improve the newly acquired system. If no acquisition took place, there would be no additional rate increase for the customers of the larger or acquiring utility.

⁴⁶ There have been nine completed acquisitions since 2019 where a Commission-regulated water utility is the acquiring utility. Six acquisitions used socialization of costs as a justification: D.19-04-015, D.19-12-038, D.21-08-002, Resolution (Res.) W-5184, Res. W-5196, and Res. W-5237.

Newly Acquired Utility Customers	Acquiring Utility Customers
<ul style="list-style-type: none"> - Improved water quality - Improved water service - Improved water reliability - Cost savings through economies of scale - Spreading of cost to larger customer base - Access to various customer programs including low-income assistance - Access to online resources 	<ul style="list-style-type: none"> - Cost Savings through Economies of Scale - Spreading of cost to larger customer base

Table 2: List of Potential Benefits from Acquisitions

The effect on existing customers of the acquiring utilities is not mentioned in the existing framework as it only discusses rates for customers from the utility being acquired. The existing framework states that utilities are authorized to place “into effect the existing rates of its adjacent or nearby water system, the acquired system’s rates, or rates lower than either.”⁴⁷ At first glance, this may seem like customers of the acquired system are protected from rate increases. However, the existing framework did not clarify that the language only applies to the initially proposed rates at the time of acquisition and that utilities are allowed to increase rates for the acquired utility or spread this increase across the acquiring utility in the next General Rate Case (GRC).

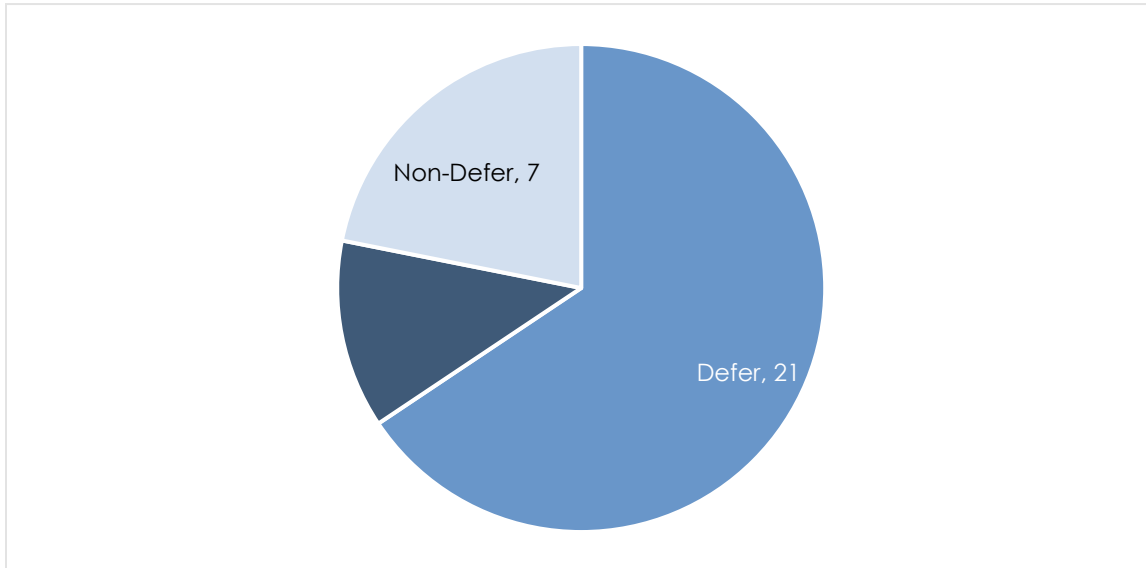


Figure 3: Deferred Rate Increases⁴⁸

⁴⁷ D.99-10-064, Appendix D, Section 4.02.

⁴⁸ Systems sold to Commission-regulated only, 2007-2021.

For the thirty-two acquisitions involving a Water IOU as the purchaser between 2007 and 2021, Figure 3 shows that almost two-thirds resulted in the continuation of existing rates of the acquired system at the time of acquisition while postponing the review and implementation of rate increases to a later date. The majority of these deferred rate increases occurred in the following GRC of the respective acquiring utility. Four acquisitions implemented interim rates at the time of approval before increasing rates at a later date while seven acquisitions resulted in an immediate rate increase at the time of approval.

Deferring rate increases to a later time does not allow for the proper measure of the true rate impact at the time of review for an acquisition. The rate increase at the time of the acquisition is illustrative and depends greatly on other assumptions—like allocations between decentralized or non-contiguous ratemaking areas and the centralized general office location—that do not take place until the rates are implemented.⁴⁹ In addition, multiple acquisitions can take place between the same GRC cycle for an acquiring utility, which could result in their rate impacts being combined and indistinguishable in the next GRC. This practice limits the Commission’s ability to consider the true cost of an acquisition at the time of approval alongside its benefits. A new OIR could develop a systematic way of forecasting the actual rate increase caused by an individual acquisition, as well as track the cumulative impact of the rate increase from each acquisition in addition to other potential rate increases during the same time. This revised practice may provide a more thorough picture of the cumulative rate increases involved with each acquisition that occurs between GRC cycles.

Case Study: East Pasadena Water Company

The confusion regarding how to consider the effects of an acquisition on customers has come into play in the Commission’s recent approval of the acquisition of East Pasadena Water Company by Cal-Am. Cal-Am proposed to allocate the approved purchase price of \$34 million across its entire customer base to minimize the overall rate increase on customers. As part of this proposal, a portion of the \$34 million approved by the acquisition would be allocated to Cal-Am’s general office, implying a rate increase for *all* of Cal-Am’s ratepayers and not just those ratepayers in ratemaking areas near East Pasadena. The Commission found that the acquisition itself was reasonable but determined that the allocation of the \$34 million should be considered in the next GRC within the larger context of Cal-Am’s operations since all of Cal-Am’s ratepayers would be affected by the allocation. As a result, the full rate impact of the acquisition on Cal-Am’s ratepayers was not one of the defining factors considered with approval of the acquisition. While there may be value in considering acquisition rate impacts cumulatively, a revised acquisitions framework would offer greater transparency on the true impacts of an acquisition, with options for spreading costs over a larger customer base or a longer timeframe for recovery.

⁴⁹ Allocations to central office are paid by all customers, whereas allocations to decentralized areas are borne only by the customers residing in that area.

Coordination with the State Water Resources Control Board

In 2012, California became the first state to legislatively recognize the Human Right to Water (HR2W) with the signing of Assembly Bill (AB) 685. Section 106.3 was added to the Water Code stating, “every human being has the right to safe, clean, affordable, and accessible water adequate for human consumption, cooking, and sanitary purposes.”

One approach to advancing this goal in California is to identify unsustainable water utilities due to inadequate management, or poor operation and maintenance of their water systems. These systems can potentially be acquired or consolidated with other water utilities that have the technical, managerial, and financial (TMF) capabilities for ensuring long-term sustainability and safe and clean drinking water service. As discussed in previous sections, the existing framework provided incentives for Commission-regulated water utilities to acquire these unsustainable water systems. The SWRCB, which regulates water quality for all water systems in California, has continued to encourage systems that consistently fail to meet water standards to voluntarily be acquired by other suitable water systems.

Since 2015 under Senate Bill (SB) 88, California authorized the SWRCB to order consolidation with a receiving water system where a public water system, or a state small water system⁵⁰ within a disadvantaged community, consistently fails to provide an adequate supply of safe drinking water. Since 2016 under AB 2501, California amended Health and Safety Code Section 116355 to authorize the SWRCB, for the purpose of providing affordable, safe drinking water to disadvantaged communities, to contract with, or provide a grant to, an administrator to provide administrative, technical, and managerial services to a designated public water system and to order the designated public water system to accept those administrative and managerial services, including full management and control.

In 2016, the SWRCB also adopted a resolution that expanded on HR2W and officially recognized HR2W as a top priority and as one of the agency’s core values. Under this resolution, the SWRCB regularly engages with communities that lack safe drinking water to evaluate the issues and determine possible solutions for the inadequately operated or maintained water systems.

Safe and Affordable Funding for Equity and Resilience (SAFER) Program

Furthermore, in 2019, to advance the goals of the HR2W, California passed SB 200 which enabled the SWRCB to establish the Safe and Affordable Funding for Equity and Resilience (SAFER) Program. The SAFER Program was set up to help inadequately operated or maintained water systems to sustainably and affordably provide safe drinking water to their customers. The program aims to provide short-term solutions such as supplying replacement water and long-term solutions including upgrading water systems and building the kind of managerial capability that helps inadequately operated or maintained systems become safe, efficient, and sustainable. Foremost among the tools created under SB 200 is the Safe and Affordable Drinking Water (SADW) Fund. The SADW Fund provides up to \$130 million per year, from 2020 through 2030, to enable the SWRCB to develop and implement sustainable solutions for

⁵⁰ A state small water system is defined as a water system that serves between 5 and 14 connections.

underperforming drinking water systems. The SWRCB will identify communities and areas of the state at risk of not having adequate safe drinking water and how investment priorities will be established over a 10-year funding program.

As part of the SADW Fund Expenditure Plan for 2021 and 2022, the SAFER program conducts a Needs Assessment annually to prioritize allocation of SB 200 funding⁵¹. The purpose of the Needs Assessment is to identify public water systems, tribal water systems, and state small water systems and regions where domestic wells are at-risk of failing to sustainably provide a sufficient amount of safe and affordable drinking water. This Assessment established the definition of “at-risk” systems as those “at risk of failing to meet one or more key Human Right to Water goals: (1) providing safe drinking water; (2) accessible drinking water; (3) affordable drinking water; and/or (4) maintaining a sustainable water system.”⁵² By establishing this definition and associated metrics, the Needs Assessment identified a list of failing water systems, and classified the remaining water systems based on their potential of failure allowing for prioritization of the SADW Fund.

Approximately 620 public water systems were determined to be at-risk of failing to sustainably provide a sufficient amount of safe and affordable drinking water, and approximately 610 state small water systems and 80,000 domestic wells were assessed via modelling as at high risk of exceeding health-based drinking water standards due to their location in aquifers with high risk of groundwater contaminants. Meanwhile, the list continues to grow as approximately 47 new water systems are added to the HR2W system list each year. A number of Commission-regulated systems, particularly small water utilities, were identified either as failing or at-risk. A revised framework for acquisitions could prioritize these HR2W systems for consolidation as this list continues to grow annually, and the need to provide safe and affordable drinking water continues to be a priority. The SAFER program may also provide a pathway for at-risk systems or their acquirers to receive funding for necessary capital improvements as well as ongoing operation and maintenance costs.

The current SWRCB efforts to achieve the HR2W did not exist at the time of the existing framework being adopted, and therefore, there is an opportunity for the Commission to coordinate with the SWRCB and combine resources to improve the acquisition process. The Commission is currently conducting regular meetings with the SWRCB to identify at-risk systems and any intersections with investor-owned utilities to review investment priorities or assist systems that have water quality issues.

Grant Funding

As past acquisitions have shown, purchasing a water system in need of infrastructure improvements comes at a significant cost, with these costs ultimately getting passed onto the ratepayers of both the acquired and acquiring water system. One possible option that water systems may take advantage of to reduce rates charged to customers is to apply for funding or grants to improve the system being acquired.

⁵¹ 2021 Drinking Water Needs Assessment, April 2021

⁵² Needs Assessment, p.9

The SWRCB currently runs two programs that provide financial assistance to water systems for improvements in water quality and reliability: the Drinking Water State Revolving Fund (DWRSF) and the SADW as mentioned above. The DWRSF was established by the federal Safe Drinking Water Act in 1996 and was originally administered by the Department of Public Health until it was transferred to the SWRCB in 2014. While the DWRSF mainly provides low-interest loans to assist in water system improvements for both publicly and privately owned water utilities, principal forgiveness may be available for utilities serving disadvantaged communities.

In contrast to water utilities that are municipals or mutuals, Commission-regulated Water IOUs are for-profit companies that earn a return on their capital investments. The Water IOUs invest in capital improvement projects that are rate based and earn a rate of return on those investments as determined by the Commission. Increasing the rate base amounts through additional investments would then lead to greater returns for the Water IOUs. As a result, this may encourage the Water IOUs to continue seeking infrastructure improvements to their water systems in addition to the regular maintenance that is conducted to maintain safe and reliable water service. However, this financial ratemaking structure may also discourage Water IOUs from seeking any assistance such as grants for their improvement projects as these grants would not increase their existing rate base nor increase their rate of return because plant funded through grants and loans are treated as contributed plant and are excluded from the utilities' rate base.

The Commission currently has no rule in place within the existing framework requiring Water IOUs to seek or prioritize grant funding that may be available when acquiring an inadequately operated or maintained water system. Thus, the incentive between reducing rates for utility customers versus increasing returns for Water IOUs has skewed more towards the latter. Out of the 32 acquisitions between 2007 and 2021 where a Water IOU is the acquirer, seven systems had issues maintaining water quality and service but only two went through the process of receiving grant funding from the SWRCB for system improvements.⁵³

Another major issue that discourages Water IOUs from seeking grant funding is the lack of explicit direction from the Commission in addressing the tax implications of accepting grants. The Tax Cuts and Jobs Act (TCJA) previously signed into law on December 22, 2017 made major changes to the Internal Revenue Code (IRC) including the taxability under IRC Section 118 of government grants for constructing, repairing, expanding, or upgrading infrastructure. The grant funding offered by the SWRCB falls under this tax provision and do not cover the income tax liabilities that Water IOUs incur when receiving such grants. In D.06-03-015, the Commission adopted ratemaking rules regarding the receipt of grant funding that stated while grant-funded portions of utility plant should not result in a "windfall" to utilities, the portions not paid for by the grant funding should be used in the determination of rates or included into rate base with a return.

In proceedings since the adoption of the TCJA, the Commission has decided that the additional income tax liability associated with grant funding that is paid for by the utility should be recovered by the utility through its rates. However, the Commission has not expressly determined whether these liabilities should be addressed by capitalizing such costs in rate base or whether they should be recovered as an expense. Each acquisition proceeding that has come before the Commission takes a unique course on this policy question.

⁵³ Cal-Am's acquisition of Ox Bow Mutual received \$2.985 million in grant funding while Golden State Water Company's acquisition of Robbins Water System received \$3.8 million in grant funding.

Furthermore, the recently adopted Infrastructure Investment and Jobs Act⁵⁴ reversed this TCJA provision, creating a period during which grants were taxable, though grants acquired before or after this window do not carry this same tax liability. A revised framework may allow the Commission to incentivize IOUs to seek or prioritize grant funding and to provide clarity on the recent changes in statute affecting utilities' tax liabilities regarding grant funding.

⁵⁴ Signed into law by President Joe Biden, Nov. 15, 2021.

Timeline and Procedural Schedule

The current procedural schedule for acquisitions and consolidations of inadequately operated and maintained water systems was previously developed and adopted in the existing framework. In the settlement agreement⁵⁵ adopted with the existing framework, the timeline and requirements for both the application and advice letter process for acquisitions were laid out. For applications, a decision must be placed on the Commission's Agenda within 245 days of filing and for advice letter filings, a resolution must be placed on the Commission's Agenda within 100 days of filing.

The Commission currently reviews acquisitions on a case-by-case basis and must analyze issues unique to each acquired water system. At this time, the Commission does not have a standard method on differentiating whether an application or an advice letter process serves as most appropriate to resolve a specific acquisition. The existing framework did not develop guidelines differentiating the two processes, only stating that an advice letter may be filed to "expedite improvements mandated by the Department of Health Services."⁵⁶ The PU Code does not provide definitive language either, with PU Code Section 851 stating that an advice letter process may be utilized for water system acquisitions valued at \$5 million or less.⁵⁷ Also, in PU Code Section 851, the Commission is required to approve or deny the acquisition within 120 days of filing if the advice letter is not protested. Figure 4 below shows the complexities of the existing framework's procedural schedule.

From 2007 to 2021, there have been a total of 58 acquisitions involving Commission-regulated water utilities, resolved through 31 decisions and 23 resolutions.⁵⁸ The average number of days to complete an acquisition via the application process is 371 days, well over the 245-day limit set by the existing framework. For resolutions, the average number of days for completion is 164 days, which is also over the limit of 100-120 days established in the existing framework and by statute.

On October 8, 2021, Governor Newsom approved AB 1250, which added PU Code Sections 2721-2722 to the existing PU Code Sections 2718-2720 to provide additional guidance on acquisitions involving small community water systems and state small water systems. Starting January 2022, the Commission is required to approve or deny a proposed application within 12 months (roughly 365 days) if the water system being acquired has consistently failed to provide safe drinking water and has been identified as failing or at risk of failing by the SWRCB. Consistent with PU Code Section 851, an advice letter may be filed for approval instead if the water system is valued at \$5 million or less. The Commission is required to approve or deny such an advice letter request within 180 days of its filing with this new statute.

⁵⁵ D.99-10-064 Appendix D pages 4-6.

⁵⁶ Authority now under the State Water Resources Control Board.

⁵⁷ PU Code Section 851 is not limited to water systems but applied to all public utilities.

⁵⁸ One resolution approved two acquisitions (Resolution W-5163 for the sale of Madden Creek Water Company and Tahoe Cedars Water Company to Tahoe City Public Utility District). One acquisition was completed by Water Division approval via advice letter without a resolution (California Water Service Company Advice Letter 1907 for its purchase of Woodside Mutual Water Company). Two acquisitions remain unknown (McCanna Ranch Water Company by Perris Public Utility Authority and Tehachapi Mountain Water Company by an unknown utility).

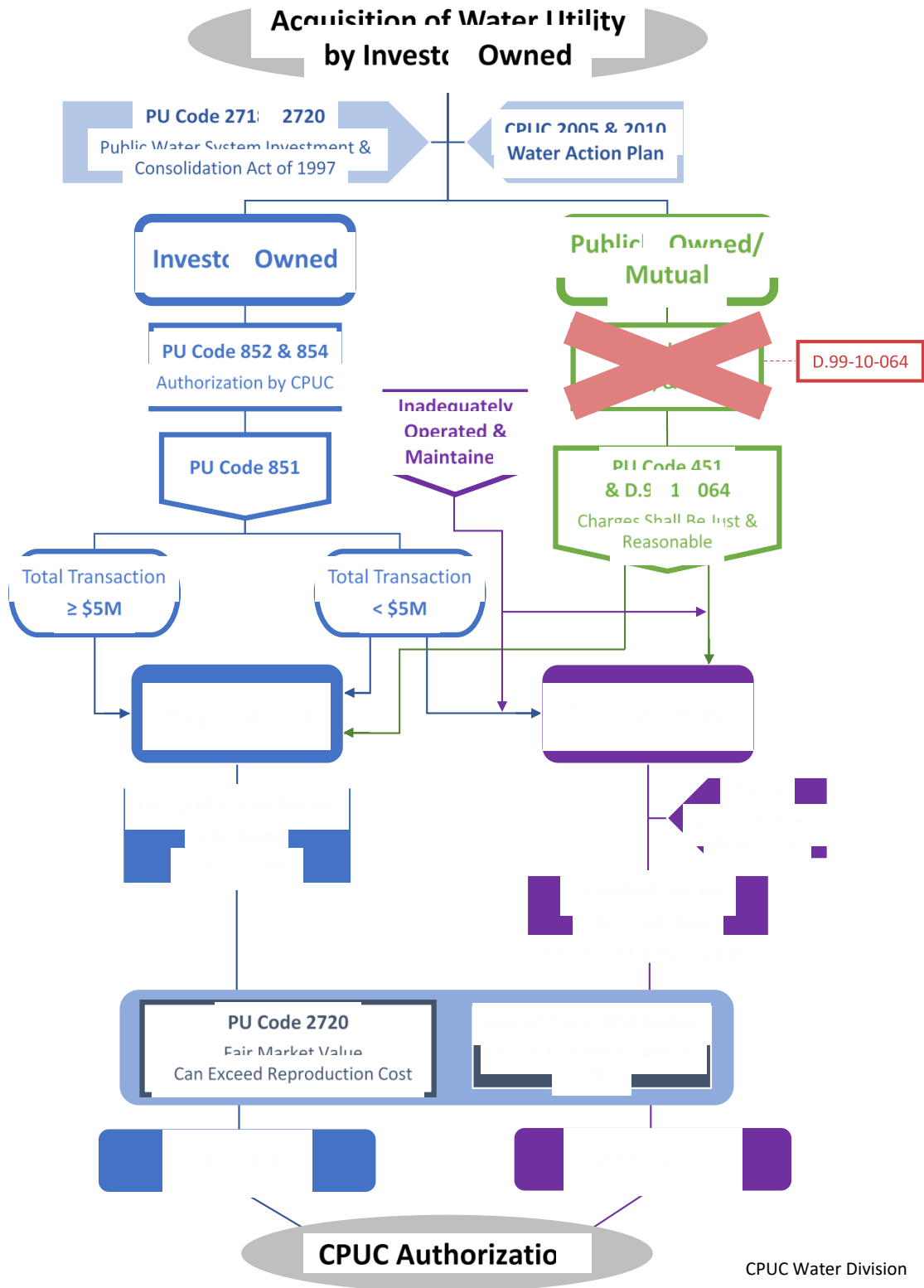


Figure 4: Roadmap of the Existing Framework

Questions to Consider in a New OIR

With the issues facing the existing framework and the clear need to address at-risk of failing or failing water systems, the Water Division (WD) recommends the Commission open a new OIR that considers the following issues to guide the Commission's decision-making process for acquisitions and potential consolidations.

Price and Valuation

How should the value of a system be determined in acquisitions?

The existing framework prescribes that an acquired system's fair market value—usually measured by the purchase price—be used as the ratemaking standard for that system. The existing framework also looks at RCNLD in comparison with the purchase price, so the new OIR could review these current practices and examine if other just and equitable methods of valuation should also be used in assessing the value of a system.

Should Section 1263.320(b) of the Code of Civil Procedure be applied to proposed acquisitions?

CCP Section 1263.320 states that any method of valuation that is just and equitable can be used to determine the fair market value of property where no relevant, comparable market exists. Water system acquisitions, where the buyer and seller's incentives are aligned, could fall under this category. The OIR could determine whether a relevant market exists for water utilities and, if not, what types of valuations could develop a reasonable fair market value.

How could Cost-Sharing procedures apply to acquisitions?

The OIR could investigate whether some type of cost-sharing similar to the Commission's existing Gain-on-Sale rules should apply to acquisitions or if proceeds from water utility acquisitions may be considered as a special type of gain on sale. Potential mechanisms to be considered include applying cost-sharing schemes to all assets, applying only to non-depreciable assets like water rights, or not applying cost-sharing rules at all. The OIR could also investigate what an equitable division of proceeds would look like, if cost-sharing procedures were to be implemented.

How should different assets and liabilities be treated for ratemaking purposes in proposed acquisitions?

The purchase price to acquire a system may not cover all assets that are transferred. Assets other than infrastructure such as water rights and contributions or liabilities such as deferred income tax may require separate valuation procedures. The OIR could investigate which of these items should be separated from the overall assessment and review of the systems being acquired.

Should there be a study or analysis conducted to examine the purchase prices of acquisitions?

Data from previously approved acquisitions have shown that the average purchase price per connection has been increasing from year to year. The Commission has a limited understanding of the factors that might be driving the increase. The OIR could provide an opportunity for a detailed study of the factors which may help in the formation of the revised framework.

Ratepayer Impacts

How should the Commission examine ratepayer impacts when reviewing an acquisition?

The approval of an acquisition by the Commission is currently constrained to review of the public interest criteria and the review of fair market value. The new OIR could discuss the potential of using ratepayer impacts as another criteria in approving an acquisition.

What standard should be used to determine ratepayer impacts in acquisitions?

The revised framework could develop a cost-benefit analysis of ratepayer impacts to standardize the review of future acquisitions. The analysis should help in determining the relative level of importance to be given to the Ratepayer Indifference Test and the Tangible Ratepayer Benefit in reviewing acquisitions.

The OIR could also investigate who is primarily affected in the application of each standard. For example, if existing customers of the acquiring utility shoulder the rate impact of an acquisition for comparatively little benefit, the Ratepayer Indifference Test would produce a different conclusion than if evaluated based on the impacts to customers of the acquired system.

Should existing customers of the acquiring utility be included in the review of ratepayer impact?

The impact that acquisitions have on ratepayers of both the acquired and acquiring utilities must be examined in the revised framework. While traditionally benefits for ratepayers from the acquired utility have been highlighted in the Commission's analyses, the effect on existing ratepayers of the acquiring utility should be further reviewed.

How should the benefits and costs of acquisitions be quantified?

Acquiring a new water system increases the overall customer base but also increases customer rates as a result of the purchase price and potentially increased infrastructure costs. When petitioning the Commission with an acquisition proposal, utilities should be able to quantify the rate impact associated with the acquisition as well as quantify the savings from economies of scale. The revised framework could require the utilities to produce a rate impact analysis even if there are plans to defer the rate changes to a later date. The analysis would provide more transparency on how customers of the acquired and acquiring utility would be affected by the proposed acquisitions.

How should rate impacts from previous acquisitions be assessed when reviewing a proposed acquisition?

For multiple acquisitions involving one utility, the rate impact from each acquisition might not seem significant on an individual basis. However, combining these acquisitions and producing a cumulative rate impact might produce a considerable rate increase before a rate review can occur in the following GRC. The revised framework could evaluate cumulative rate impacts applicable to an acquiring utility when the same utility is proposing multiple acquisitions between GRC cycles.

Inadequately Operated and Maintained Systems

How should acquisitions be prioritized for inadequately operated and maintained systems?

While the existing framework incentivized water system acquisitions by investor-owned utilities, development of a new acquisitions framework presents an opportunity to refine the Commission's overall acquisition policy and align this effort with the Commission's adopted Environmental and Social Justice goals. There is also opportunity to provide guidance on coordination between the Commission and the SWRCB to achieve the Human Right to Water for all Californians.

How should coordination efforts between the Commission and the SWRCB be improved on to address inadequately operated and maintained systems?

Currently, acquisitions come before the Commission through the existing framework via an application or an advice letter process as discussed above. Notice is provided to existing service lists of utilities and affected customers. The SWRCB is currently not part of this noticing requirement in some cases, so additional noticing should be provided to the SWRCB, including the relevant DDW (Division of Drinking Water) and DFA (Division of Financial Assistance) contacts. These SWRCB contacts have continually monitored these at-risk systems with water quality concerns and have met regularly with the WD to spotlight these systems, but official notice to the SWRCB should be provided at the outset of these acquisition proposals in order to facilitate ongoing coordination and communication efforts between the Commission and the SWRCB.

How should the acquisitions of systems in disadvantaged communities be approached?

In reviewing the current incentives for acquisitions, the Commission may look at the "inadequately operated and maintained small water utilities" classification from the existing framework and include systems located in Disadvantaged or Severely Disadvantaged Communities in a new acquisitions framework. The Commission currently relies on the definition of a disadvantaged community, as defined by Health and Safety Code Section 116275(aa), but the new acquisition framework may review the California Communities

Environmental Health Screening Tool, Version 3 (CalEnviroScreen 3.0)⁵⁹ provided by the California Environmental Protection Agency, that identifies disadvantaged communities by collecting multiple metrics and outputting a single value at the census tract scale.

What incentives for acquiring inadequately operated and maintained systems would be most effective?

Another aspect to consider in a new OIR is the review of the incentives available to the IOUs from the existing framework and whether these incentives are still necessary to attract IOUs to acquire inadequately operated and maintained water systems.

Should the incentives for acquiring well-maintained systems be decreased?

To ensure the HR2W for all in California, inadequately operated and maintained water systems in need of urgent help should be prioritized over systems that are in good or stable condition without major water quality issues. The OIR could investigate adjusting incentives based on the quality of the system being acquired.

How should the Commission treat grant funding in acquisitions?

Grant funding would reduce the impact on ratepayers for acquired and acquiring utilities, while potentially minimizing the incentive for an IOU to acquire a system. One option to consider in a new OIR would be a requirement for IOUs to take grant funding when available; other options to consider include reviewing the prioritization of grant funding based on the resulting rate impact to customers. The revised framework could require utilities to report in proposed acquisition on efforts to seek grant funds and to provide an analysis of cost savings from potential grants.

What options other than acquisitions should be considered?

A review of the Commission's acquisitions policy also offers the chance to expand guidance on providing assistance to struggling systems if the acquisition process is untenable. An administrator role similar to the program provided by the SWRCB under the SAFER program may be an option if the proposed acquisition is deemed infeasible by the Commission.

⁵⁹ As of October 20, 2021, The Office of Environmental Health Hazard Assessment (OEHHA) announced the availability of a new version of the California Communities Environmental Health Screening Tool: CalEnviroScreen 4.0. CalEnviroScreen is a screening methodology that can be used to help identify California communities that are disproportionately burdened by multiple sources of pollution.

Schedule and Timeline

How can the Commission process acquisitions within the required time limits?

The Commission did not previously resolve acquisitions, on a consistent basis, within the time frame required by D.99-10-064. To address this issue, the OIR could first identify the causes for delays in acquisition proceedings, especially those that have proceeded beyond the allotted timeline required in the existing framework.

Two possible pathways exist for re-evaluating the procedural schedules required by the existing framework. The OIR could investigate the validity of the existing timeline, determining whether it represents a suitable amount of time to fully resolve an acquisition or what steps need to be taken by the Commission and/or water systems to address the deficiencies. In addition, the OIR could examine proposals for new timelines⁶⁰ and recognize that the existing framework does not reflect the complexities of current acquisition proceedings.

What would a new procedural structure look like?

An example roadmap for how acquisitions could proceed is provided for reference below. A new acquisitions framework could investigate the Commission's ability to consider other factors, such as ratepayer impacts and gain on sale rules or cost sharing methods, in parallel with the existing framework's evaluation of fair market value.

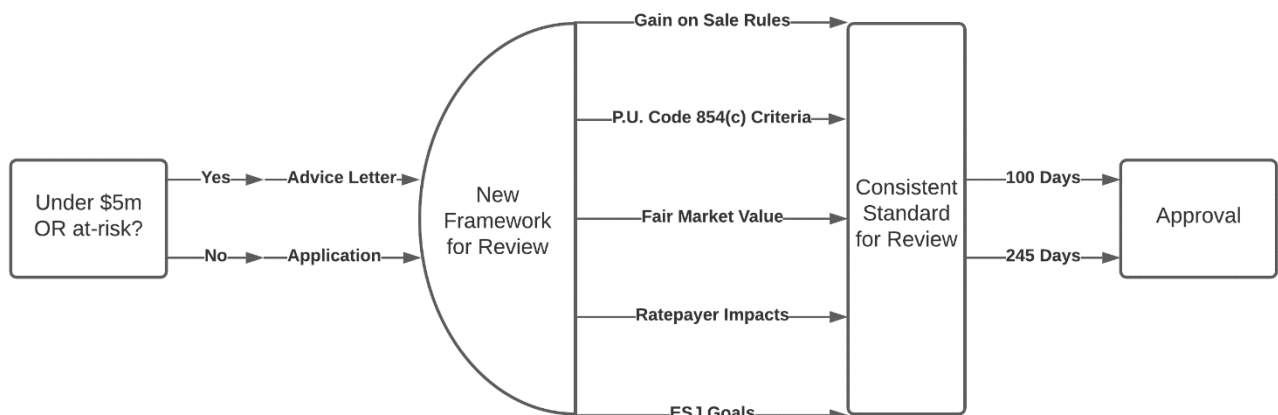


Figure 5: Example Roadmap for Acquisitions

In developing a new acquisitions framework, the OIR could set out clear guidelines for when an acquisition should be processed through an advice letter versus through an application. The OIR could also determine how acquisitions of mutual and municipal water systems should be treated, and if their treatment should merit a separate roadmap. In addition, the OIR could investigate how a procedural schedule for

⁶⁰ Exclusive of timelines spelled out in statute

inadequately operated and maintained systems could be accelerated to direct appropriate resources to this critical need.

What reporting requirements should be adopted for proposed acquisitions?

The OIR could also establish exactly what reporting requirements will be necessary in the application as well as advice letter process for acquisitions. This could include determining what information must be submitted in the application or advice letter filing, as well as establish points throughout the process to serve as status updates while processing acquisitions. This will allow the acquisition to proceed on a definitive track, while requiring only the information that will be useful in each acquisition.

Legislative Update

Should the Commission recommend that the Legislature revisit the Public Water System Investment and Consolidation Act of 1997 and clarify the legislative intent?

Given the length of time that has transpired since 1997 and the significant events that have occurred since then, the opportunity is ripe to revisit the Act considering the recent legislative updates to the PU Code Sections 2718-2720. The Commission has a wealth of decisions and experiences with 58 acquisitions that have come before the Commission between 2007 and 2021, and with certain acquisitions, parties have debated the legislative intent of PU Code Section 2718-2720 in reviewing acquisitions. The new OIR could raise the question of whether the Commission should recommend the Legislature revise the code, given the attention to acquisitions demonstrated by approval of AB 1250 and the increasing need to address at-risk or failing water systems.

Conclusion

In addition to the Public Water System Investment and Consolidation Act of 1997, the existing framework relied on D.99-10-064 to lay the foundation for the Commission to process and examine proposed acquisitions involving Commission-regulated Water IOUs. Although the Commission has reviewed and approved numerous acquisitions under this existing framework, a re-evaluation of the process is needed to provide further guidance and develop consistent standards of review for contentious issues that arise with acquisitions. As more acquisitions continue to take place, the complexity of selling and purchasing a water system increases as each acquisition presents a new series of facts to consider. Consequently, the Commission faced difficulties reviewing acquisitions in a timely manner with issues that arose and appeared outside the scope of the existing framework. The case-by-case review for each acquisition has led to delayed proceedings and inconsistent Commission review applied with each acquisition.

As the price of drinking water increases for customers leading to water rates becoming less affordable, the Commission should place a greater emphasis on the review of ratepayer impacts from acquisitions. As discussed in this staff white paper, the Commission does not have standard guidelines to examine the effect of acquisitions on ratepayers, including those of the acquiring utility as well as those of the acquired utility. The existing framework focuses only on impacts of customers that are being acquired and does not account for the rate impacts to existing customers of the acquiring utility.

Thus, there is a need for the Commission to open a new Order Instituting Rulemaking (OIR) to account for all variables (existing and potential) and develop a revised framework to guide and standardize the Commission's review of acquisitions. This revised framework would address the inconsistencies in the Commission review of past acquisitions, especially review of the valuation of water systems, and create a more consistent review process for all parties involved. The revised framework would bring renewed focus on the ratepayers, especially those of an acquiring utility, and provide better guidance for the Commission to assess the advantages and disadvantages an acquisition may have for ratepayers of the acquiring utility as well as those of the acquired utility. This re-evaluation of the current Commission process on acquisitions would build on the experiences the Commission confronted since the Consolidation Act of 1997 and would re-examine the goal of achieving economies of scale for the acquisition of smaller water systems by larger investor-owned utilities. Progressing from the existing acquisitions framework would allow the Commission to better balance the intersection of affordability with safe and reliable water service for all Californians.

Appendices

Appendix A – D.99-10-064, Settlement Agreement

APPENDIX D

Page 1

BEFORE THE PUBLIC UTILITIES COMMISSION OF THE STATE OF CALIFORNIA

Order Instituting Rulemaking on the Commission's)
own motion to set rules and provide guidelines for)
the Acquisition and Mergers of Water Companies)

R.97-10-048

SETTLEMENT

1.00 Introduction

1.01 The parties to this Settlement ("Parties") relating to the Order Instituting Rulemaking issued by the California Public Utilities Commission ("Commission") on October 22, 1997, are the Ratepayers Representation Branch ("RRB") of the Water Division and the California Water Association ("CWA").

1.02 The Parties agree that no signatory hereto nor any member of the staff of the Commission assumes any personal liability as a result of this Settlement. The Parties agree that no legal action may be brought in any state or federal court, or in any other forum, against any signatory representing the interests of RRB, any individual of RRB, its attorneys, or the RRB itself regarding this Settlement. All rights and remedies are limited to those available before the Commission.

2.00 General Requirements Regarding Acquisitions and Mergers of Public Utilities

2.01 Definition of Acquisition. An "acquisition" is a merger, a purchase of stock or assets, or an exchange of stock.

2.02 Notice Of Intention. The Parties agree that any request for authorization to acquire a Class A or B water utility should be preceded by a Notice of Intention. Such notice should include a showing as to how the merger or acquisition would affect reliability, compliance with regulations relating to health and safety, economies of scale, and customers.

2.03 Processing. The Parties agree that applications should be processed according to the schedules attached to this Settlement.

2.04 Results of Operations. The Parties agree that each application should include a forecast of the results of operation for (1) the acquiring utility, (2) the acquired utility, and (3) the combined operation for the first and fifth years following acquisition, together with all supporting documentation.

2.05 Appraisal. The Parties agree that the filing of each application should include an appraisal, together with all supporting materials and workpapers. The appraisal should include all assets, including the value of the land and the cost of replacing the existing improvements, less accumulated depreciation. The complexity and detail required will necessarily vary based on the size and price of the acquired water system.

2.06 Facilities Funded by the Federal or State Government. The Parties agree that the cost of any plant or improvement of a privately-owned utility which is funded by a loan from the federal or state government and not included in rate base should not be included in the appraisal for the purpose of setting rates. The acquiring utility should be allowed to continue any surcharge established to repay any such loan until fully repaid.

2.07 Assets Funded by Contributions. The Parties agree that any asset funded by contribution should be valued in the appraisal in accordance with Section 820 of the Evidence Code.

3.00 Acquisition of Inadequately Operated and Maintained Small Water Utilities

3.01 Definition of Inadequately Operated and Maintained Small Water Utility. An "inadequately operated and maintained small water utility" is any operation serving under 2,000 customers that is subject to an outstanding order of the Department of Health Services to implement improvement.

3.02 Use of Advice Letter. To expedite improvements mandated by the Department of Health Services, the transfer of assets and related obligations of an inadequately operated and maintained small water utility may be approved by the Commission pursuant to an advice letter.

3.03 Incentives. The Parties agree that, for a period not to exceed seven years, a utility acquiring an inadequately operated and maintained utility should, pursuant to D.92-03-093, be permitted to exercise any one or combination of the following options:

- A. Establish a memorandum account for expenses associated with unanticipated repairs,
- B. Design rates to recover up to 100% of fixed costs in the service charge,
- C. File for an increase in rates based on the most recent increase in the Consumer Price Index for All Urban Consumers, and
- D. Set rates on the basis of the applicable rate of return on rate base permitted a Class C or a Class D water utility.

APPENDIX D
Page 3

3.04 Premium Above Purchase Price. The Parties agree that, if the purchase price is less than book value, the acquiring utility should be authorized to earn a return on the price paid plus 50 percent of the difference between book value and the price paid. The amount above the purchase price should be amortized over the average remaining life of the plant. In addition, the price paid shall include for purposes of ratemaking any cost incurred to complete the acquisition.

4.00 Acquisition of Mutual and Publicly-Owned Water Systems

4.01 Sections 852 and 854 of the Public Utilities Code. The Parties agree that neither Section 852 nor Section 854 of the Public Utilities Code requires a privately-owned utility to obtain authorization from the Commission before acquiring a publicly-owned utility.

4.02 Filing of Rates. The Parties agree that the acquiring utility should be authorized to file an advice letter placing into effect the existing rates of its adjacent or nearby water system, the acquired system's rates, or rates lower than either.

4.03 Notice. Notice of a proposed acquisition should be given to all affected customers at the time when any advice letter or application is filed with the Commission. Additionally, the notice should contain a comparison of the rates before the acquisition and for the first year after the acquisition and identify any cost, including a reasonable return, not fully reflected in the first year's rates. With respect to the acquisition of a water system of a municipality, similar notice should be given to all affected customers prior to any election.

5.00 Financing Subject to Approval by the Commission. The Parties agree that each utility is required to file an application for approval of long-term financing involved in each acquisition. An example of long-term financing is a municipality that agrees to sell its water system in exchange for annual payments from the acquiring utility. The Parties further agree that a utility may either file an application for the long-term financing of a particular acquisition or rely on authorization previously given by the Commission for long-term financing.

ACQUISITION OF A CLASS A OR B WATER UTILITY

DAY	EVENT
- 40	Notice of Intention
- 20	Notice of Deficiency
0	Application filed
20	Utility notified by RRB whether it will request an independent appraisal (excludes municipal corporations)
30*	Prehearing Conference
80	RRB's Report
115-125	Hearings
155	Briefs
215**	Proposed Decision
245***	Commission's Agenda

* Scheduled dates after the prehearing conference assume no independent appraisal.

** Or 60 days after the case is submitted.

*** Or 90 days after the case is submitted.

ACQUISITION OF A CLASS C OR D WATER UTILITY

DAY	EVENT
0	Application filed
30	Notice of Deficiency
45	Prehearing Conference
90	RRB's Report
120-125	Hearings
155	Briefs
215*	Proposed Decision
245**	Commission's Agenda

* Or 60 days after the case is submitted.

** Or 90 days after the case is submitted.

ADVICE LETTER

DAY	EVENT
0	Advice Letter Filed
30	Notice of Deficiency
40*	Utility's Response
70**	Draft Resolution
100**	Commission's Agenda

* Assumes that utility fully responds to deficiency letter within 10 days. (If complete response not received by Day 40, the schedule will be adjusted accordingly.)

** If Commission approval is required.

REQUIREMENTS FOR APPLICATIONS AND ADVICE LETTERS

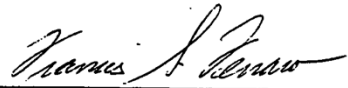
In addition to an appraisal, a filing must include the following:

Proposed Rates
Copy of Purchase Agreement
Service Area Map
(mutual and governmental acquisitions only)
Copy of Notice to Customers
Service List, Including Expected Interested Parties
(such as wholesale suppliers and adjacent utilities)

Respectfully submitted,

Program Manager, Ratepayer
Representation Branch of the
Water Division

February 2, 1999



Vice President, Regulatory Affairs
California Water Service Company

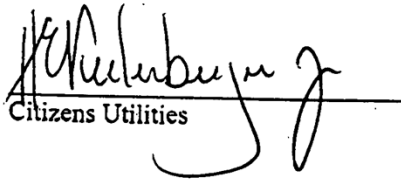
February 2, 1999

Respectfully submitted,


California American Water

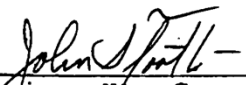
February 2, 1999

Respectfully submitted,


Citizens Utilities

February 2, 1999

Respectfully submitted,



Dominguez Water Corporation
V.P. Finance

February 2, 1999

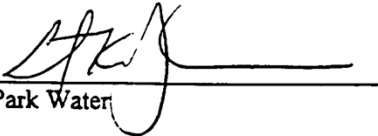
Respectfully submitted,



Great Oaks Water Company

February 2, 1999


Respectfully submitted,


Park Water

February 2, 1999

Respectfully submitted,

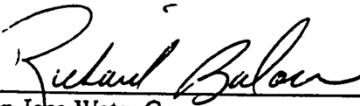
SAN GABRIEL VALLEY WATER COMPANY

By: 
Michael L. Whitehead

Title: President

Date: February 2, 1999

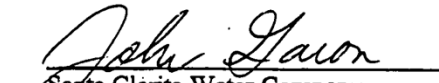
Respectfully submitted,



San Jose Water Company

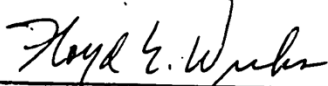
February 2, 1999

Respectfully submitted,



Santa Clarita Water Company
John Garon
V.P./CFO
February 2, 1999

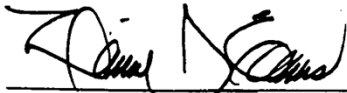
Respectfully submitted,



Southern California Water Company

February 2, 1999

Respectfully submitted,



Suburban Water Systems

February 2, 1999

Respectfully submitted,

 (U-342w)
Valencia Water Company

February 2, 1999

CERTIFICATE OF SERVICE

I hereby certify that I have this day served the foregoing document entitled **SETTLEMENT** upon all known parties of record by mailing, by first-class mail, a copy thereof properly addressed to each party.

Dated at San Francisco, California, this 2nd day of February, 1999.

/s/ BERLINA GEE

Berlina Gee

(END OF APPENDIX D)

Appendix B – Referenced Statutes and Code Sections

Public Utilities Code Sections 2718 through 2722:

2718: This chapter shall be known and may be cited as the Public Water System Investment and Consolidation Act of 1997.

2719: The Legislature finds and declares all of the following:

- (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.

2720: (a) 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 Section 1263.320 of the Code of Civil Procedure .
- (b) If the fair market value exceeds reproduction cost, as determined in accordance with Section 820 of the Evidence Code , the commission may include the difference in the rate base for ratesetting 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.
- (c) The provisions of subdivisions (a) and (b) shall also be applicable to the acquisition of a sewer system by any sewer system corporation or water corporation.
- (d) Consistent with the provisions of this section, the commission shall retain all powers and responsibilities granted pursuant to Sections 851 and 852.

2721: (a) For purposes of this section, the following terms have the following meanings:

(1) “Consolidate” means to join two or more small community water systems, state small water systems, or affected residences not served by a small community water system or state small water system into a single consolidated water system.

(2) “Small community water system” has the same meaning as set forth in Section 116275 of the Health and Safety Code.

(3) “State small water system” has the same meaning as set forth in Section 116275 of the Health and Safety Code.

(b) (1) A water or sewer system corporation may file an application and obtain approval from the commission through an order authorizing that water or sewer system corporation to consolidate with a small community water system or state small water system identified as failing or at risk of failing by the State Water Resources Control Board.

(2) The commission shall approve or deny an application filed pursuant to paragraph (1) within 12 months of its filing, unless the commission makes a written determination that the deadline cannot be met, including findings as to the reason, and issues an order extending the deadline by up to four months. The commission may grant additional extensions of four months or less consistent with this paragraph.

(3) A water or sewer system corporation shall submit a fee of ten thousand dollars (\$10,000) when filing an application for authority to complete a consolidation made pursuant to paragraph (1).

(4) All moneys collected pursuant to paragraph (3) shall be deposited into the Consolidation For Safe Drinking Water Fund, established pursuant to Section 2722.

(c) (1) (A) For a consolidation valued at five million dollars (\$5,000,000) or less, a water or sewer system corporation may file an advice letter and obtain approval from the commission through a resolution authorizing that water or sewer system corporation to consolidate with a small community water system or state small water system identified as failing or at risk of failing by the State Water Resources Control Board.

(B) If an advice letter filed pursuant to this paragraph is uncontested, approval may be given by the executive director or the director of the division of the commission having regulatory jurisdiction over the water or sewer system corporation.

(C) Absent incomplete documentation, the commission shall approve or deny the advice letter within 180 days of its filing by the applicant water or sewer system corporation, if the advice letter is not contested, unless the executive director makes a written determination that the deadline cannot be met, including findings as to the reason, and issues a response extending the deadline by up to 60

days. The executive director may grant additional extensions of 60 days or less consistent with this subparagraph.

(2) For a consolidation valued at five million dollars (\$5,000,000) or less, the commission may designate a different procedure if it determines that the consolidation warrants a more comprehensive review than the advice letter procedure described in paragraph (1) provides.

(d) For purposes of a consolidation pursuant to either subdivision (b) or (c), the commission shall prioritize cases in which a water or sewer system corporation consolidates with a small community water system or state small water system that is subject to a citation issued pursuant to Section 116650 of the Health and Safety Code or a compliance order issued pursuant to Section 116655 of the Health and Safety Code for failure to meet primary or secondary drinking water standards, as defined in Section 116275 of the Health and Safety Code.

(e) A water or sewer system corporation seeking to consolidate with a small community water system or state small water system pursuant to this section shall give adequate public notice and provide adequate opportunities for public participation, as determined by the commission.

(f) This section does not require a small community water system or state small water system that is not subject to the jurisdiction, control, and regulation of the commission to obtain authorization from the commission before consolidating with a small community water system or state small water system.

2722: The Consolidation For Safe Drinking Water Fund is hereby created. All moneys in the fund are available, upon appropriation by the Legislature, to the commission and shall be used only for the purpose of processing applications pursuant to subdivision (b) of Section 2721 along with any other associated regulatory costs.

Code of Civil Procedure Section 1263.320:

(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.

Public Utilities Code Sections 851 through 854:

851: A public utility, other than a common carrier by railroad subject to Part A of the Interstate Commerce Act (49 U.S.C. Sec. 10101 et seq.), shall not sell, lease, assign, mortgage, or otherwise dispose of, or encumber the whole or any part of its railroad, street railroad, line, plant, system, or other property necessary or useful in the performance of its duties to the public, or any franchise or permit or any right thereunder, or by any means whatsoever, directly or indirectly, merge or consolidate its railroad, street railroad, line, plant, system, or other property, or franchises or permits or any part thereof, with any other public utility, without first having either secured an order from the commission authorizing it to do so for qualified transactions valued above five million dollars (\$5,000,000), or for qualified transactions valued at five million dollars (\$5,000,000) or less, filed an advice letter and obtained approval from the commission authorizing it to do so. If the advice letter is uncontested, approval may be given by the executive director or the director of the division of the commission having regulatory jurisdiction over the utility. The commission shall determine the types of transactions valued at five million dollars (\$5,000,000) or less, that qualify for advice letter handling. For a qualified transaction valued at five million dollars (\$5,000,000) or less, the commission may designate a procedure different than the advice letter procedure if it determines that the transaction warrants a more comprehensive review. Absent protest or incomplete documentation, the commission shall approve or deny the advice letter within 120 days of its filing by the applicant public utility. The commission shall reject any advice letter that seeks to circumvent the five million dollar (\$5,000,000) threshold by dividing a single asset with a value of more than five million dollars (\$5,000,000), into component parts, each valued at less than five million dollars (\$5,000,000). Every sale, lease, assignment, mortgage, disposition, encumbrance, merger, or consolidation made other than in accordance with the advice letter and approval from the commission authorizing it is void. The permission and approval of the commission to the exercise of a franchise or permit under Article 1 (commencing with Section 1001) of Chapter 5, or the sale, lease, assignment, mortgage, or other disposition or encumbrance of a franchise or permit under this article shall not revive or validate any lapsed or invalid franchise or permit, or enlarge or add to the powers or privileges contained in the grant of any franchise or permit, or waive any forfeiture.

This section does not prevent the sale, lease, encumbrance, or other disposition by any public utility of property that is not necessary or useful in the performance of its duties to the public, and any disposition of property by a public utility shall be conclusively presumed to be of property that is not useful or necessary in the performance of its duties to the public, as to any purchaser, lessee, or encumbrancer dealing with that property in good faith for value, provided that this section does not apply to the interchange of equipment in the regular course of transportation between connecting common carriers.

852: No public utility, and no subsidiary or affiliate of, or corporation holding a controlling interest in, a public utility, shall purchase or acquire, take or hold, any part of the capital stock of any other public utility, organized or existing under or by virtue of the laws of this state, without having been first authorized to do so by the commission; provided, however, that the commission may establish by order or rule categories of stock acquisitions which it determines will not be harmful to the public

interest, and purchases within those categories are exempt from this section. Every assignment, transfer, contract, or agreement for assignment or transfer of any stock by or through any person or corporation to any corporation or otherwise in violation of any of the provisions of this article is void and of no effect, and no such transfer shall be made on the books of any public utility. Nothing in this section prevents the holding of stock previously lawfully acquired.

853: (a) This article does not apply to any person or corporation which transacts no business subject to regulation under this part, except performing services or delivering commodities for or to public utilities or municipal corporations or other public agencies primarily for resale or use in serving the public or any portion thereof, but shall apply to any public utility, and any subsidiary or affiliate of, or corporation holding a controlling interest in, a public utility, if the commission finds, in a proceeding to which the public utility is or may become a party, that the application of this article is required by the public interest.

(b) The commission may from time to time by order or rule, and subject to those terms and conditions as may be prescribed therein, exempt any public utility or class of public utility from this article if it finds that the application thereof with respect to the public utility or class of public utility is not necessary in the public interest. The commission may establish rules or impose requirements deemed necessary to protect the interest of the customers or subscribers of the public utility or class of public utility exempted under this subdivision. These rules or requirements may include, but are not limited to, notification of a proposed sale or transfer of assets or stock and provision for refunds or credits to customers or subscribers.

(c) The provisions of Sections 851 and 854 that prohibit any assignment, acquisition, or change of control without advance authorization from the commission, do not apply to the transfer of the ownership interest in a water utility, with 10,000 or fewer service connections, from a decedent to a member of the decedent's family in the manner provided in Section 240 of the Probate Code or by a will, trust, or other instrument.

(d) It is the intent of the Legislature that transactions with monetary values that materially impact a public utility's rate base should not qualify for expedited advice letter treatment pursuant to this article. It is the further intent of the Legislature that the commission maintain all of its oversight and review responsibilities subject to the California Environmental Quality Act, and that public utility transactions that jurisdictionally require a review by the commission, as the lead agency, under the act should not qualify for expedited advice letter treatment pursuant to this article. An advice letter may be filed for transactions by the public utility if the lead agency has completed the appropriate review under the California Environmental Quality Act for the transaction, and the commission is the responsible agency under the act. The advice letter shall be subject to approval by resolution voted upon by the commission.

853.2: For a water or sewer system corporation or an entity merging with or acquiring control of a water or sewer system corporation with less than 2,000 service connections, the following shall apply

to transactions valued at five million dollars (\$5,000,000) or less, notwithstanding Sections 851 and 854 :

(a)(1) A water or sewer system corporation or an entity merging with or acquiring control of a water or sewer system corporation shall receive the commission's approval before entering into a transaction that would otherwise be subject to Section 851 or 854 .

(2) If a water or sewer system corporation or an entity merging with or acquiring control of a water or sewer system corporation fails to receive the commission's approval pursuant to paragraph (1), the transaction is voidable by the commission until the commission does either of the following:

(A) Retroactively approves the transaction upon a determination that the transaction is in the best interests of both the corporation and its ratepayers.

(B) Conditionally approves the transaction, subject to the fulfillment of specified conditions that would ensure that the transaction is in the best interests of both the corporation and its ratepayers.

(b) The commission may delegate the authority to make the determinations described in subdivision (a) to the director of the division that investigates water and sewer system service quality issues and analyzes and processes utility rate change requests.

854: (a) No person or corporation, whether or not organized under the laws of this state, shall merge, acquire, or control either directly or indirectly any public utility organized and doing business in this state without first securing authorization to do so from the commission. The commission may establish by order or rule the definitions of what constitute merger, acquisition, or control activities which are subject to this section. Any merger, acquisition, or control without that prior authorization shall be void and of no effect. No public utility organized and doing business under the laws of this state, and no subsidiary or affiliate of, or corporation holding a controlling interest in a public utility, shall aid or abet any violation of this section.

(b) Before authorizing the merger, acquisition, or control of any electrical, gas, or telephone corporation organized and doing business in this state, where any of the utilities that are parties to the proposed transaction has gross annual California revenues exceeding five hundred million dollars (\$500,000,000), the commission shall find that the proposal does all of the following:

(1) Provides short-term and long-term economic benefits to ratepayers.

(2) Equitably allocates, where the commission has ratemaking authority, the total short-term and long-term forecasted economic benefits, as determined by the commission, of the proposed merger, acquisition, or control, between shareholders and ratepayers. Ratepayers shall receive not less than 50 percent of those benefits.

(3) Not adversely affect competition. In making this finding, the commission shall request an advisory opinion from the Attorney General regarding whether competition will be adversely affected and what mitigation measures could be adopted to avoid this result.

(4) For an electric or gas utility, ensures the utility will have an adequate workforce to maintain the safe and reliable operation of the utility assets.

(c) Before authorizing the merger, acquisition, or control of any electrical, gas, or telephone corporation organized and doing business in this state, where any of the entities that are parties to the proposed transaction has gross annual California revenues exceeding five hundred million dollars (\$500,000,000), the commission shall consider each of the criteria listed in paragraphs (1) to (8), inclusive, and find, on balance, that the merger, acquisition, or control proposal is in the public interest.

(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 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 which may result.

(d) 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.

(e) The person or corporation seeking acquisition or control of a public utility organized and doing business in this state shall have, before the commission, the burden of proving by a preponderance of the evidence that the requirements of subdivisions (b) and (c) are met.

(f) In determining whether an acquiring utility has gross annual revenues exceeding the amount specified in subdivisions (b) and (c), the revenues of that utility's affiliates shall not be considered unless the affiliate was utilized for the purpose of effecting the merger, acquisition, or control.

(g) Paragraphs (1) and (2) of subdivision (b) shall not apply to the formation of a holding company.

(h) For purposes of paragraphs (1) and (2) of subdivision (b), the legislature does not intend to include acquisitions or changes in control that are mandated by either the commission or the Legislature as a result of, or in response to any electric industry restructuring. However, the value of an acquisition or change in control may be used by the commission in determining the costs or benefits attributable to any electric industry restructuring and for allocating those costs or benefits for collection in rates.

Public Utilities Code Section 10061:

(a) Notwithstanding Article 1 (commencing with Section 10001) and this article, and except as provided in Section 37420.5 of the Government Code , a municipal corporation, by following the provisions of this section, may lease, sell, or transfer all or part of a public utility owned and operated by it for furnishing water or sewer service. As used in this section, “municipal corporation * * *” means a city or a city and county.

(b) Any municipal corporation owning and operating a public utility for furnishing water or sewer service, a part of which or all of which public utility is operated and used for furnishing water or sewer service outside the boundaries of the municipal corporation, may lease, sell, or transfer, for just compensation, all or any part of the portion of the public utility located outside the boundaries of the municipal corporation to any other municipal corporation, public agency, water corporation, or sewer system corporation upon the terms and conditions agreed upon by the selling municipal corporation if, by resolution adopted by a majority of its legislative body, it has determined that the public utility, or portion thereof, is not necessary for supplying water or sewer service to its own inhabitants and if the acquiring entity by resolution adopted by a majority of the members of its legislative body or board of directors has concurred in the lease, sale, or transfer and the terms and conditions thereof and if the acquiring entity will be bound to render water or sewer service to the persons formerly served through the system being sold on terms and conditions that are just and reasonable and do not unreasonably discriminate against the customers of the acquired entity.

(c) Any municipal corporation owning and operating a public utility for furnishing water or sewer service may sell or transfer, for just compensation, all or any part of the public utility located inside its municipal boundaries to any other municipal corporation, public agency, water

corporation, or sewer system corporation upon the terms and conditions agreed upon by the selling municipal corporation, if the sale or transfer is approved as follows:

- (1) The municipal corporation, by resolution adopted by a majority of its legislative body, has determined that the public utility, or portion thereof, is not necessary for supplying water or sewer services to its own inhabitants, or that its inhabitants will be provided with equal or better service by the acquiring entity on terms that are just and reasonable and do not discriminate against the customers of the acquired entity, and orders the issue submitted to the qualified voters of the municipality at a special or general election held for that purpose.
 - (2) The acquiring entity by resolution adopted by a majority of its legislative body or board of directors has concurred in the sale or transfer and in the terms and conditions thereof.
 - (3) The sale or transfer is approved by a majority of all voters voting on the issue in the election held for that purpose.
 - (4) The municipal corporation, public agency, water corporation, or sewer system corporation proposing to acquire a municipal corporation public utility for furnishing water or sewer service shall disclose to the customers of the public water or sewer system to be acquired, not less than 30 days prior to the date of election for formal approval of the acquisition, a written statement which includes all of the following:
 - (A) A summary of the price and terms of the proposed acquisition.
 - (B) A comparison of the applicable water or sewer charges before and after the proposed acquisition.
 - (C) The estimated savings to be achieved or additional costs expected to result, or both, from the proposed acquisition.
- (d) Subject to subdivision (e), a municipal corporation may lease a public utility furnishing water or sewer service by a resolution adopted by a majority of its legislative body and without lease term or other restrictions stated in any other law.
- (e) A municipal corporation acting pursuant to subdivision (c) shall specify the manner of soliciting and filing, and the method of evaluating, proposals for the acquisition of the public utility. Upon receipt and staff evaluation of a proposal or proposals the municipal corporation, if it determines that the proposal or proposals are responsive, shall schedule a public hearing, and notice thereof shall be published in accordance with Section 6066 of the Government Code . At the hearing, the municipal corporation shall examine proposals received and staff recommendations, and without lease term or other restrictions, may lease, sell, or transfer, for just compensation, the public utility to the entity that the municipal corporation finds best qualified to continue to provide equal or better service to the customers of the system. If the resolution proposes a sale, the resolution shall place

the question on the ballot at the next regularly scheduled election or at a special election called for that purpose. The municipal corporation may, in its sole discretion, reject all proposals.

(f) Any agreement entered into before September 17, 1965, between municipal corporations for the lease, sale, or transfer of all or any part of a public utility owned and operated by one of the municipal corporations and furnishing water service to the inhabitants of the municipal corporation to which the lease, sale, or transfer is made is hereby validated.

Government Code Section 37420.5:

(a) Notwithstanding Article 2 (commencing with Section 10051) of Chapter 1 of Division 5 of the Public Utilities Code, the City of El Monte, the City of Montebello, and the City of Willows may sell its public utility for furnishing water service pursuant to this article for the purpose of consolidating its public water system with another public water system only if the potentially subsumed public water system is wholly within the boundaries of the city and if the city determines that it is uneconomical and not in the public interest to own and operate the public utility for furnishing water service, subject to all of the following requirements:

- (1) The legislative body of the city shall not sell the water utility property for less than its fair market value, as defined in Section 1263.320 of the Code of Civil Procedure .
- (2) The legislative body of the city shall not sell the water utility property without a four-fifths vote of the city's legislative body.
- (3) There are at least two water suppliers that provide drinking water to residents in the city prior to the sale.
- (4) The city has deferred necessary maintenance for aging or failing water infrastructure of public water systems operated by the public utility. The necessity of the maintenance shall be demonstrated by a study conducted by an independent third party that evaluates performance of the system applying American Water Works Association standards or other equivalent standards.
- (5) The receiving water system's service area borders the service area of the subsumed water system.
- (6) The subsumed water system's customers shall not pay water rates different from customers already receiving service from the receiving water system. Consolidation of the water systems shall be economically feasible for the ratepayers of the subsumed water system. Ratepayers of the subsumed water system shall be notified of the applicable rate that will be in effect during the first year after consolidation has been completed. Any rate increases following the sale of a public utility for furnishing water service shall be phased in over time.
- (7) Consolidation of the water systems is technically and economically feasible.

(8)(A) The legislative body of the city shall not sell its public utility for furnishing water service unless it considers oral and written protests at its second regularly scheduled meeting following the adoption of a resolution pursuant to Sections 37422 and publication pursuant to subparagraph (B). In addition to the requirements of Section 37422 , the resolution shall allow 45 days for hearing protests to the sale and shall state the city's intended use of the sale proceeds. Notice of the sale may be given by including notice in the agency's regular billing statement. One written protest per parcel, filed by an owner or tenant of the parcel, shall be counted in calculating a protest. The city shall maintain all written protests for a minimum of two years following the date of the hearing to consider written protests.

(B) Notwithstanding Section 37423 , the resolution shall be published at least once in a daily newspaper published and circulated in the city or, if there is none, the legislative body shall designate a newspaper published in the county. It shall also be posted for not less than 10 days in at least three conspicuous places in the city.

(C)(i) Notwithstanding Section 37425 , if the legislative body of the city finds that protests have been filed by at least 10 percent of interested persons, the legislative body of the city shall call an election pursuant to Section 37427 . If an election is called pursuant to this paragraph, the legislative body of the city shall not sell the public utility for furnishing water service unless the sale is approved by a majority of the city's registered voters voting on the issue.

(ii) If 50 percent or more of interested persons protest the sale of the public utility, the city shall not take further steps for the sale of the public utility. The city, after one year has passed, may sell the public utility if the requirements of this section are met, including adoption of a new resolution pursuant to subparagraph (A).

(iii) For purposes of this paragraph, “interested person” means a person who is a resident of the city proposing to sell its public utility pursuant to this section.

(9) The legislative body of the city has adopted a resolution, at a regularly scheduled meeting, that paragraphs (1) to (8), inclusive, have been met.

(b) This section shall remain in effect only until January 1, 2022, and as of that date is repealed, unless a later enacted statute that is enacted before January 1, 2022, deletes or extends that date.

Appendix C – Commission-Regulated Systems on the Human Right to Water List

System	PWSID
Yosemite Spring Park Utility Company	CA2010005
Havasu Water Company	CA3610017
Cazadero Water Company	CA4900508
Twin Valley	CA4300575
Ramona Water Company	CA3301529
Nacimiento Water Company	CA4010027
California American Water - Goldside	CA2010014
Del Oro Water Company – Country Estates	CA1500314
Del Oro Water Company – River Island Territory 1	CA5400665
Del Oro Water Company – Grandview	CA5400666
Del Oro Water Company – Metropolitan	CA1000057
Del Oro Water Company – Traver	CA5400553

Appendix D – List of Acquisitions Involving Commission-Regulated Systems between 2007 and 2021

	Acquired Water Utility	Water Utility Purchaser	Connections	Purchase Price	Decision/Resolution	Approval Date
1	Grand Oaks Water Company	California Water Service Company	43	\$0	D0705053	5/24/2007
2	Peerless Water Company	City of Bellflower	1,812	\$5,800,000	W-4656	8/23/2007
3	Arrowhead Manor Water Company	County of San Bernardino	331	\$300,000	D0708022	8/24/2007
4	Alco Water Service - Buena Vista District	California Water Service Company		\$300,000	D0709013	9/6/2007
5	Toro Water Service	California-American Water Company	248	\$408,000	D0711034	11/19/2007
6	Matt Dillon Water Company	Tuolumne Utilities District	186	\$100,000	D0802025	2/28/2008
7	Mar Vista Water Company	Trout Gulch Mutual Water Company	186	\$295,860	D0805005	5/15/2008
8	River Island Water Company	Del Oro Water Company	352	\$760,000	D0807034	7/31/2008
9	Arbuckle Water Company (Mutual)	Del Oro Water Company	55	\$100,000	D0809010	9/5/2008
10	Tehachapi Mountain Water Company					9/10/2008
11	California-American Water Company - Felton District	San Lorenzo Valley Water District	1,324	\$13,400,000	W-4719	11/7/2008
12	McCanna Ranch Water Company	Perris Public Utility Authority				12/19/2008
13	Klein Homes Water Company	San Jose Water Company	19	\$25,000	W-4745	2/20/2009
14	Mount Lassen Woods Subdivision (New Development)	Del Oro Water Company	132	\$165,000	D0904016	4/29/2009
15	Woodside Mutual Water Company	California Water Service Company	47	\$1	AL 1907 (No Res.)	7/6/2009
16	Alco Water Service - San Jerardo District	County of Monterey			W-4786	9/24/2009
17	Ponderosa Sky Ranch Water System	Sky View County Water District	110	\$50,000	D0910018	10/15/2009
18	West Riverside Canal Company	Empire Water Corporation (Non-Public Utility)	3	\$0	D1011002	11/10/2010
19	James Water Company	California Water Service Company	23	\$1	D1202003	2/1/2012
20	Stewart Water Company	Gordon Water Acres Water Company (Mutual)			W-4907	2/16/2012
21	Central Water System	Plainview Mutual Water Company	42	\$24,000	D1204020	4/19/2012
22	Lewiston Valley Water Company (& Sewer)	Lewiston Community Services District	12	\$35,000	W-4920	6/7/2012
23	Riverview Acres Water Company	Salyer Mutual Water Company	53	\$1	W-4923	6/21/2012
24	Watertek Incorporated	Del Oro Water Company	146	\$60,000	D1209013	9/13/2012
25	Garrapata Water Company	California-American Water Company	49	\$50,000	D1301033	1/24/2013
26	Valencia Water Company	Castaic Lake Water Agency	30,000	\$73,000,000	D1402041	2/27/2014
27	Idylwild Water System	Raineri Mutual Water Company	45	\$16,000	D1403009	3/14/2014
28	Lake Forest Water Company	Tahoe City Public Utility District	118	\$453,700	W-4980	5/16/2014
29	Yermo Water Company	Apple Valley Ranchos Water Company	250	\$300,000	W-4998	8/29/2014
30	Ox Bow Mutual Water Company	California-American Water Company	96	\$495,000	W-5042	6/16/2015
31	Rural Water Company	Golden State Water Company	950	\$1,700,000	D1506049	7/1/2015
32	Black Butte Water Company	Del Oro Water Company	87	\$47,197	D1508036	8/25/2015
33	Traver Water Company	Del Oro Water Company	180	\$250,000	D1509015	9/21/2015

34	Dunnigan Water Works (& Sewer)	California-American Water Company	253	\$2,000,000	D1511012	11/10/2015
35	Buzztail Community Service District (Mutual)	Del Oro Water Company	34	\$73,359	W-5068	11/23/2015
36	Trinity Village Water Company	Trinity Village Mutual Water Company	191	\$250,000	W-5076	1/21/2016
37	Adams Ranch Mutual Water Company	California-American Water Company	173	\$800,000	W-5080	2/25/2016
38	Beasore Meadows Water Company	Beasore Mutual Water Company	75	\$1	W-5091	4/7/2016
39	Wendell Water Company	Wendell Lane Mutual Water Company	25	\$7,500	W-5100	8/22/2016
40	Geyserville Water Works	California-American Water Company	318	\$1,415,210	D1611014	11/17/2016
41	Meadowbrook Water Company	California-American Water Company	1,695	\$4,000,000	D1612014	12/6/2016
42	Larkspur Meadows Water Company	Del Oro Water Company	37	\$83,000	D1703019	3/23/2017
43	Del Oro Water Company - Walnut Ranch District	City of Colusa	79	\$280,000	W-5136	3/23/2017
44	Benbow Water Company	Del Oro Water Company	134	\$590,586	D1705003	5/11/2017
45	Madden Creek Water Company	Tahoe City Public Utility District	169	\$4,700,000	W-5163	4/26/2018
46	Tahoe Cedars Water Company		1,167			
47	Timberland Water Company	Tahoe City Public Utility District	136	\$445,000	W-5166	4/26/2018
48	Rolling Hills Water System	Bakman Water Company	361	\$297,172	W-5184	1/31/2019
49	Rio Plaza Water Company	California-American Water Company	520	\$1,750,000	D1904015	4/25/2019
50	Mesa-Crest Water Company	Park Water Company	708	\$2,600,000	D1904023	4/25/2019
51	Golden State Water Company - Ojai District	Casitas Municipal Water District	2,899	\$34,481,628	D1905044	5/30/2019
52	Hat Creek Water Company	Del Oro Water Company	63	\$80,000	W-5196	8/1/2019
53	Crane Ridge Mutual Water Company	California Water Service Company	27	\$1	W-5206	9/26/2019
54	Hillview Water Company	California-American Water Company	1,472	\$7,470,459	D1911003	11/13/2019
55	Fruitridge Vista Water Company	California-American Water Company	4,760	\$20,750,000	D1912038	12/23/2019
56	Cobb Mountain Water Company	Cobb Area County Water District	64	\$25,728	W-5239	6/3/2021
57	Robbins Water System	Golden State Water Company	94	\$1,000	W-5237	6/24/2021
58	East Pasadena Water Company	California-American Water Company	3,024	\$34,000,000	D2108002	8/5/2021

(END OF APPENDIX A)