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Ms. Blanca S. Bayo, Director
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Florida Public Service Commission
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Betty Easley Conference Center, Room 110
Tallahassee, Florida 32399-0850

Re: Docket No. 980744-WS

Dear Ms. Bayo:

Enclosed herewith for filing in the above-referenced docket on behalf of Florida Water Services Corporation ("Florida Water") are the following documents:

1. Original and fifteen copies of the Prefiled Direct Testimony of Hugh Gower;

2. Original and fifteen copies of the Prefiled Direct Testimony and Exhibits CHH-1 through CHH-4 of Charles H. Hughes;

3. Original and fifteen copies of the Prefiled Direct Testimony and Exhibits JC-1 through JC-3 of John Cirello; and

4. Original and fifteen copies of the Prefiled Direct Testimony and Exhibits JAP-1 through JAP-6 of James A. Perry.

Please acknowledge receipt of these documents by stamping the extra copy of this letter "filed" and returning the copy to me.

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Thank you for your assistance with this filing.

Sincerely,

J. Stephen Menton

JSM/rl
Enclosures
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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of the foregoing was furnished by hand delivery(*) and U. S. Mail to the following this 20th day of November, 2000:

Jennifer Brubaker, Esq.(*)
Division of Legal Services
Florida Public Service Commission
2540 Shumard Oak Boulevard
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Tallahassee, FL 32399-0850

Charles Beck, Esq.
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J. STEPHEN MENTON, ESQ.

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Investigation into ratemaking considerations of gain on sale from sale of facilities of Florida Water Services Corporation to Orange County.	)))))	Docket No. 980744-WS Filed: November 20, 2000

PREFILED DIRECT TESTIMONY OF

CHARLES H. HUGHES

FILED ON BEHALF

OF

FLORIDA WATER SERVICES CORPORATION

KENNETH A. HOFFMAN, ESQ.
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Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Charles H. Hughes. My business address is:

Hughes Consulting
111 Oak Lane
Sneads Ferry, North Carolina 28460

Q. IN WHAT CAPACITY ARE YOU EMPLOYED?

A. I am owner of Hughes Consulting Company.

Q. WHAT BUSINESS SERVICE DOES HUGHES CONSULTING OFFER?

A. Hughes Consulting offers comprehensive consulting for the electric, natural gas, telecommunications and the water, wastewater industries. Our consulting group's major emphasis is in the water and wastewater related industry.

Hughes Consulting offers services in the governmental and regulatory areas, as well as contract services, market research and economic analysis, critical issues management, efficiency evaluation, governmental lobbying and relations and franchise negotiations, public policy and business management review.

Q. PLEASE DESCRIBE YOUR PROFESSIONAL BACKGROUND.

A. After attending Greensboro College and the University of North Carolina School of Banking, I began my employment career as branch manager with GAC Finance Corporation with responsibilities for marketing, lending, collections and operations. In 1971, I joined the Bank of North Carolina (now Nations Bank) and was promoted to Executive Vice President and City Manager for the Hendersonville, North Carolina area. I had full responsibility for management, marketing, lending and all other bank operations. In 1976, I joined Cooper Construction Company in

Hendersonville, North Carolina as sales manager for all commercial construction. My duties included full responsibility for estimating, project management, and engineering review of company projects. In 1979, after acquiring the State of North Carolina's General Contractor License, I formed the Hughes Building Corporation. I served as Chief Executive Officer and President of Hughes Building Corporation, which specialized in commercial, residential, and government contracts. Within the scope of this work was the installation of water and sewer lines.

In 1980, 1982 and 1984, I was elected to the North Carolina House of Representatives. While in the Legislature, I was elected House Minority Whip. During my tenure I was appointed to serve on various committees such as Appropriation Expansion and Base Budget Committee, Committee on Aging, Banks and Thrift Institutions, Courts and Judicial Districts, Economy and Small Business, Transportation, courts and Administration Justice, Governmental Ethics, Higher Education, and Law Enforcement.

In 1985, I was appointed Director of Research and Senior Policy Advisor to the Governor of North Carolina. I was responsible for research and policy making in all areas of State Government, including utility review. In 1989, I was appointed to the North Carolina Utility Commission and served as a Commissioner until September of 1997.

Q. WHAT WERE YOUR RESPONSIBILITIES ON THE NORTH CAROLINA UTILITY COMMISSION?

A. As a Commissioner, I was responsible for regulation of all public utilities in North Carolina under the Commission's jurisdiction as interpreted in Chapter 62 of the General Statues of North Carolina. This included electric,

telephone, natural gas, transportation, railroad and water and wastewater utilities.

I was also the Commission's designated lead person in the area of water and wastewater.

Q. DID YOU REPRESENT THE COMMISSION ON ANY COMMITTEES OF THE NATIONAL ASSOCIATION OF REGULATORY UTILITIES?

A. Yes, I served on the NARUC Water Committee and was elected Chairman of the NARUC Water Committee, as well as a member of the NARUC Executive Committee.

Q. HAVE YOU SERVED ON ANY OTHER BOARDS OR COMMITTEES?

A. Yes, I served as a member of the Public Advisory Forum to the Officers and Directors of the American Water Works Association; Public Council on Water Supply Research of the American Water Works Association Research Foundation; NARUC's representative for the Federal Advisory Committee on Drinking Water Disinfection By-Products Rulemaking of the U.S. Environmental Protection Agency; and served as Faculty Advisor for the National Judicial College at the University of Nevada.

I was also responsible for the Eastern and Western Utility Rate Schools, which are designed to provide comprehensive understanding of rate setting concepts.

Q. ARE YOU PRESENTLY SERVING ON ANY WATER COMMITTEES OR BOARDS?

A. Yes. I am presently serving on the Small Company Committee and the Regulatory Law Committee for the National Association of Water Companies.

Q. HAVE YOU RECEIVED ANY SPECIAL RECOGNITION OR AWARDS DURING YOUR CAREER?

A. Yes, In 1987, I received the National Commander's Award for "Distinguished Service to the Nation's Veterans and Their Families", Disabled American Veterans.

In 1988, I received the State Award for Making North Carolina a "Quality of Life State" from the Concerned Charlotteans in Charlotte, North Carolina.

In 1989, Governor James G. Martin presented me The Order of the Long Leaf Pine, the highest recognition the State of North Carolina awards for service to the State.

In 1997, Governor James B. Hunt, Jr., presented me The Order of the Long Leaf Pine, the highest recognition the State of North Carolina awards for service to the State.

In 1997, the Board of the National Association of Regulatory Utility Commissions adopted a Special Resolution in my honor. A copy of my resume is attached to my testimony as Exhibit __ (CHH-1).

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my testimony is to set forth the state and federal regulatory policies, decisions and laws which support a determination by this Commission that the shareholders of Florida Water Services Corporation ("Florida Water") should retain in full the $4.2 million gain on sale of Florida

Water's water and wastewater systems in Orange County. I will focus on the rationale of prior decisions and actions of this Commission, the North Carolina Utilities Commission, and Congress and the Florida Legislature, all of which provide a number of compelling reasons for this Commission to continue its policy of allowing water and wastewater utilities such as Florida Water to retain in full the gain on the sale of a utility system including the facilities and customers which provided the stream of revenues for the system.

I. FLORIDA PUBLIC SERVICE COMMISSION POLICY AND PRECEDENT

Q. ARE YOU FAMILIAR WITH PRIOR DECISIONS OF THIS COMMISSION ANALYZING THE SALE OF A SYSTEM BY FLORIDA WATER?

A. Yes, I am.

Q. WHERE WOULD YOU BEGIN YOUR ANALYSIS?

A. I would begin with the Lehigh rate case. In that case, an affiliate of Florida Water, Lehigh Utilities, Inc., petitioned for a rate increase. One of the issues in the case involved whether Florida Water's customers should share in the after tax gain of $4.2 million realized by Lehigh's parent, Minnesota Power & Light Company, as a result of the sale of the St. Augustine Shores water and wastewater systems to St. Johns County as a result of a condemnation action. In Order No. 93-0301-FOF-WS issued in Docket No. 911188-WS, the Commission laid out three important principles in determining that the shareholders of Minessota Power & Light Company should retain the gain in full. First, the Commission held that the ratepayers of a utility do not acquire

a proprietary interest in utility property that is being used for utility service. Second, the Commission determined that it is the shareholders, not the customers, who bear the risk of loss in their investments. Third, the Commission found that the remaining Lehigh customers did not contribute to Lehigh's recovery of its investment in the St. Augustine Shores systems. See Lehigh Order, at pages 22-23.

Q. DO THESE PRINCIPLES APPLY EQUALLY AS WELL TO FLORIDA WATER'S SALE OF THE ORANGE COUNTY SYSTEMS?

A. Absolutely. The principle that customers do not acquire a proprietary or ownership interest in utility property by virtue of paying rates for service is an immutable principle that dates back to the decision of the United States Supreme Court in Board of Public Utility Commissioners v. New York Telephone Company, 271 U.S. 23, 32 (1926), where the court held:

> Customers pay for service, not for the property used to render it... By paying bills for service they do not acquire any interest, legal or equitable, in the property used for their convenience or in the funds of the company. Property paid for out of moneys received for service belongs to the company, just as does that purchased out of proceeds of its bonds and stock.

Some sixty years later, in Pacific Gas & Electric Company v. Public Utilities Commission of California, 475 U.S. 1 (1986), the Supreme Court struck down a California PUC order requiring an electric utility to distribute with its bills a customer advocacy group's literature. The court rejected the Commission's argument that customers "owned" the "extra space" in billing envelopes, and determined that the Commission "misperceives... the relevant property rights...." 475 U.S. at 17. The property rights argument was forcefully articulated in Justice Marshall's concurring opinion:

> The State seizes upon appellant's status as a regulated monopoly in order to argue that the inclusion of postage and other billing costs in the utility's rate base demonstrates that these items "belong" to the public, which has paid for them. However, a consumer who purchases food in a grocery store is "paying" for the store's rent, heat, electricity, wages, etc., but no one would seriously argue that the consumer thereby acquires a property interest in the store. That the utility passes on its overhead costs to ratepayers at a rate fixed by law rather than the market cannot affect the utility's ownership of its property, nor its right to use that property for expressive purposes.

475 U.S. at 22.

Q. WHAT CONCLUSIONS DO YOU DRAW FROM THE LEHIGH RATE CASE AND THE TWO UNITED STATES SUPREME COURT CASES THAT YOU HAVE DISCUSSED?

A. The conclusions are clear. "Ownership" of utility assets is clearly vested in the utility's shareholders, thereby affording the shareholders with all of the rights attendant to ownership, including the right to realize and retain increases in the market value of utility assets, as well as the risk of losses. These decisions also indicate that allocating to customers any portion of the gain on sale of a utility system would constitute an unlawful taking of utility property without unjust compensation.

Q. HAS THE COMMISSION REAFFIRMED ITS CONCLUSION THAT UTILITY CUSTOMERS DO NOT ACQUIRE AN OWNERSHIP INTEREST IN UTILITY PROPERTY?

A. Yes. In Order No. PSC-93-1821-FOF-WS issued in Docket No. 930373-WS, a case involving a petition by North Ft. Myers Utility, Inc. to expand its service territory to include the territory that had been served by Lake Arrowhead Village, Inc., an issue arose as to whether the customers of Lake

Arrowhead were due a refund based on a payment made by North Ft. Myers to Lake Arrowhead to purchase collection lines and lift stations. The customers apparently maintained that the contributions-in-aid-of-construction they had paid to Lake Arrowhead justified a refund to the customers of the amount paid by North Ft. Myers to Lake Arrowhead to purchase the wastewater facilities. This Commission rejected the customer's request for a refund and concluded on pages 7 and 8 of the Order:

> We find that a refund to the customers or off-set of connection fees is not appropriate because customers of utilities do not have any proprietary claim to utility assets. Although customers pay a return on utility investment through rates for service, they do not have any ownership rights to the assets, whether contributed or paid for by utility investment. Furthermore, the customers are not affected by the payment to LAVI for the on-site facilities since there is no effect on the rate base of NFMU.
>
> In addition, we find that the owner of LAVI is entitled to receive value for the sale of the utility, including the collection system. The property rights that rest in the ownership of the utility land and facilities are constitutionally protected. To deny this property interest would constitute an unconstitutional taking by this Commission. Any contribution to the system by the customers would have no value without the risk and investment of the utility owner(s) in the land and facilities that are now being removed from utility service. Given the customers' lack of proprietary claim and the utility's fundamental property rights, we find no refund of the purchase price to the customers to be appropriate.

Q. DO YOU AGREE WITH THIS COMMISSION'S PRIOR DETERMINATIONS THAT THE RISK OF OWNERSHIP IN A UTILITY SYSTEM, INCLUDING THE UTILITY ASSETS, LIES STRICTLY WITH THE UTILITY OWNERS?

A. Yes, I do. The Commission must bear in mind that it is utility stockholders who provide the capital investment in the utility plant and bear the risk

associated with that investment. The failure to earn a Commission authorized rate of return on utility investment is a risk that rests solely with utility shareholders. Similarly, the failure or delay in recovering a return on and a return of prudent investments that are required of a monopoly provider that has an obligation to provide service - - the so-called "regulatory lag" inherent in ratemaking - - is a risk that lies solely with utility shareholders. I am advised by Florida Water that its 1995 rate case filing requested a return on and a return of some $100 million in capital investments made during 1992 through 1995 that were ultimately determined by this Commission to be prudent. In addition, a private utility is subject to additional risk and delay in recovering its investments when it acquires a system and makes the necessary and environmentally required improvements to provide reliable and safe service. Recovery of these prudent investments is delayed until the utility's next rate case. Finally, there are the risks associated with a utility's ability to increase its territory, customer base, stream of revenues and achieve economies of scale when competing utilities, governmental or private, compete to provide service in territory that has not been certificated or franchised to a specific provider. For these reasons, this Commission has correctly concluded in the past that it is not reasonable to insulate customers from the risk associated with these capital investments and then award these same customers the gains typically reflecting market value on the sale of utility systems.

Q. WHAT ABOUT THE FINDING IN THE LEHIGH RATE CASE THAT THE REMAINING LEHIGH RATEPAYERS DID NOT

CONTRIBUTE TO THE UTILITY'S RECOVERY OF ITS INVESTMENT IN THE ST. AUGUSTINE SHORES SYSTEMS?

A. That component of the Commission's decision in the Lehigh rate case applies equally here as well. According to figures provided to me by Florida Water, there were four water systems and one wastewater system sold to Orange County. It is my understanding that prior to September 1993, the Orange County systems had stand-alone rates. Therefore, other systems would not have contributed to the recovery of utility investments in the Orange County systems from the date of acquisition of the Orange County systems[1] and continuing through the period of time stand-alone rates remained in effect. It is also my understanding that during the period from September 1993 through the date of sale in December 1997, the Orange County systems were part of a uniform rate structure approved by the Commission (September, 1993 through January, 1996); were then moved to modified stand-alone rates (January 23, 1996 through September, 1997); and finally were incorporated in a cap-band rate structure from September 20, 1996 through the date of sale. During this time, that is from September, 1993 through December, 1997, the Orange County systems subsidized other Florida Water systems under the Commission's jurisdiction by approximately $465,000. These facts confirm that at no time have other Florida Water systems contributed to the recovery of Florida Water's (or its predecessors') investment in the Orange County systems. In fact, the very opposite is true. The Orange County

[1]I have been advised by Florida Water that the Orange County systems were purchased by Florida Water's predecessor entities on the following dates: (1) University Shores systems - - September 29, 1978; (2) Daetwyler and Lake Conway systems - - October 5, 1978; (3) Holiday Heights system - - May, 1987; and (4) Westmont system - - July 31, 1987.

systems more accurately have subsidized other Florida Water systems from September 1993 through the sale in December 1997. Since that subsidy is built into the rates of the other Florida Water systems, the shareholders of Florida Water currently subsidize and will continue to subsidize other Florida Water systems from the sale date of December 1997 until the Company files another general rate case to readjust rates.

Q. WOULD A DECLARATION BY THIS COMMISSION THAT UTILITY CUSTOMERS ARE AUTHORIZED TO SHARE IN THE GAIN ON THE SALE OF THE SYSTEM OR HAVE OWNERSHIP RIGHTS IN UTILITY ASSETS ADVERSELY AFFECT A UTILITY'S FINANCIAL VIABILITY?

A. It very well could. I will address the issue of promoting utility viability and capacity development later in my testimony. I will say that in my time as Executive Vice President of the Bank of North Carolina, one of my responsibilities included the bank's lending program. I also worked with Shearson Lehman Brothers, Inc. on the financing of water and wastewater infrastructure projects during my tenure as Director of Research for the Governor of North Carolina. A very basic and important part of the review of a lender's application is to insure that the assets being pledged are free and clear of encumbrances and truly reflect the value shown on the financial statement. In the case of a water or wastewater utility, a Commission policy that puts a cloud over a utility's ownership of its assets or its right to retain a gain on the sale of a system that includes those assets and the customers who provide the revenues for that system would create questions and risks for a

lender regarding the ownership and value of utility assets. The more uncertainty associated with these issues - - the higher the interest rates.

Q. DID THE COMMISSION HAVE A SECOND OCCASION TO CONSIDER THE APPROPRIATE AND LAWFUL RATEMAKING TREATMENT FOR THE GAIN ON THE SALE OF THE ST. AUGUSTINE SHORES SYSTEMS?

A. Yes, it did. In a rate case filed by Florida Water's predecessor entity, Southern States Utilities, Inc., in 1992, the issue of the appropriate ratemaking treatment for the gain on the sale of the St. Augustine Shores systems was again raised before the Commission. Once again, the Commission concluded that the gain on the sale of the St. Augustine Shores systems should be retained by the shareholders of the Florida Water. The Commission reaffirmed and expanded on its rationale in the Lehigh rate case by concluding:

> We agree with Mr. Sandbulte that customers who did not reside in the SAS service area did not contribute to recovery of any return on investment on the SAS system. Further, when this system was acquired by St. Johns County, SSU's investment in the SAS system and its future contributions to profit were forever lost. Thus, the gain on the sale serves to compensate the utility's shareholders for the loss of future earnings. Arguably, if the sale of this system had been accompanied by a loss, any suggestion that the loss be absorbed by the remaining SSU customers would be met with great opposition. However, the rationale for sharing a loss is basically the same as the rationale for sharing a gain. Since SSU's remaining customers never subsidize the investment in the SAS system, they are no more entitled to share in the gain from that sale than they would be required to absorb a loss from its.

Order No. PSC-93-0423-FOF-WS issued in Docket No. 920199-WS, at pages 58-59.

Q. DO THE PRINCIPLES ARTICULATED BY THE COMMISSION IN THE FINAL ORDER IN FLORIDA WATER'S 1992 RATE CASE APPLY TO THE SALE OF THE ORANGE COUNTY SYSTEMS?

A. Yes, they do. The Commission once again emphasized that the remaining customers of Florida Water did not contribute to the recovery of any return on investment in the systems that were sold. This principle holds true for the sale of the Orange County systems. The Commission also emphasized that upon the sale of the St. Augustine Shores systems, the company's future revenue streams from the St. Augustine Shores customers and contributions to profits were forever lost. That factual determination also applies here with the sale of the Orange County systems.

Q. DID THE OFFICE OF PUBLIC COUNSEL CHALLENGE THE COMMISSION'S DECISION CONCERNING THE GAIN ON THE SALE OF THE ST. AUGUSTINE SHORES SYSTEMS IN THE 1992?

A. Yes. On reconsideration, the Office of Public Counsel argued that customers should share in the gain on the sale of the St. Augustine Shores systems on the ground that Florida Water's predecessor, Southern States, had sold its Skyline Hills system in Lake County at a loss and that the order in the Southern States' Lake County rate case, Order No. 17168 issued in February 1987, had taken the loss into account in establishing rates for the remaining systems. The Commission rejected OPC's argument due to the lack of an evidentiary record as the Skyline Hills case was a proposed agency action order. See, Order No. PSC-93-1598-FOF-WS issued in Docket No. 920199-WS, at pages 18-19. Ultimately, OPC appealed the gain on sale issue to the First District Court of Appeal and the First District affirmed the

Commission's conclusion that Florida Water retain the gain in sale of the St. Augustine Shores systems. Citrus County v. Southern States Utilities, 656 So.2d 1307 (Fla. 1st DCA 1995).

Q. DID THAT END THE SAGA OF THE ST. AUGUSTINE SHORES SYSTEMS?

A. No. The appropriate ratemaking treatment for the gain on the sale of these systems was raised once again in Florida Water's 1995 rate case. In the 1995 rate case, the Commission considered the appropriate regulatory treatment for Florida Water's gain on sale of the St. Augustine Shores systems as well as the Venice Garden Utilities systems which had been sold to Sarasota County. The Commission remained consistent, citing its decision in its final order in the 1995 rate case for its conclusion that the gains on the sales of the Venice Gardens and St. Augustine Shores systems should be retained in full by the shareholders of Florida Water's parent company, Minnesota Power & Light Company. The Commission again rejected OPC's argument that the Skyline Hills order dictated a conclusion that Florida Water's customers should share in the gain on the sales of these systems. See Order No. PSC-96-1320-FOF-WS issued in Docket No. 950495-WS, at page 200.

Q. DID THE COMMISSION MAKE ANY OTHER STATEMENTS IN ITS FINAL ORDER IN FLORIDA WATER'S 1995 RATE CASE WHICH SHOULD BE ADDRESSED IN THIS PROCEEDING?

A. Yes. In the final order in the 1995 rate case, the Commission noted that "the situation would be different" had the St. Augustine Shores or Venice Gardens been regulated by the Commission at the time of the sale or previously included in a uniform rate structure. In the case of the Orange County

systems, these systems were under the regulation of the Commission at the time of the sale and I am told by Florida Water were part of a uniform rate structure from approximately September 1993 through January 1996 - - a little over two years out of the ten to twenty years that these systems were owned and operated by Florida Water or its predecessor entity, Southern States.

Q. DO THESE FACTS JUSTIFY A DEPARTURE FROM THIS COMMISSION'S CONSISTENT PRECEDENTS AND POLICY THAT A UTILITY RETAIN IN FULL THE GAIN ON SALE OF A UTILITY SYSTEM ?

A. No, they do not. The fact that this Commission regulated these systems at the time of sale and that they were subject to a uniform rate structure for a relatively short period of time during Florida Water's (or predecessors') ownership and operation has no bearing on the principles articulated by this Commission for determining the appropriate and lawful regulatory treatment of the gain on the sale of a system. Notwithstanding the Commission's jurisdiction over these systems and their inclusion in a uniform rate structure for a little over two years, the legal principle remains intact that customers acquire no proprietary or ownership interest in utility property and that only the utility bears the risk of loss or benefits from the gain on its investment in and the sale of a utility system. The Commission's rationale that the sale of a system results in the permanent loss of the utility customers and their stream of revenues applies without regard to the particular rate structure or regulatory body. Finally, the rationale previously and appropriately employed by the Commission concerning whether the remaining customers

contributed to the recovery of the utility's investment in the systems that were sold applies without regard to a particular rate structure or the governing regulatory authority. In this case, the facts are that the remaining customers of Florida Water did not contribute to Florida Water's recovery of its investment in the Orange County systems. Simply put, whether the Orange County systems were regulated by the Commission, a county or hypothetically by any state agency or a local government has no bearing on the legal and regulatory principles which have been historically utilized by this Commission to support a determination that a gain or loss on the sale of a water or wastewater system resides with the utility shareholders and not its customers. The only potential impact that a rate structure, uniform or otherwise could have on the Commission's analysis is whether that rate structure, uniform or otherwise, resulted in rates for the sold systems that did not recover their cost of service. As previously explained, that is not the case with the Orange County systems as these systems, on a net basis, had rates in effect which more than recovered Florida Water's cost of service for these systems.

Q. DID FLORIDA WATER REASONABLY RELY ON THE PRIOR FLORIDA PUBLIC SERVICE COMMISSION ORDERS THAT YOU HAVE DISCUSSED IN NEGOTIATING THE SALE OF ITS ORANGE COUNTY SYSTEMS?

A. I believe so. As I will explain later in my testimony, in my experience as a regulator in North Carolina, I found that utility companies rely on and react to a utility commission's gain on sale policy in negotiating the purchase price for its systems. Here, Florida Water was aware only of the fact that it had

litigated the sale of its St. Augustine Shores systems three times, including an appeal, and the sale of its Venice Garden system one time, and under pertinent facts similar to those involved in the sale of the Orange County systems, this Commission had determined that Florida Water should retain in full the gains on these sales. Without notice of a prior Commission decision or policy to the contrary, I believe Florida Water had every right in negotiating the sale of the Orange County systems to rely on the Commission decisions that I have discussed for the proposition that it would be entitled to retain in full the $4.2 million gain on sale. Otherwise, based on my experience in North Carolina, Florida Water would have been in a position of either having to negotiate a higher sales price to account for some partial sharing of a gain or perhaps, in doing so, the sale would not have been consummated.

II. DECISIONS OF THE NORTH CAROLINA UTILITIES COMMISSION

Q. ARE YOU FAMILIAR WITH DECISIONS OF THE NORTH CAROLINA UTILITIES COMMISSION CONCERNING THE GAINS ON SALES OF SYSTEMS OVER THE LAST DECADE?

A. Yes, I am.

Q. CAN YOU GIVE US SOME BACKGROUND ON THESE DECISIONS?

A. Yes, I served on the North Carolina Commission where some controversial decisions were made and lessons were learned.

Q. CAN YOU EXPLAIN?

A. Yes. In 1990, the North Carolina Utilities Commission split the gain on the proposed sale of four systems owned by Carolina Water Service, Inc. on a

50/50 basis between the utility shareholders and utility customers. A copy of that Order is attached to my testimony as Exhibit __ (CHH-2). The four systems or subdivisions involved were known as the Beatties Ford/Hyde Park East, Genoa, Raintree and Riverbend systems. All were proposed to be sold by Carolina Water to a governmental utility. The events that occurred after the establishment of the 1990 policy showed that such a policy was indeed contrary to the public interest, either drove up the sales price or served as a disincentive to sale, and thereby discouraged and impeded the beneficial sale of water systems.

Q. WHAT EVENTS TRANSPIRED AFTER THE NORTH CAROLINA COMMISSION'S 1990 DECISION SPLITTING THE GAIN ON SALE ON A 50/50 BASIS?

A. After the Commission ordered a 50/50 split of the gains on sale, Carolina Water renegotiated the sales price of the Beatties Ford/Hyde Park East system, increasing the price by approximately $100,000. The result was the renegotiated price caused the taxpayers and ratepayers to spend more for the acquisition. In the case of another Carolina Water system, the Farmwood "B" system, the contract between the selling and buying parties contained a provision wherein the purchase price would escalate in proportion to any gain flowing to the remaining customers. In addition, Carolina Water ultimately chose not to sell the Riverbend subdivision as a result of the North Carolina Commission's decision to split the gain.

Q. WHAT WERE THE CONSEQUENCES OF THE NORTH CAROLINA COMMISSION'S 1990 DECISION?

A. The North Carolina Commission's decision to split the gain on a 50/50 basis turned out to be contrary to the public interest. The policy served to either drive up the sales price of a system to the detriment of the acquiring system's ratepayers or to ultimately result in the abandonment of the sale. The policy provided incentives for inefficiencies by incenting a selling utility to form a separate corporation for a particular system prior to a proposed sale to effect a full liquidation. The marginal benefit of a small refund to the customer was truly outweighed by the harmful consequences of a gain splitting policy. In this case, as a utility commissioner, I gained a real understanding that the Commission should not impose economic barriers or regulatory impediments to the orderly purchase and transfer of private water and wastewater systems.

Q. DID THE NORTH CAROLINA COMMISSION SUBSEQUENTLY REVERSE ITS 50/50 GAIN SPLITTING POLICY?

A. Yes, it did. Based on the events that transpired after our initial decision, in September 1994, the North Carolina Commission reversed its previous gain on sale policy and authorized the stockholder of Carolina Water to retain 100% of the gain on sale of the Farmwood "B" and Chesney Glen subdivisions to the City of Charlotte. A copy of the September 1994 Order is attached to my testimony as Exhibit _ (CHH-3).

Q. DOES THE NORTH CAROLINA UTILITIES COMMISSION CONTINUE TO ADHERE TO A POLICY THAT UTILITY SHAREHOLDERS RETAIN IN FULL THE GAIN ON THE SALE OF A WATER OR WASTEWATER SYSTEM?

A. Yes. The most recent decision of which I am aware involved the sale by Carolina Water Service of three water systems to the City of Charlotte. The

North Carolina Commission order that 100% of the gain on sale of these water utility systems shall be assigned to Carolina Water Services' stockholder. The order was issued on March 29, 1986 and is attached to my testimony as Exhibit _ (CHH-4).

III. 1996 AMENDMENTS TO SAFE DRINKING WATER ACT

Q. WHILE YOU SERVED AS CHAIRMAN AND A MEMBER OF THE NARUC WATER COMMITTEE, DID YOU WORK WITH ANY SPECIFIC ISSUES THAT IN YOUR OPINION CHANGED THE WATER INDUSTRY AND CONTINUES TO CHANGE REGULATORY POLICY?

A. Yes, the federal law reflected in the 1996 amendments to the Safe Drinking Water Act ("SDWA").

Q. HOW ARE THE 1996 AMENDMENTS TO THE SDWA RELEVANT TO THIS CASE?

A. One of the primary purposes of the 1996 federal SDWA is to promote viability and capacity development in the water industry to insure that drinking water systems acquire and maintain adequate, technical, managerial and financial capabilities to enable them to consistently provide safe drinking water. I understand that the Commission staff has been studying this issue over the last couple of years in connection with the Commission's acquisition adjustment policy. The 1996 amendments to the SDWA contain federal capacity development requirements and states must meet those requirements to receive their full allotment of federal-state revolving loan funding. The federal law provisions concerning capacity development and state revolving loan funds are found in Title 42 United States Code Section 300G-9 and

300J-12, respectively. The Florida Legislature has implemented these provisions of the federal SDWA by its enactment of Section 403.8615, Florida Statutes, which addresses capacity development for new water systems and authorizes Florida's Department of Environmental Protection ("DEP") to adopt rules to implement capacity development which the DEP has done and Section 403.8532, Florida Statutes, which establishes a drinking water state revolving loan fund "to assist public drinking water systems in achieving and maintaining compliance with the Florida Safe Drinking Water Act and the federal Safe Drinking Water Act, as amended, and to conserve and protect the quality of waters of the state." I would note that Section 403.8615(2), Florida Statutes, prohibits the DEP from issuing permits for the construction or operation of a public water supply system which seeks to commence operations after October 1, 1999 unless that system can demonstrate technical, managerial and financial capability.

Q. ARE REGULATORY DECISIONS THAT PROMOTE CAPACITY DEVELOPMENT AND FINANCIAL VIABILITY CONSISTENT WITH THE 1996 AMENDMENTS TO THE SWDA?

A. Yes. The water industry as a whole continues to experience ever increasing capital requirements. These capital requirements are not only a result of aging infrastructures, but also increasing regulatory pressure to comply with the 1996 amendments to the SWDA. The essence of the SWDA is about serving higher quality, safer drinking water to the consuming public. It is therefore imperative that sound regulatory policies be maintained so that the private utilities regulated by this Commission are able to sustain the

necessary technical, managerial and financial capability to provide reasonably priced and environmentally compliant safe drinking water.

Q. HOW DO THE VIABILITY AND CAPACITY DEVELOPMENT GOALS OF CONGRESS AND THE FLORIDA LEGISLATURE IMPACT THE GAIN ON SALE ISSUE IN THIS CASE?

A. A continuation of this Commission's policy that utility shareholders retain in full the gain on the sale of a system is essential to water and wastewater utility viability and allows utilities such as Florida Water to strengthen and expand their technical and managerial expertise and operations and continue on the path of expanded, regionalized provision of water and wastewater services. The water and wastewater industry continues to be a rising cost industry with many factors driving up costs. Regulatory policies that promote utility viability will benefit water and wastewater customers of Florida Water and throughout the state by striving to insure the provision of safe drinking water, environmentally compliant wastewater service and the potential for delivering reclaimed water at reasonably priced rates. Where, as here, Florida Water essentially sells a business, the retention in full of the gain realized on that sale and the reinvestment of those monies into utility operations is integral to the promotion of utility viability and capacity development as envisioned by the 1996 amendments to the SDWA and the implementation of viability and capacity development programs in Florida by the Legislature and DEP.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

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EMPLOYMENT HISTORY

Areas of Expertise	Government Regulator, Governmental Lobbying, Research and Analysis, General Policy Formulation and Analysis, Strategic Planning, Organizational/Administrative Skills, Inter-personal Relations, Lawmaking, Law Research, Marketing, Consumer Finance and Consumer Services, General Management, Collection Management, Banking, Lending, Crisis Management, Governmental Affairs, Sales Construction, Macro/Micro Budget Analysis, Computer Operations.
10/97-Present	OWNER, HUGHES CONSULTING COMPANY Hughes Consulting specializes in comprehensive consulting for the electric, natural gas, telecommunications and the water, wastewater industries with major emphasis in the water and wastewater related industry. The company also offers services in the governmental and regulatory areas, as well as contract services, market research and economic analysis, critical issues management, efficiency evaluation, governmental lobbying and relations and franchise negotiations, public policy and business management review.
4/89 – 9/97	COMMISSIONER, NORTH CAROLINA UTILITIES COMMISSION Appointed by Governor James G. Martin as one of seven Commissioners responsible for regulation of all public utilities in North Carolina under the Commission's jurisdiction as interpreted in Chapter 62 of the General Statues of North Carolina.

1/85-3/89 DIRECTOR OF RESEARCH, OFFICE OF THE GOVERNOR, STATE OF NORTH CAROLINA

Ensured uniform implementation of Governor's policies throughout State Government, generated policy documents, coordinated a centralized information service to pertinent agencies and executive and legislative personnel, advised the Governor on legislative and other matters, analyzed research data for Governor and Executive Staff, handled sensitive/confidential matters as Governor assigned, tracked legislation for the Governor and his designees, analyzed special issues, tracked public opinion, carried out special projects for the Governor, and lobbied Legislators on special legislation.

11/84-1/85 TRANSITION LIAISON, OFFICE OF THE GOVERNOR, STATE OF NORTH CAROLINA.

Acted as Transition Liaison in the areas of budget and policies. Designed Governor-elect's agenda and legislative programs.

9/83-11/84 RESEARCH DIRECTOR, JIM MARTIN FOR GOVERNOR CAMPAIGN

Directed research; prepared and analyzed press conferences, debates, raw data, and media-related information; reviewed various publications, etc. Responsible for researching, producing, and editing position papers and speeches. Developed Tax Proposal and Economic Forecasts for States revenues. Generated innovative ideas for program implementations.

11/80-11/84 REPRESENTATIVE TO THE NORTH CAROLINA GENERAL ASSEMBLY

Minority Whip. Specific areas of involvement and committee assignments: Aging; Appropriations Expansion Budget; Appropriations Expansion Budget Committee on Justice and Public Safety; Appropriations Budget; Appropriations Base Budget Committee on Justice and Public Safety, Banks and Thrift Institutions, Courts and Judicial Districts, Economy, Small Business, Transportation, Insurance and Wildlife, commercial Fishing, Courts and Administration of Justice, Governmental Ethics, Higher Education, Law Enforcement, and Wildlife Resources.

Co-organized and led a weekly prayer breakfast for the General Assembly members (1981-1983).

7/82-9/83 SELF-EMPLOYED, SALES AND MARKETING

1/79-6/82	OWNER, HUGHES BUILDING CORPORATION, HENDERSONVILLE, NORTH CAROLINA
	Specialized in commercial construction.
11/76-1/79	SALES MANAGER, COOPER CONSTRUCTION COMPANY, HENDERSONVILLE, NORTH CAROLINA
	Responsible for marketing, sales, contracts, and estimating of pre-engineered metal buildings.
2/1-11/76	EXECUTIVE VICE PRESIDENT AND CITY MANAGER, BANK OF NORTH CAROLINA, HENDERSONVILLE, NORTH CAROLINA.
	Responsible for management, marketing, lending, and bank operations.
8/66-2/71	BRANCH MANAGER, G.A.C. FINANCE CORPORATION, JACKSONVILLE, NORTH CAROLINA.
	Responsible for branch management, marketing, lending, collections and operations.
7/63-8/66	MANAGEMENT TRAINEE, SEARS AND ROEBUCK COMPANY, RALEIGH, NORTH CAROLINA

EDUCATION

1965-68	GREENSBORO COLLEGE
	SCHOOL OF BANKING, UNIVERSITY OF NORTH CAROLINA
	UNIVERSITY OF NEVADA, NATIONAL JUDICIAL COLLEGE

FORMER AND PRESENT ACTIVITIES

Chairman, National Association of Regulatory Utility Commissioners Water Committee. NARUC's Representative, Public Advisory Forum to the Officers and Directors of the American Water Works Association. Member, Public Council on Water Supply Research of the American Water Works Association Research Foundation. NARUC's Representative, Federal Advisory Committee on Drinking Water Disinfection By-Products Rulemaking of the U.S. Environmental Protection Agency. Faculty Advisor, National Judicial College at the University of Nevada. Exchange Council 1981-1986. Hendersonville Jaycees President, 1976-1977 and Chairman of the Board, 1977-1978. Former Scoutmaster. Salvation Army Boy Scout Troop. Secretary of the Bank Administration Institute. W.N.C. chapter, 1975. Award for Leadership, Hendersonville Job Service. Helped organize and establish the Woodmen of the World Chapter, Hendersonville, North Carolina.

SPECIAL AWARDS

1989- Order of the Long Leaf Pine- Highest Recognition the State of North Carolina Bestows for Distinguished Service to the State by Governor James G. Martin.

1988- State Award for Making North Carolina a "Quality of Life State", Concerned Charlotteans of North Carolina.

1987- National Commander's Award for "Distinguished Service to the Nation's Veterans and Their Families', Disabled American Veterans.

1997- Order of the Long Leaf Pine – Highest Recognition the State of North Carolina Bestows for Distinguished Service to the State by Governor James B. Hunt, Jr.

SPECIAL INTERESTS

Music, Fishing, and Hunting

CHURCH HOME

New River Community Church, Sneads Ferry, North Carolina. Worship and Praise Leader.

PERSONAL

Married for 35 years to Mary Suzanne Kirkman; Two children: Angela Hughes Teague and Russell Hughes
Six grandchildren: Blaine, Chase, Charleston, Shelby, Hannah, and Corey

REFERENCES

Available upon request

STATE OF NORTH CAROLINA
UTILITIES COMMISSION
RALEIGH

Docket No. 980744-WS
Exhibit __ (CHH-2)

DOCKET NO. W-354, SUB 82
DOCKET NO. W-354, SUB 86
DOCKET NO. W-354, SUB 87
DOCKET NO. W-354, SUB 88

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

In the Matter of

Application by Carolina Water Service, Inc. of North Carolina, 2335 Sanders Road, Northbrook, Illinois 60062, for Authority to Transfer the Water and Sewer Utility Franchise Serving Beatties Ford Park and Hyde Park East Subdivisions in Mecklenburg County to the Charlotte Mecklenburg Utility District (Owner Exempt From Regulation)

Application by Carolina Water Service, Inc. of North Carolina, 2335 Sanders Road, Northbrook, Illinois 60062, for Authority to Transfer the Water Utility Franchise to Provide Water Utility Service in Robin Lakes, Foxfire, South Haven, Rollingwood, Lakewood, Southern Plaza, and Rita Pines Subdivisions in Wayne County, North Carolina, to the Southeastern Wayne Sanitary District (Owner Exempt From Regulation)

Application by Carolina Water Service, Inc. of North Carolina, 2335 Sanders Road, Northbrook, Illinois 60062, for Authority to Transfer the Water Utility Franchise to Provide Water Utility Service in Raintree, Hickory Hills, and Bellwood Subdivisions in Wayne County, North Carolina, to the Eastern Wayne Sanitary District (Owner Exempt From Regulation)

Application by Carolina Water Service, Inc. of North Carolina, 2335 Sanders Road, Northbrook, Illinois 60062, for Authority to Transfer the Water and Sewer Utility Franchise to Provide Water Utility Service in Riverbend Subdivision, in Craven County, North Carolina, to the City of New Bern (Owner Exempt From Regulation)

ORDER DETERMINING REGULATORY TREATMENT OF GAIN ON SALE OF FACILITIES

HEARD IN: Commission Hearing Room 2115, Dobbs Building, 430 North Salisbury Street, Raleigh, North Carolina, on July 18-19, 1990

BEFORE: Commissioner Ruth E. Cook, presiding, Chariman William W. Redman, Commissioners Sarah Lindsay Tate, Robert O. Wells, Julius A. Wright, Charles H. Hughes, and Laurence A. Cobb

APPEARANCES:

For the Applicant:

Edward S. Finley, Jr., Hunton & Williams, Post Office Box 109, Raleigh, North Carolina 27602

For Heater Utilities, Inc., and the Carolina's Chapter of the National Association of Water Companies:

Robert F. Page, Crisp, Davis, Schwentker, Page & Currin, Post Office Drawer 30489, Raleigh, North Carolina 27622

For the City of Charlotte:

H. Michael Boyd, Deputy City Attorney, City of Charlotte, 600 East 4th Street, Charlotte, North Carolina 28202

For the Using and Consuming Public:

David T. Drooz and Robert B. Cauthen, Jr., Staff Attorneys, Public Staff - North Carolina Utilities Commission, Post Office Box 29520, Raleigh, North Carolina 27626-0520

Lorinzo L. Joyner, Assistant Attorney General, North Carolina Department of Justice, Post Office Box 629, Raleigh, North Carolina 27602

BY THE COMMISSION: This matter was initiated by the filing of an application by Carolina Water Service, Inc. of North Carolina (Carolina Water Service, CWS, Company or Applicant) on April 10, 1990, to relinquish its certificate and for the approval of regulatory treatment in the matter of the application by CWS for authority to transfer the water and sewer utility franchise serving the Beatties Ford Park and Hyde Park East (Beatties Ford) subdivisions in Mecklenburg County to the Charlotte Mecklenburg Utility District (CMUD) (owner exempt from regulation). CWS requested that the Commission address the issue of regulatory treatment of the gain on the sale of CWS's facilities used to provide service to the Beatties Ford area. On May 3, 1990, the Commission issued an Order approving the transfer of ownership of the water and sewer utility serving Beatties Ford to CMUD. The Commission also ordered that the issue of who shall retain the gain on the sale be deferred until the next general rate case of CWS or until CWS provides the Commission with additional financial information and requests a hearing on this issue.

On May 17, 1990, the Applicant requested a hearing as referred to in the Commission's May 3, 1990, Order. In anticipation of such hearing, CWS requested the Commission to issue a schedule that set forth dates upon which testimony from the Applicant and other parties might be due. On May 23, 1990, the Commission issued an Order which set a hearing to address the issue of who

shall retain the gain on the sale of the Beatties Ford system. The Order also required the filing of testimony and other information in support of the Company's position in this matter.

On May 24, 1990, CWS filed an application to relinquish certificate and to seek approval of regulatory treatment for the sale of the Genoa, Raintree, and Riverbend systems to Wayne County sanitary districts and the City of New Bern (owners exempt from regulation), respectively.

On June 5, 1990, a letter from New Bern City Manager Walter B. Hartman was received expressing the City's support for the Riverbend transfer. The letter was placed in the official file.

The Orders approving the transfers and setting a hearing on regulatory treatment of the gains on the sale of the three systems discussed in the previous paragraph were issued on June 7, 1990. The City of Charlotte petitioned the Commission for leave to intervene in the above-captioned matter so that the City could fully participate in the proceedings before the Commission.

In accordance with the Commission's May 23, 1990, Order requiring the filing of testimony, Mr. Patrick O'Brien of CWS filed testimony on June 15, 1990.

In response to the petition filed by the City of Charlotte, the Commission issued an Order on June 26, 1990, which stated that the petition filed by the City of Charlotte for leave to intervene in the above-captioned matter was hereby granted.

On June 29, 1990, the Public Staff filed the testimony and exhibits of William E. Carter, Jr., Director of the Accounting Division. Testimony and exhibits of Earl L. Lineberger, Jr., on behalf of the City of Charlotte, were also filed on June 29, 1990. A petition for leave to intervene and a motion to accept prefiled testimony of William E. Grantmyre and Jerry Tweed, on behalf of Heater Utilities, Inc., and the Carolinas Chapter of the National Association of Water Companies were also filed, respectively.

A notice of intervention related to the above-captioned matter was filed by the Attorney General's office on July 6, 1990.

The Public Staff filed a motion on July 9, 1990, requesting that the Commission adopt certain procedures to be adhered to during the hearing of the above-captioned dockets.

On July 11, 1990, the Commission issued an Order allowing in these dockets the June 29, 1990, petitions for leave to intervene and motion to accept the prefiled testimony of Jerry Tweed on behalf of the Carolina Chapter of the National Association of Water Companies.

On July 11, 1990, the Commission also issued an Order allowing in these dockets the June 29, 1990, petition for leave to intervene and motion to accept

the prefiled testimony of William E. Grantmyre on behalf of Heater Utilities, Inc.

A Public Hearing was held on July 18-19, 1990, as scheduled by the Commission. Mr. William P. Cunningham, State Representative, testified on behalf of the citizens located in Beatties Ford.

CWS presented the testimony and exhibits of Patrick J. O'Brien, Vice President and Treasurer of CWS.

The City of Charlotte presented the testimony of Earl L. Lineberger, Jr., Chief Engineer for CMUD.

Heater Utilities, Inc., presented the testimony of William E. Grantmyre, President and House Counsel for Heater Utilities, Inc.

On behalf of the Carolinas Chapter of the National Association of Water Companies, Jerry Tweed, Vice-President, presented testimony.

The Public Staff presented the testimony and exhibits of William E. Carter, Director of the Accounting Division.

Based upon the foregoing, the evidence adduced at the hearing, and the entire record in this matter, the Commission makes the following:

FINDINGS OF FACT

1. Both CWS's stockholder and the ratepayers of CWS share in the risks associated with the utility property used and useful to provide water and sewer service to the ratepayers.

2. The City of Charlotte has annexed the Beatties Ford (Trinity Park) and Hyde Park East subdivisions in Mecklenburg County. CWS presently provides water and sewer service to the Beatties Ford subdivision and sewer service to Hyde Park East subdivision. The City of Charlotte is obligated by law to provide water and sewer service to these annexed subdivisions. If the Charlotte Mecklenburg Utility District ("CMUD") is unable to acquire the water distribution and sewer collection systems of CWS in these subdivisions, CMUD will contract for the installation of a basic water and sewer system within these subdivisions, as required by law. The total of the minimum expenses which a CWS customer would be required to pay for CMUD water/sewer service is $3,606. The total estimated costs of installing water and sewer systems in the subject subdivisions which would permit all of CWS's customers to be CMUD customers, plus the costs of connecting the residences to the parallel CMUD system, are as follows:

Total Water	$ 603,050
Total Sewer	$1,829,000
Total Water and Sewer	$2,432,050

3. CMUD and CWS have reached a tentative agreement whereby CMUD will pay $850,000 for the water distribution and sewer collection systems of CWS in the subject subdivisions.

4. If CMUD acquires the subject water and sewer systems of CWS, the customers on the systems will pay substantially lower water and sewer rates, will receive fire protection, and will enjoy generally enhanced water service.

5. Sale of the other CWS systems at issue in this proceeding (Genoa, Raintree, and Riverbend) will result in advantages to the customers in these systems. For example, the acquiring governmental entities are exempt from taxes (including taxes on contributions in aid of construction) and have lower cost of capital, significant economies of scale, fire protection, and generally enhanced water service.

EVIDENCE FOR FINDINGS OF FACT NOS. 1-5

Whether CWS's remaining ratepayers or its shareholders should keep any gains on the potential sales of property used in regulated utility operations is the issue that was addressed by witnesses testifying for parties at the hearing which began on July 18, 1990. The evidence for this finding is found in the testimony and exhibits of Company witness O'Brien, witness Lineberger for the City of Charlotte, witness Grantmyre for Heater Utilities, Inc., witness Tweed for the Carolinas Chapter of the National Association of Water Companies, and witness Carter for the Public Staff.

Company witness O'Brien testified that the shareholders of the utility, who own the divested facilities, should incur the entire economic impact of either a gain or a loss on the disposition of a system, including the water and sewer systems at issue in this proceeding. Witness O'Brien further testified that the private investment utility customers, who do not own the facilities nor bear the associated economic risks, should not participate in any gains, nor should they be burdened by a divestment loss.

Public Staff witness Carter disagreed with witness O'Brien. Witness Carter testified that the fact that CWS has title to the property that may be sold is not sufficient reason that shareholders should incur the entire economic impact of either a gain or a loss on the disposition of a system. He further testified that the party who assumes the risk of loss on the property is the party who should have the right to a gain on the sale of that property.

Witnesses O'Brien and Carter both agreed that whichever party assumed the economic risks associated with the property should be the party who receives any gain resulting from the sale of the property; however, they did not agree on which party, CWS's stockholder or its remaining ratepayers, has borne the economic risks associated with the property. It is witness O'Brien's testimony that CWS's stockholder is the party that has assumed the risk associated with the property that may be sold. It is witness Carter's testimony that CWS's remaining ratepayers have assumed the risks associated with the property.

Witness O'Brien testified that CWS's stockholder assumes the economic risk of the replacement of utility property at a cost greater than the cost of the original property that must be replaced. Witness O'Brien testified that, in an original cost jurisdiction, the risk of inflation for the replacement of depreciated property is placed on the utility investor; therefore, it would clearly be unfair to award the inflationary gains realized upon the sale of such assets to a utility's customers who were insulated from this risk.

Witness O'Brien also testified that stockholders provide the capital for investment in utility plant and bear the risks associated with that investment. Witness O'Brien emphasized that a situation similar to Love Canal could occur wherein all the customers pack up and move. He asserted that if this were to happen, there would be no recapture of the stockholder's capital costs related to abandoned systems. The failure to earn the rate of return allowed by the Commission is another risk that is assumed by the stockholders, according to witness O'Brien.

Witness O'Brien further testified that CWS faces the risk that a competitive entity, such as a municipal or quasi-municipal provider, will parallel its lines. Also, according to witness O'Brien, CWS faces the prospect of failing to recover the costs of acquiring systems and making needed improvements and operating them until CWS's next general rate case. CWS, as testified to by witness O'Brien, must start to depreciate the cost of acquired systems at the time of acquisitions and the depreciation and carrying costs incurred between acquisition and inclusion of the plant in rate base is never recovered.

Witness O'Brien cited a risk that the Commission may refuse to include the full purchase price in rate base on the theory that part of the system acquired constitutes excess capacity even though most systems are constructed to serve many more customers that the number connected in early years. CWS's investor realized this risk in the form of actual disallowances in its last general rate case, Docket No. W-354, Sub 81.

Public Staff witness Carter testified that as a general rule, risks associated with investment in utility systems fall on a utility's ratepayers. He further testified that customers are required to pay for repairing plant that has been damaged through no fault of the utility. He noted several instances in which this has been true. For example, witness Carter discussed the recent damage inflicted upon Carolina Water Service's system, as well as other utility systems, by Hurricane Hugo. According to witness Carter, CWS requested that its customers pay for the costs associated with repairing the damaged water systems caused by Hurricane Hugo. Witness Carter emphasized the fact that the costs of the damage inflicted by Hurricane Hugo are being absorbed by the Company's ratepayers.

Witness Carter discussed other instances in which utility customers bear risks associated with utility plant. He stated that one such instance is through the payment of expenditures incurred in drilling non-productive wells. He testified that when non roductive wells are drilled, the costs of those wells are added to the cost of productive wells and are included in rate base and depreciated over the lives of the productive wells. During cross-examination witness O'Brien agreed that the Company has actually passed the costs for losses such as storm damages, non-productive wells, and plant retirements to its ratepayers.

Witness Carter gave other examples of risks that have been assumed by a utility's ratepayers. One example given by witness Carter was that electric utility ratepayers have been required to assume the costs associated with unexpected outages of electric generating plants. He testified that ratepayers have been required to pay the higher costs of the replacement power that is

generated through the utility's less efficient generating plants, or higher cost power that is purchased from other utilities when a utility's generating plant is forced out of service through no imprudent action on the part of the utility's management. Also, witness Carter emphasized that ratepayers are required to pay costs of repairing the plants that are not covered by insurance. He also noted that ratepayers are required to pay depreciation expense, operating and maintenance expenses, taxes, and a return on newly-capitalized plant as part of getting the damaged plants back into service. Witness Carter mentioned other examples of risks associated with electric generating plants that have been assumed by an electric utility's ratepayers including fires, explosions, expenditures necessary to meet retroactive Nuclear Regulatory Commission design requirements, and the premature failure of major components of generating plants.

Witness Carter also cited instances where ratepayers of telephone companies have assumed risks associated with telephone plant. He testified that ratepayers of telephone utilities have assumed the risks of technological obsolescence. He stated that in recent years digital central office equipment has replaced other central office equipment that has become obsolete before the end of its estimated useful life, and that some telephone companies have requested that the obsolete equipment that was replaced be recognized as an extraordinary loss and amortized to cost of service over a number of years. Witness Carter further testified that other telephone companies have requested that deficiencies in the accumulated depreciation account which resulted from technological obsolescence be amortized over a number of years. Witness Carter stated that, in both of these instances, it has been the utilities' ratepayers, not their stockholders, that have assumed the risks and borne the costs associated with the premature obsolescence of telephone equipment.

Witness Carter testified that since ratepayers do in fact bear risks associated with utility property, they should also be entitled to any gain when utility property is later sold.

A difference of opinion exists between the witnesses as to whether the existence of uniform rates is a fact that should be considered in determining whether a utility's stockholders or its ratepayers should receive the benefit of any gain on the sale of utility property. Company witness O'Brien testified that the existence of uniform rates should not have any effect on whether the stockholders or ratepayers should get the benefit of any gain or loss on the sale of public utility property. He stated that uniform rates are approved on the basis of being just, reasonable and non-discriminatory, and that there is a presumption that all customers pay the appropriate price for service and for the facilities that serve them. He further testified that there is no relationship between the rate structure and the accounting for a gain or loss on the sale of a facility, and that the payment of rates, uniform or otherwise, does not give rise to the acquisition of rights, title, or interest in utility property.

Public Staff witness Carter disagreed with witness O'Brien on this subject. Witness Carter testified that the existence of uniform rates is a critical fact that should be considered in determining whether a utility's ratepayers or its stockholders should be assigned the gain or loss on the disposition of a utility system. Witness Carter further testified that under

uniform rates all customers are charged the same rates for utility service even though the cost of providing service to each customer, or even each subdivision, is not the same, nor is the quality of service provided to each customer or subdivision the same. Witness Carter emphasized that under uniform rates there is a pooling of risks and costs among the customers of all systems. He further testified that since there is a sharing of risks among the customers of all systems, a gain on the sale of any of the systems should be given to the remaining customers of the utility.

Counsel for CWS pointed out to witness Carter that at the time of the hearing the Genoa system had only been included in the uniform rate structure of CWS for approximately one month. Witness Carter replied that CWS made the decision not to include the Genoa system in its 1988 rate case, Docket No. W-354, Sub 69. He stated that this system had been owned by the Company for approximately six months at the time of the 1988 rate case. Witness Carter also pointed out that in its last general rate case, Docket No. W-354, Sub 81, CWS included systems in rate base that had been owned less than six months; therefore, the Company could have chosen to include the Genoa system in Docket No. W-354, Sub 69.

Company witness O'Brien emphasized that CWS has not earned the rate of return allowed by the Commission during the years 1980 through 1989. Witness O'Brien testified that the Commission should consider this fact to be a reason that CWS's stockholder should receive the benefit of any gains resulting from the sale of utility systems or facilities. Public Staff witness Carter testified that whether CWS earns a return greater than or less than the return found fair by the Commission should not influence whether CWS's stockholder should retain the gains on the sales of the systems. Witness Carter said that this Commission does not guarantee that CWS will in fact earn the rate of return found fair by the Commission. He emphasized that CWS is given the opportunity to earn the rate of return found fair by the Commission but is not guaranteed that it will do so. Witness Carter explained that one of the reasons that CWS has not earned the rate of return found fair by the Commission is its acquisitions of many new systems during this time period. Witness Carter further testified that CWS's management probably knew that the Company's earnings would suffer in the short term as a result of its large expansion program. He stated that this was a fact known by CWS's management before it began its large expansion program. He testified that this was a known risk that CWS's management assumed and the fact that CWS did not earn the rate of return found fair by the Commission is not a reason that the benefits of any gain on the sale of utility property should be given to CWS's stockholder. Witness Carter testified that CWS's existing customers have probably paid higher rates as a result of CWS purchasing under-capitalized water and sewer companies in various states of disrepair and making the necessary expenditures to repair and upgrade the facilities in order to provide quality service. He testified that since existing customers have probably paid higher rates as a result of CWS's expansion program, that is a very good reason that CWS's remaining ratepayers should receive the benefit of a gain on the sale of these systems.

Both Company witness O'Brien and Public Staff witness Carter testified that if each of the affected systems were sold to a city or sanitary district the customers on the systems being sold would receive many benefits. The two

witnesses did not agree, however, on whether CWS would benefit from the sales of the affected systems. Witness O'Brien testified that generally divestments limit both CWS's current and future opportunity to maximize long-term returns to its shareholders through customer growth. He stated that divestments also minimize opportunities to reduce overhead costs and create both transfer costs and morale problems when displaced personnel must be relocated. Downsizing the customer base and associated operating personnel additionally impedes the development of organizational depth and backup support. Moreover, divestment typically requires the removal of facilities resulting in substantial abandonment costs.

Witness O'Brien further testified that in its twenty-five year history only six systems of the approximately 250 that have been owned by Utilities, Inc., have ever been sold. He also stated that in the twenty years in which CWS has operated in North Carolina, not one of its approximately 90 subdivisions served has been sold.

Witness Grantmyre testified that Heater Utilities, Inc., has sold two of its systems to municipalities at gains, and that the gains were accounted for below-the-line. Witness Grantmyre also testified that two of its systems had been paralleled, and another system would soon be paralleled. Witness Grantmyre testified that all losses associated with the paralleling of its systems have been borne by the stockholders.

Witness O'Brien did testify that on rare occasions there are times when municipal acquisition of one of CWS's systems is both sensible and desirable. One specific example cited by witness O'Brien where the sale of a system or facility may be in CWS's best interests is the ability of a municipal provider to parallel CWS's facilities. He stated that unnecessary duplication of investment in comparable facilities does not benefit the utility, the municipality, or the customers, and that in such instances, a sale, even at a loss may be preferable. He further testified that in such an instance the loss would be borne by the shareholders.

Public Staff witness Carter testified that there are additional reasons why the sale of these systems would be beneficial to CWS. He gave the following reasons, other than the probability that the Beatties Ford facilities would be paralleled, that the sale of these systems would be advantageous to CWS, even if the entire gain on the sale is given to CWS's remaining ratepayers:

(1) CWS can avoid potential expenditures for dechlorination facilities and tertiary filters in Beatties Ford.

(2) In selling the Genoa and Raintree systems, CWS has the opportunity to sell two systems on which, according to witness O'Brien, CWS has not earned a reasonable return since it purchased them.

(3) CWS can avoid significant future capital expenditures for both water and sewer facilities in the Riverbend subdivision in order to comply with increasing environmental standards.

(4) CWS will no longer have to assume the capital expansion costs of the required new sewage treatment plant in the Riverbend subdivision at a cost of $500,000.

(5) CWS will have additional capital from the sales of all of the affected systems. Even if the gains are ultimately given to CWS's remaining ratepayers, CWS will have the money now to invest in additional plant or otherwise spend as management deems appropriate.

Witness Tweed testified that if all of the gain on the sale of a water system is flowed back to customers, the water company would have no incentive to sell the system.

Both witness O'Brien and witness Carter agreed that in a complete liquidation of the assets of a water or sewer company, the stockholders should receive the entire gain or loss on the liquidation, since there would be no remaining customers who could receive the gain or absorb the loss. Witness Carter testified, however, that under a partial liquidation there are remaining customers who can receive the benefit of a gain or absorb the loss.

Witness O'Brien testified that under a partial liquidation the Company is undergoing a complete liquidation of a system and a partial liquidation of the Company. He testified that CWS is selling complete independent systems and transferring the customers to another utility capable of meeting their needs. Witness O'Brien further testified that each system is independent in that it is totally self-sufficient, and that the mains, backbone plant and appurtenances of each system serve that system only and no other. He contrasted the sale of a complete independent system and the loss of its customers to the selling of excess plant by an electric utility which involves no loss of customers. He testified that gains on those two sales situations should be treated differently for ratemaking purposes. Witness Carter agreed that in CWS's situation there will be a loss of customers if the systems are sold, whereas there was no loss of customers when electric utilities sell excess plant; however, he testified that he did not believe the gains on the sale should be treated differently for ratemaking purposes. He testified that in both instances the ratepayers should be given the benefit of the gains on the sales. While CWS's systems are physically independent, they are not financially self-sufficient because the uniform rate structure results in customers of all CWS's systems being responsible for the risks and costs of each CWS system.

Witness Carter was asked a series of hypothetical cross-examination questions concerning partial liquidations. Witness Carter testified that the facts, circumstances, dollar amounts, and number of customers on the systems being liquidated all must be examined and a decision made based on all these facts. He stated that a decision on which party should receive the benefits of a gain or absorb a loss must be made on a case by case basis, based on the facts in each case.

Witness Tweed also testified that the Commission should weigh each case based upon its own merit. Witness Tweed added that in some cases investors pay more for a utility system than is allowed in rate base; therefore, they have an investment on which they are not receiving a return. He stated that if the Commission continues to disallow a return on excess investment, and also takes

the gain on sale from the stockholders, this would discourage investors with regard to future investment.

Public Staff witness Carter testified that if a utility could prove that the price it paid for a water or sewer system was reasonable, even though it was more than the system's original cost, then the gain should be calculated on the difference between the sales price and the total purchase price less accumulated depreciation. In other words, the gain would be reduced by the amount of any acquisition adjustment that was not included in rate base.

Witnesses Tweed and Grantmyre offered additional reasons why giving the remaining ratepayers any gains from the sales of water or sewer systems would not be a good policy. Some of the reasons they offered are as follows:

(1) If all the gain is flowed back to customers, the water company will have no incentive to sell the system to a city.

(2) If part of the gain is flowed back to the customers, the water company would likely increase its sales price to a city to compensate for the amount flowed back to the customers.

(3) Such a Commission policy would terminate or at least dramatically reduce the number of systems sold to cities.

(4) Cities will lose by having to pay a higher purchase price or undergo expensive construction costs in duplicating the facilities which they can not purchase.

(5) The customers being acquired by a city will lose by either not being served by the city or by receiving service at higher rates than would have been possible if the city's cost of acquiring the system were lower.

(6) Investors will lose interest in acquiring additional systems in North Carolina and will invest their money in other states.

(7) This policy would encourage utilities to form separate corporations for each system.

(8) Such a policy would encourage cities to parallel existing facilities. This would result in competition for customers and increased operating expenses to serve an area.

(9) Bankers would be even more reluctant to loan money to water companies.

(10) Such a policy may hinder the process of larger water and sewer companies acquiring the smaller ones.

Public Staff witness Carter offered rebuttal to the above arguments by witnesses Tweed and Grantmyre. Witness Carter testified that if the Commission establishes a policy that gains on the sales of utility property should be given to the utility's remaining ratepayers, that policy should not have any

effect on negotiations between a water or sewer company and a city. He stated that the water or sewer company would continue to try to get the highest price on the sale of a system to a city, and the city would continue to try to purchase the system at the lowest possible price. Witness Carter emphasized that it would continue to be to a city's advantage to purchase a water or sewer system from a utility if the facilities were in good condition and could be purchased from a utility for less money than the city would have to spend to parallel the facilities. He further testified that, in his opinion, if a city initially offered an extremely low price for a system at the beginning of the negotiations, it would abandon that position as negotiations progressed, and the two parties would probably end at the same negotiated price as they would have reached absent a policy of giving gains on the sales of water or sewer systems to a utility's remaining ratepayers. Witness Carter also testified that, in his opinion, if a water or sewer company initially tried to increase its sales price to reflect the fact that the gain on the sale would be given to its remaining customers, the two parties would again probably reach the same negotiated sales price they would have reached absent the Commission policy of giving the remaining ratepayers the benefit of the gains on the sales of utility property.

Witness Carter testified that he did not believe that if the Commission established the policy of giving the gains on the sales of utility property to a utility's remaining ratepayers it would affect the decisions of investors to purchase additional water and sewer companies in North Carolina. Witness Carter emphasized that the most important factor to an investor is the regulatory climate in North Carolina as far as the opportunity to earn a reasonable return on his investment. Witness Carter conceded that keeping the gain on a sale may be in the back of an investor's mind, but the most important consideration to an investor is where his money can earn the most favorable return on an ongoing utility business. Witness Carter added that both witness O'Brien and witness Grantmyre stated that they do not buy systems with the intent of selling them. Witness Carter testified that in CWS's most recent rate case, Docket No. W-354, Sub 81, the Commission granted CWS a 13.45% return on equity. Witness Carter stated that an investor would be more interested in investing in a State that allows a 13.45% return on equity on its utility operations, but does not allow the investor to keep the gains on sales of utility systems, than he would be in investing in a State that permits him to keep the gain on sales of utility systems but only grants the company the opportunity to earn a 12% return on equity on its utility operations. Witness Carter emphasized the fact that these are the first systems to be sold by CWS, and that sales of utility systems do not occur very frequently. Witness Carter also testified that he did not believe that a water utility would form a separate corporation for each system if the Commission determines that gains on the sales of utility systems should be given to the utility's remaining ratepayers. He stated that this would be expensive and would not be a wise management decision. He did state that a water or sewer utility may set up separate corporations for groups of systems with similar operating costs and characteristics. He further testified that he thought that it would be reasonable for a water or sewer company to take such action.

Public Staff witness Carter testified that if CWS failed to sell the Beatties Ford facilities to CMUD, it would indicate imprudence on the part of the Company's management. Witness Carter gave several reasons for his

testimony. He stated that the Company's refusal to sell to CMUD would result in the Beatties Ford facilities being paralleled by CMUD. If this happens, CWS will lose customers to CMUD and not receive any money from CMUD. He further stated that this would likely cause an increase in CWS's rates following its next general rate case. Witness Carter further explained that CMUD would have to spend more money to parallel the Beatties Ford facilities than it would pay to CWS to acquire the facilities. Other reasons, according to witness Carter, included CWS not acting in the best interests of its customers by causing customers who switch to CMUD to have to pay a tap fee for water and sewer service. If CWS sells to CMUD, the Beatties Ford customers will not be required to pay a tap fee to CMUD. Witness Carter explained that if the customers who connect to the CMUD system have to pay an unnecessary tap fee these customers will be financially damaged by CWS's decision. In addition, witness Carter testified that if CWS does not sell the Beatties Ford facilities to CMUD, the remaining customers will also suffer financially because there will be fewer customers to cover the costs of operating the Beatties Ford facilities. Another factor discussed by witness Carter is that if the Company does not sell to CMUD, its decision will cause CMUD to incur unnecessary expenses. He emphasized that these problems would arise without a corresponding benefit to CWS.

Witness Lineberger, Chief Engineer with CMUD, presented testimony related to fees that customers will have to pay to the City of Charlotte if the Beatties Ford facilities are not sold by CWS to CMUD. According to witness Lineberger, the failure to sell the facilities to CMUD will result in the paralleling of the Beatties Ford facilities by CMUD. If this were to happen, customers who want to connect to the City's system will have to pay both the tapping privilege and connection fees. The required fees for a typical water and sewer resident are $994 and $2,012, respectively. Based on witness Lineberger's testimony, additional expenses must be incurred for the plumbing service needed to connect to the City's system.

Witness Lineberger also discussed the total estimated cost of installing a water distribution and sewage collection system required by annexation. He stated that the cost related to providing the basic systems, plus the cost of extending additional water and sewer mains necessary to parallel CWS's facilities in Beatties Ford/Hyde Park East, along with the cost of connecting the current customers, would be at least $2,432,050, excluding tapping privilege fees. This cost would be shared by the City and the customers.

Witness Carter testified that if CWS refuses to sell the Beatties Ford facilities it would not be acting in the best interests of its stockholders. He stated that if CWS unnecessarily imposes extra costs on its former customers, remaining customers, and CMUD, this would be not in the best interests of its stockholders. He emphasized that CWS's management should strive to avoid actions which unnecessarily harm the clear public interest. Moreover, noted witness Carter, if the gain is passed on to the remaining ratepayers, CWS's stockholder will not be harmed since CWS will not have lost any of its investment. Witness Carter pointed out that witness O'Brien testified that unnecessary duplication of investment in comparable facilities does not benefit the utility, the municipality, or the customers, and that in such instances a sale, even at a loss, may be preferable.

Public Staff witness Carter was cross-examined concerning his testimony which stated that if CWS sells the Beatties Ford facilities to CMUD and passes the gain to the remaining ratepayers, CWS's stockholder will not be harmed and will not have lost any of its investment. Counsel for CWS asserted that witness Carter has ignored any expectation that the investor has for future revenues and profitability from operating the Beatties Ford system. He asked witness Carter if he wasn't failing to recognize the consequences that would flow to CWS's stockholder from a shrinkage of the Company's business. Witness Carter's response to this assertion was that there will be some shrinkage of business even if CWS does not sell the Beatties Ford facilities to CMUD because some customers will leave CWS and connect to the CMUD system. He continued by saying if that happens there will be less remaining customers to absorb the fixed costs associated with the Beatties Ford system, but if the Beatties Ford facilities are sold, that problem will not develop. Moreover, CWS can reinvest its proceeds (equal to net original cost) from the systems being sold and therefore acquire new systems or new ventures to replace what has been sold.

Witness Carter testified that he was also of the opinion that CWS's failure to sell the Genoa, Raintree and Riverbend systems would indicate imprudence on the part of CWS's management. He stated that the sale of the Genoa and Raintree systems will benefit existing customers of those systems. He further testified that the sale of the Riverbend system will benefit both CWS and its remaining customers by eliminating future capital expenditures for a required new sewer treatment plant at a cost of $500,000, and by eliminating expenditures necessary to comply with increasing environmental standards.

Public Staff witness Carter testified that if CWS does not sell the Beatties Ford facilities to CMUD, the Commission, in CWS's next general rate case, could impose a rate of return penalty on CWS for its imprudent management decision. In addition, witness Carter stated that if CWS does not sell the Beatties Ford facilities to CMUD and CMUD parallels the Beatties Ford facilities, resulting in a loss of customers from CWS to CMUD, the Commission could exclude a portion of the Beatties Ford facilities from rate base. In addition, he stated that operation and maintenance expenses, depreciation expense, and taxes related to the property disallowed from rate base, could be excluded from determining the cost of service in CWS's next general rate case. Witness Carter recommended that the Commission take either or both of these actions in CWS's next general rate case if CWS does not sell the Beatties Ford facilities to CMUD. He also recommended that the Commission consider imposing a rate of return penalty on CWS in its next general rate case for its imprudent management decision if it does not sell the Genoa, Raintree, and Riverbend systems.

Witness Carter made a specific recommendation that the gains on the sales of any of the affected systems should be given to CWS's remaining ratepayers; however, he did not make a specific recommendation in this proceeding on the method the Commission should use to give the benefit of gains on the sales of the affected systems to the remaining ratepayers. He testified that there are two ratemaking methods available to give CWS's remaining ratepayers the benefit of the gains on the sales of these systems. One method is to amortize the net-of-tax gains to operations over a specific time period and to deduct the unamortized balance from rate base. Another method is to treat the net-of-tax gains as cost-free capital and deduct it from rate base. Under the second

method, none of the gain would be amortized to operations. Witness Carter testified that the amortization method has the advantage of reducing expenses over the amortization period, which would result in lower rates than would otherwise be granted to CWS during the amortization period. He stated that the advantage of deducting the entire net-of-tax gain from the rate base is that it results in lower rates for the ratepayers over the long term. The net-of-tax gain would be deducted from rate base in every rate case. An advantage of this method for CWS is that the funds represented by the net-of-tax gains are retained in the business and can be used to make upgrades and improvements to the water systems instead of being returned to CWS's remaining customers through lower rates than would otherwise be granted to CWS during the amortization period.

Witness Carter's specific recommendation in this proceeding is that the net-of-tax gains on the sales of these systems be recorded in a deferred account until the appropriate ratemaking method of giving the benefits of the gains to CWS's remaining customers is determined in CWS's next general rate case. He stated that this would give all parties in CWS's next rate case proceeding an opportunity to address the appropriate method of returning the benefits of the gains to CWS's remaining ratepayers. He also recommended that CWS file reports with the Commission and Public Staff concerning the calculations of each gain and workpapers supporting the calculations. In addition, he recommended that the Commission require CWS to file journal entries related to the gains, including the removal of the plant and associated accounts from the CWS's books and records.

Witness Carter testified that in recent years the general policy of this Commission has been to give the gains on the sales or transfers of utility plant to the utilities' ratepayers. Some of the cases presented by witness Carter that have received such treatment are listed on Carter Exhibit II. They include Duke Power Company, Docket No. E-7, Subs 338 and 408; Carolina Power & Light Company, Docket No. E-2, Sub 461; Piedmont Natural Gas Company, Docket No. G-9, Sub 212; Virginia Electric and Power Company, Docket No. E-22, Sub 273; and all independent telephone companies excluding Southern Bell and General Telephone Company of the South, Docket No. P-100, Sub 81.

CONCLUSIONS

1. The transfer of the water and sewer systems herein to the governmental entities will result in substantial advantages to the customers of these systems and should be encouraged by the Commission.

2. Carolina Water Service, Inc. of North Carolina and its remaining customers should equally share in the benefits of gains resulting from the sale of CWS's facilities used to provide utility service in the Beatties Ford/Hyde Park East, Genoa, Raintree, and Riverbend subdivisions.

The Commission determines that the transfers of each of the water and sewer systems at issue in this proceeding is in the best interest of their customers and should be approved. The Commission has issued orders approving the transfers and deferring the regulatory treatment of the gain on each of the sales. The Commission in this proceeding has been presented evidence

concerning which party should receive the benefit of the gains on the sales of these systems.

After weighing all of the evidence the Commission concludes that the appropriate ratemaking treatment is that CWS and its remaining customers should share equally in the benefit of any gains resulting from the sales of facilities used to provide utility service in the Beatties Ford/Hyde Park East, Genoa, Raintree, and Riverbend subdivisions. The Commission emphasizes that CWS's remaining ratepayers will receive an equal portion of the benefit of only the amount of sales proceeds left after CWS's stockholders have recovered their investment and all reasonable transaction costs associated with the transfers.

Witnesses for both CWS and the Public Staff testified that the party that assumes the risks associated with utility property is the party that should receive the benefit of any gain or absorb any loss on the sale of property that has been used to provide utility service. The parties to these proceedings have identified numerous risks associated with the public utility property which is the subject of transfer. Testimony has been presented asserting which party does in fact assume such risks, and the Commission recognizes that the ultimate decision regarding which party bears such risks is a matter of judgement based upon the evidence presented. The Commission, after careful weighing of the evidence presented, is not persuaded that the entire risks associated with the utility property is assumed by either CWS or its ratepayers. The Commission concludes that CWS and its ratepayers share in the risks associated with the property that has been used to provide public utility service.

Furthermore, the Commission believes that factors other than a determination as to who bears the risks should be and have been given appropriate consideration in reaching a determination in this matter. The parties appearing in these proceedings agree that the customers on the systems being transferred would receive many benefits after being acquired by the city or sanitary districts. The Commission, as a matter of policy, recognizes the inherent advantages often associated with municipal and sanitary district service and in fact has actively sought municipal and county a quisition of troubled water and sewer systems under our jurisdiction. See, for example, Carolina Water Service, Inc. of North Carolina - Rate Increase Proceeding, Docket No. W-354, Subs 69 and 81 (Commission directed the company to negotiate the purchase of water in bulk from, or sale of troubled water systems to, the Asheville-Buncombe Water Authority). See also Cowan Valley Water System - Jackson County, Docket No. W-829, Sub 3 (Commission actively sought county bulk water service to a regulated water system under emergency operatorship). In reaching its decision in this matter, the Commission has given weight to the premise that if the stockholders are deprived of all of the gains on a potential sale of a system to a municipality, or similar entity, such a policy would remove any incentive to sell the system, thereby often depriving the customers of such system many benefits associated with municipal acquisition.

G.S. 62-2(1) and (3) declare it to be the policy of the State "[t]o provide fair regulation of public utilities in the interest of the public" and "[t]o promote adequate, reliable and economical utility service to all of the citizens and residents of the State." (emphasis added.) The Commission is of the opinion that the transfers herein meet these policy goals and should be encouraged.

The principle adopted herein--that whoever assumes the risks associated with utility property should receive the gain--has been recognized by this Commission in previous dockets and by commissions and courts in other jurisdictions, both state and federal. Many of these decisions are collected and discussed in the brief of the Public Staff. An examination of these decisions disclose that the gain on sale has been allocated to the stockholders or to the ratepayers, or to both, depending upon the evidence before the various commissions and courts. The Commission has determined in this proceeding, based upon all the evidence presented to it, that the gain on sale of the subject water and sewer systems should be equally allocated to the CWS shareholder and the remaining ratepayers of CWS.

The Commission further concludes that CWS should record 50% of the amount of the net-of-tax gains on the sales of these systems in a deferred account to be returned to its remaining customers following the Company's next general rate case. The Commission will decide in CWS's next general rate case proceeding the appropriate manner to give CWS's remaining ratepayers their portion of the benefit of the net-of-tax gains.

CWS is required to file reports with the Commission and the Public Staff providing the calculations of each gain and workpapers supporting the calculations. Journal entries related to the plant, including the removal of plant and associated accounts from the Company's books and records, are also required to be filed by CWS in a manner consistent with the decision herein.

IT IS, THEREFORE, ORDERED as follows:

1. That 50% of the gains on the sales of Beatties Ford/Hyde Park East, Genoa, Raintree, and Riverbend systems should be assigned to CWS's remaining ratepayers in a manner to be determined in CWS's next general rate case and that 50% of said gain should be assigned to CWS's shareholder(s).

2. That CWS shall give written notification to the Commission after the sale and transfer of each system has been completed.

3. That CWS record 50% of the net-of-tax gains in a deferred account until the Commission decides the manner in which the benefit of the gains should be returned to CWS's remaining ratepayers.

4. That CWS file reports with the Commission and Public Staff concerning the calculations of each gain and the workpapers supporting the calculations. Any party disagreeing with the calculations of each gain may contest the amount of gain in CWS's next general rate case.

5. That CWS file journal entries related to gains, including the removal of the plant and associated accounts from CWS's books and records in a manner consistent with the provisions of this Order.

ISSUED BY ORDER OF THE COMMISSION

This the 16th day of October 1990.

NORTH CAROLINA UTILITIES COMMISSION

(SEAL)

Sandra J. Webster, Chief Clerk

Commissioner Tate dissents.

Docket No. 980744-WS
Exhibit __ (CHH-3)

STATE OF NORTH CAROLINA
UTILITIES COMMISSION
RALEIGH

DOCKET NO. W-354, SUB 133
DOCKET NO. W-354, SUB 134

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

DOCKET NO. W-354, SUB 133

In the Matter of
Application by Carolina Water Service, Inc. of North Carolina, 2335 Sanders Road, Northbrook, Illinois 60062, for Authority to Transfer the Assets Serving the Farmwood "B" Subdivision in Mecklenburg County to the City of Charlotte (Owner Exempt from Regulation) and to Transfer Assets

DOCKET NO. W-354, SUB 134

In the Matter of
Application of Carolina Water Service, Inc. of North Carolina, 2335 Sanders Road, Northbrook, Illinois 60062, for Authority to Transfer the Assets Serving the Chesney Glen Subdivision in Mecklenburg County to the City of Charlotte (Owner Exempt from Regulation) and to Transfer Assets

ORDER DETERMINING REGULATORY TREATMENT OF GAIN ON SALE OF FACILITIES

HEARD IN: Commission Hearing Room 2115, Dobbs Building, 430 North Salisbury Street, Raleigh, North Carolina, on Tuesday, June 7, 1994, at 9:30 a.m.

BEFORE: Commissioner Ralph A. Hunt, Presiding; and Commissioners William W. Redman, Jr., Laurence A. Cobb, Allyson K. Duncan, and Judy Hunt

APPEARANCES:

For Carolina Water Service, Inc. of North Carolina:

Edward S. Finley, Jr., Hunton & Williams, Attorneys at Law, Post Office Box 109, Raleigh, North Carolina 27602

For the Public Staff:

Paul L. Lassiter, Staff Attorney, Public Staff - North Carolina Utilities Commission, Post Office Box 29520, Raleigh, North Carolina 27626-0520
For: The Using and Consuming Public

BY THE COMMISSION: On November 18, 1993, Carolina Water Service, Inc. of North Carolina (CWS or Company) filed an application in Docket No. W-354, Sub 133, seeking authority to relinquish its certificate of public convenience and necessity to provide water utility service to a section of the Farmwood Subdivision in Mecklenburg County, North Carolina. In its application, CWS asserted that the area in question, Farmwood "B", represents only a portion of the entire Farmwood water system and that CWS will continue to provide service to the other portions of Farmwood Subdivision. CWS requested authority to transfer the Farmwood "B" assets to the Charlotte-Mecklenburg Utility Department (CMUD) and for CWS's stockholders to retain 100% of the gain on this sale.

On February 16, 1994, CWS filed an application in Docket No. W-354, Sub 134, seeking authority to relinquish its certificate of public convenience and necessity to provide water utility service to the Chesney Glen Subdivision in Mecklenburg County, North Carolina. CWS requested authority to transfer the Chesney Glen assets to CMUD and for CWS's stockholders to retain 100% of the gain on this sale.

By Order issued April 11, 1994, the Chairman consolidated these matters for hearing on June 7, 1994, in Raleigh. Upon call of the matters for hearing at the appointed time and place, both CWS and the Public Staff were present and represented by counsel. CWS presented the testimony of Carl Daniel, its Vice President, in support of the Company's applications. The Public Staff presented the testimony of Kenneth E. Rudder, Utilities Engineer, and Katherine A. Fernald, Supervisor of the Water Section of the Public Staff Accounting Division.

On June 27, 1994, CWS filed letters requesting that the Commission enter an immediate Order in these consolidated dockets approving the transfers in question while deferring a ruling on the gain on sale issue to a later date, said ruling to be made by further Order. On June 28, 1994, the Public Staff filed a response stating that it did not object to severing the issue of regulatory treatment of the gain on sale of utility assets from the actual transfers of the property in question.

On July 6, 1994, the Commission issued an Order approving the transfer of the water utility systems serving the Farmwood "B" and Chesney Glen subdivisions in Mecklenburg County from CWS to CMUD. The Commission's Order provided that the Commission would rule on the gain on sale issue by further Order in these consolidated dockets.

Based on the foregoing, the evidence adduced at the hearing, the entire record in this matter, the Commission now makes the following

FINDINGS OF FACT

1. The sales of Farmwood "B" and Chesney Glen by CWS are sales of portions of systems as both Farmwood "B" and Chesney Glen are parts of larger systems owned and operated by CWS.

2. Sales to municipal systems and sanitary districts result in advantages to the consumers of transferred systems through generally lower rates,

fire protection, better water quality, more storage, better production facilities, and more economies of scale.

3. By Order entered in Docket Nos. W-354, Subs 82, 86, 87, and 88, on October 16, 1990, the Commission concluded that CWS and its remaining customers should equally share in the benefits of gains resulting from the sale of the Company's facilities used to provide utility service in the Beatties Ford/Hyde Park East, Genoa, Raintree, and Riverbend Subdivisions. By Order entered in Docket Nos. W-354, Subs 71 and 72, on May 21, 1993, involving applications filed by Heater Utilities, Inc., the Commission reaffirmed that gain on sale policy.

4. Events occurring since the Commission initially established its gain splitting policy in 1990 indicate that such policy, contrary to the public interest, serves as a disincentive to sell and may thereby discourage and impede beneficial sales to municipal and other government-owned entities.

EVIDENCE AND CONCLUSIONS FOR FINDINGS OF FACT NOS. 1 - 4

The evidence supporting these findings of fact is found in the applications and the testimony of Company witness Daniel and Public Staff witnesses Rudder and Fernald.

CWS witness Daniel testified that only a portion of the Farmwood system is being transferred to CMUD. The section of Farmwood being transferred is Farmwood "B" which contains 175 customers. CWS acquired the Farmwood System along with 20 other systems as part of the purchase of the assets of Waterco in 1980. CWS proposes transferring two wells, including associated pumping equipment, and one 10,000 gallon storage tank to CMUD as part of the Farmwood "B" transfer.

Witness Daniel further testified that Chesney Glen is a residential subdivision in Mecklenburg County, southeast of the City of Charlotte, with 27 customers. Like Farmwood "B", Chesney Glen represents only a portion of a larger subdivision called Courtney. In fact, Chesney Glen was constructed as Phase III of Courtney. There are no wells or storage tanks located within Chesney Glen.

By Order entered in Docket Nos. W-354, Subs 82, 86, 87, and 88, on October 16, 1990, the Commission concluded that CWS and its remaining customers should equally share in the benefits of gains resulting from the sale of the Company's facilities used to provide utility service in the Beatties Ford/Hyde Park East, Genoa, Raintree, and Riverbend Subdivisions. By Order entered in Docket Nos. W-354, Subs 71 and 72, on May 21, 1993, involving applications filed by Heater Utilities, Inc. (Heater), the Commission reaffirmed the above-referenced gain on sale policy.

The issue now to be resolved by the Commission in these consolidated dockets is whether or not the Commission's policy of splitting gains continues to be in the public interest. The Public Staff takes the position that the Commission has addressed the issue of who should receive the gain on sale in past dockets and has decided to split the gain. The Public Staff further argues that CWS has offered no new evidence in this docket appreciably different from what was offered in past dockets and, therefore, the Commission should adhere to the position it adopted in the past.

CWS provided evidence that shows that action has been taken in response to the Commission's decision in past dockets to split the gain that is harmful to the public interest and that such developments exemplify why the Commission's gain splitting policy can be detrimental and should be revised. CWS states further that through written statements in the past Orders, upon which the Public Staff relies, certain members of the Commission have questioned the wisdom and appropriateness of the past decisions to equally split gains. Through these written statements, those Commissioners have suggested that the issue should be revisited and that the ramifications to the public good of the decisions to split the gains should be taken into account. Based on those statements, CWS argues that the Public Staff's reliance on the past holdings equally splitting gains is inappropriate and not in the public interest.

With the benefit of hindsight, the Commission can now see that the policy to split the gains or losses on sales of water and/or sewer systems has had a negative impact on the public good. For example, the proposed sale of the Beatties Ford system from CWS to CMUD in 1990 was renegotiated after this Commission ruled to split the gain. That resulted in the Charlotte-Mecklenburg taxpayers and ratepayers spending more on the acquisition of the Beatties Ford system than they would have spent if this Commission's ruling had been to flow the gain to stockholders only. Furthermore, the Farmwood "B" contract between CWS and CMUD contains a provision wherein the price to CMUD escalates in proportion to the portion of any gain that is flowed to CWS's remaining customers. In addition, all involved parties know that CWS chose not to sell its Riverbend utility system as a result of the Commission's ruling in Docket No. W-354, Sub 88.

These facts, consequences of the Commission's decisions in the prior CWS and Heater dockets, suggest that the Commission's gain splitting policy is contrary to the public interest. A policy of gain splitting for sales of water and/or sewer systems may undermine the achievement of economies of scale and encourage inefficient operations. That result is clearly not in the public interest. Moreover, with respect to Beatties Ford, the sales price for Beatties Ford, paid from public funds, was artificially increased. The sales price for Genoa was reduced to the detriment of CWS. The beneficial sale of Riverbend to New Bern fell through. None of those harmful consequences would have taken place but for the Commission's decision to split the gain. On balance, the marginal benefit to remaining ratepayers of the gain splitting policy is outweighed by the harmful consequences of such policy.

The gain splitting policy must also be examined within the context of the impact of the policy on the process through which the ownership of private water and sewer systems customarily changes hands. Under the most common pattern, the private system is installed by a developer with no interest or ability to operate and maintain the system over the long term. Companies like CWS, with capital and operational expertise and with the long-term desire to operate the systems, acquire them from developers or small operators. Over time, as municipal development and expansion take place, opportunities often arise through which a municipality or governmental system takes over from the private utility operator. At each step, the customer benefits from the transfer of ownership. Water quality may improve, and the potential exists for lower rates. That being the case, the Commission should not impose economic barriers to the orderly transfer

of water systems to municipal entities, as was inadvertently done in the Riverbend situation.

If economic incentives are removed so that this succession of ownership becomes inadvisable, customers are denied those benefits. If companies like CWS are prevented from retaining the gain on sale in North Carolina, a substantial incentive is removed for those companies to buy systems from developers or small, undercapitalized operators in the first instance. Likewise, a substantial incentive is removed to negotiate to sell systems to municipal or governmental entities. At a minimum, the sale price is artificially increased above the fair market based price to adjust for the payment of part of the gain to customers. The result is harm to consumers because the natural progression of transfer of ownership to the most efficient provider is disrupted. These harmful consequences are clearly not in the public interest.

The Public Staff takes the position that the gain splitting policy will not hinder the beneficial transfer of ownership of systems. CWS, an actual participant in the transactions in question, asserts to the contrary. After further review, the Commission now agrees with CWS on this issue and concludes that the current gain splitting policy, as it pertains to transfer of water and sewer systems, should be changed in order to remove a significant disincentive to transfer to municipal and other government-owned entities.

The detrimental effect of the Commission's gain splitting policy as it pertains to the sale of water and/or sewer systems is reflected in the transactions at issue in this case. The purchase price for the Farmwood "B" system increases by $58,000 if the Commission requires CWS to split 50% of the gain with the remaining shareholders. This is an added taxpayer expense that is inconsistent with the public interest. It appears that this provision would not have been included in the CWS-CMUD contract except in response to the Commission's gain splitting policy.

Furthermore, Burnette Utilities recently sold two of its systems in Mecklenburg County to CMUD. Under the Commission's current policy, the utility is permitted to retain 100% of the gain where there is a complete as opposed to a partial liquidation. Burnette sold its remaining system to a former employee so that there was a complete liquidation, and Burnette therefore retained 100% of the gain. Structuring the transaction in that fashion poses risks to the customers of the system sold to the former employee. The Commission finds it difficult to conclude that the Commission's gain splitting policy had no effect on the way that Burnette structured the transaction.

The Public Staff relies upon the Commission's decisions to split the gain with respect to sales by CWS of the Beatties Ford, Genoa, and Riverbend systems in Docket Nos. 354, Subs 82, 86, 87, and 88, and the sales by Heater of the Country Acres and Pinewood systems in Docket Nos. W-354, Subs 71 and 72. Careful examination of the language from the two Orders in those cases, however, indicates that the Public Staff's reliance upon them as precedent is less than compelling. The Commission's October 16, 1990, Order in Docket Nos. W-354, Subs 82, 86, 87, and 88 was not unanimous. The Commission's May 21, 1993, Order

in Docket Nos. W-274, Subs 71 and 72, indicated even less consensus on the part of the Commission in addressing the gain on sale issue.

Of the seven commissioners hearing the Heater case, only three sponsored the majority opinion. Two of those commissioners, Robert O. Wells and Julius A. Wright, are no longer members of the Commission. Even so, the majority opinion contains the following statement of policy:

> As noted earlier, the Commission recognizes the benefits to customers upon the transfer of systems to municipal operators or sanitary districts. It is the Commission's intent to continue to encourage such transfers where feasible and, accordingly, the Commission will continue to monitor the policy adopted herein with regard to any adverse consequences that such policy may have upon the future transfer of systems to municipal operators.

Commissioners Tate and Duncan concurred in the majority opinion in the Heater case. Nevertheless, their concurrence stated:

> However, the Commission has an overriding responsibility to set public policy that is in the public interest. There is evidence in this case that our decision in the C.W.S. cases, Docket No. W-354, Subs 82, 86, 87 and 88 has discouraged sales from private water companies to cities. There is also evidence that planned sales have not taken place or that the sales price has been increased due to our decision. It is also alleged that water companies are forming separate corporations to circumvent the requirement to split the gains. In my view, none of these results are in the public interest of North Carolina. If additional proof is offered that our decision has prevented sales, the Commission should reverse the C.W.S. Order and conclude that good public policy is more important than an accounting practice.

Commissioner Hughes dissented in the Heater case. Commissioner Hughes stated in his dissent:

> Encouragement to sell systems arises or is enhanced when companies are allowed the opportunity to retain 100 percent of the gain realized on such sales. I believe that such encouragement reflects good public policy, since the quality and price of water and sewer services, generally speaking, tend to be much more favorable when provided by a governmental agency.
>
> . . .
>
> By denying the Company the opportunity to retain 100 percent of a gain from the sale of a system(s), the Commission is continuing a policy that can only serve to discourage the future sale of water and sewer systems to municipalities and to county-wide systems operated by governmental agencies. Such undesirable results are clearly evidenced by the record in this proceeding. Discouragement of such sales is a policy or practice to be shunned and not

embraced. For the foregoing reasons, I dissent from the Majority's instant decision.

Commissioner Cobb concurred in the result of the Heater opinion. In his concurrence, Commissioner Cobb stated:

> I agree with the decision not to change our rulings with respect to gain and loss from the sale of water systems at the present time. I agree with Commissioner Tate that our decisions appear to have discouraged sales from private water companies to public utilities to the detriment of the public interest. However, great confusion could result if the Commission as presently composed were to change the rule only to have it changed again after three new Commissioners are installed in a few months. I would hope that the "new" Commission would revisit this question in the near future. I am prepared to do so.

Far from constituting binding legal precedent in support of the Public Staff's position, the two cases upon which the Public Staff relies primarily indicate that the majority of the Commission, when it last addressed the issue, found the current policy contrary to the public interest. If anything, those decisions suggest that the Commission's views on this issue have evolved and that the Commission no longer supports the wisdom of the gain splitting policy. Therefore, the Commission rejects the Public Staff's reliance upon the prior CWS and Heater decisions for purposes of these consolidated dockets and hereby announces that in future proceedings, the Commission will follow a policy, absent overwhelming and compelling evidence to the contrary, of assigning 100% of the gain or loss on the sale of water and/or sewer utility systems to utility company shareholders. In so deciding, the Commission intends to encourage, to the maximum extent possible, the sale of water and sewer systems to municipalities and other government-owned entities. It is, and shall continue to be, the policy of this Commission to take such actions as will encourage the larger water and sewer utilities with greater operational and capital resources, including governmental entities, to acquire the smaller, under-capitalized, less efficient systems. Such policy serves the public interest by promoting efficiencies through economies of scale and generally results in more favorable rates and an enhanced quality of service.

IT IS, THEREFORE, ORDERED as follows:

1. That 100 percent of the gain on the sale of the public water utility systems owned by CWS which serve the Farmwood "B" and Chesney Glen Subdivisions in Mecklenburg County, North Carolina shall be assigned to CWS's stockholder.

2. That CWS shall file reports with the Commission and Public Staff concerning the calculations of the gain and the workpapers supporting the calculations. Any party disagreeing with the calculations of the gain may contest the amount of the gain in CWS's next general rate case.

3. That CWS shall file journal entries related to the gain including the removal of the plant and associated accounts from CWS's books and records consistent with the provisions of this Order.

ISSUED BY ORDER OF THE COMMISSION.

This the 7th day of September 1994.

NORTH CAROLINA UTILITIES COMMISSION

Geneva S. Thigpen

Geneva S. Thigpen, Chief Clerk

(SEAL)

Commissioner William W. Redman, Jr., dissents. Commissioner Redman supports an equal sharing of the gain resulting from the sale of the water utility systems at issue in these proceedings.

Chairman Hugh A. Wells and Commissioner Charles H. Hughes did not participate.

Docket No. 980744-WS
Exhibit __ (CHH-4)

STATE OF NORTH CAROLINA
UTILITIES COMMISSION
RALEIGH

DOCKET NO. W-354, SUB 143
DOCKET NO. W-354, SUB 145

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

Docket No. W-354, Sub 143

In the Matter of)
Application by Carolina Water Service,)
Inc. of North Carolina, 2335 Sanders)
Road, Northbrook, Illinois 60062, for)
Authority to Transfer the Franchise)
Serving the Hidden Hills and Farmwood)
Section 18 Subdivisions in Mecklenburg)
County to the City of Charlotte (Owner)
Exempt from Regulation) and to Transfer)
Assets) ORDER DETERMINING
) REGULATORY TREATMENT
Docket No. W-354, Sub 145) OF GAIN ON SALE OF FACILITIES
)
In the Matter of)
Application by Carolina Water Service,)
Inc. of North Carolina, 2335 Sanders)
Road, Northbrook, Illinois 60062, for)
Authority to Transfer the Franchise Serving)
the Habersham Subdivision in)
Mecklenburg County to the City of)
Charlotte (Owner Exempt from Regulation))
and to Transfer Assets)

HEARD IN: Commission Hearing Room 2115, Dobbs Building, 430 North Salisbury Street, Raleigh, North Carolina, on September 28, 1995, at 9:30 a.m.

BEFORE: Judge Hugh A. Wells, Presiding; and Commissioners Charles H. Hughes Jr., Laurence A. Cobb, Ralph A. Hunt and Jo Anne Sanford.

APPEARANCES:

For the Applicant Carolina Water Service, Inc. of North Carolina:

Edward S. Finley, Jr., Hunton & Williams, Post Office Box 109, Raleigh, North Carolina 27602

For the Public Staff:

Antoinette R. Wike, Chief Counsel, and Paul L. Lassiter, Staff Attorney, Public Staff - North Carolina Utilities Commission, Post Office Box 29520, Raleigh, North Carolina 27626-0520
For: The Using and Consuming Public

BY THE COMMISSION: On January 30, 1995, Carolina Water Service, Inc. of North Carolina (CWS or Company), filed an application with the Commission for authority to transfer the water utility systems in the Hidden Hills and the Farmwood-Section 18 Subdivisions in Mecklenburg County to the Charlotte Mecklenburg Utility Department ("CMUD"), which is exempt from the Commission's regulation. CWS currently serves 32 customers in the Hidden Hills subdivision and 58 customers in the Farmwood-Section 18 subdivision. The transfer will result in a $25.48 decrease in the average monthly bill (based on an average usage of 6,000 gallons per month). CMUD will not be charging any tap-on or other fees to the existing customers. These systems will be connected to the CMUD system, which has elevated storage, and the connection will result in better long term service to the customers.

CWS has also requested a determination on the regulatory treatment of the gain resulting from this sale and a ruling that the Company's shareholder be entitled to retain 100 percent of such gain. The Public Staff, in initially bringing this matter before the Commission, took the position that since the issue of the regulatory treatment of the gains on sale of water and sewer systems was on appeal in three CWS dockets, and since CWS, by contract, had agreed to the transfer in question no matter how the gain on sale issue was decided, a ruling on the gain on sale issue in this docket should be deferred until after the Court of Appeals ruled on the appeals. In the alternative, if the ruling was not deferred, the Public Staff requested the Commission to schedule an evidentiary hearing to consider the gain on sale issue in this case.

By order dated May 24, 1995, the Commission approved the transfer, denied the Public Staff's motion to defer ruling on the gain on sale issue, and granted the Public Staff's alternative motion for an evidentiary hearing.

On May 18, 1995, CWS filed an application in Docket No. W- 354, Sub 145 for authority to transfer the water utility system in the Habersham subdivision in Mecklenburg County to CMUD. In its application in Docket No. W-354, Sub 145, CWS likewise requested that the Commission allow

CWS to retain all the gain on sale of the system. By motion filed May 26, 1995, the Public Staff requested that the Commission consolidate for hearing CWS's applications in Docket No. W-354, Sub 143 and Docket No. W-354, Sub 145, that the Commission continue the hearing in the two dockets and accompanying filing dates by 60 days, and that the Commission place the burden of going forward (e.g. filing of initial testimony) on CWS. In a response dated June 5, 1995, CWS agreed that the two dockets should be consolidated, asked that the Commission deny the request for continuance and offered, should the Commission desire to do so, for CWS to file initial direct testimony first.

By order dated June 20, 1995, the Commission consolidated the two dockets, continued the hearing, accepted the tendered pre-filed testimony by CWS for filing and established a further schedule under which the parties should prefile direct and rebuttal testimony.

By order dated June 26, 1995, the Commission authorized the transfer of the Habersham subdivision system. Pre-filed direct and rebuttal testimony was filed by Carl Daniel, Regional Vice President, on behalf of CWS. The Public Staff filed direct and rebuttal testimony on behalf of Katherine Fernald, Supervisor of the Water Section of the Accounting Division of the Public Staff, and direct testimony of Andy Lee, Director of the Water and Sewer Division of the Public Staff.

Based on the foregoing, the evidence adduced at the hearing, and the entire record in this matter, the Commission now makes the following

FINDINGS OF FACT

1. In 1990, CWS was confronted by efforts of three municipal or governmental entities to acquire three of its systems. The City of Charlotte, through CMUD, sought to acquire CWS's Beatties Ford system in Mecklenburg County. The Eastern Wayne Sanitary District sought to acquire CWS's Genoa system in Wayne County, and the Town of New Bern sought to acquire CWS's Riverbend system in Craven County. Order Determining Regulatory Treatment of Gain on Sale of Facilities, October 16, 1990, Docket Nos. W-354, Subs 82, 86, 87 and 88. CWS entered into tentative contracts to sell the three systems and requested the Commission to rule on the issue of whether the Company's stockholder should be permitted to retain 100 percent of the gain on sale in Docket Nos. W-354, Subs 82, 86, 87, and 88. Heater Utilities Inc., the Carolinas' Chapter of the National Association of Water Companies, and the City of Charlotte intervened in the Commission proceeding to support the position of CWS. The Public Staff and the Attorney General advocated giving 100 percent of the gain to the Company's ratepayers. After an evidentiary hearing, the Commission held in Docket Nos. W-354, Subs 82, 86, 87, and 88 that the gain should be split 50/50 between the Company's ratepayers and its shareholder. The Commission reasoned that both the shareholder and the ratepayers bore part of the risk in maintaining the systems and both should share equally in the profits upon disposition through sale.

2. As CWS's contracts for the Beatties Ford, Genoa, and Riverbend systems were tentative and conditioned on the Commission's ruling, each of the three contracts was renegotiated in light of the Commission's actions. CWS sought to obtain a higher price for the systems since the

Commission's ruling denied the Company half of the profit for which it had initially bargained. CMUD paid an increased price for Beatties Ford. While the Eastern Wayne Sanitary District determined that it would rather parallel the Genoa system than pay more than what it had initially bargained to pay, it ultimately paid less than the tentative contract price. New Bern was unwilling to pay an increased price, and the sale of the Riverbend system to New Bern did not take place.

3. In 1992, in the aftermath of the CWS gain on sale cases, Heater Utilities, Inc., sold the system in the Pinewood Subdivision to the City of Goldsboro and sought to discontinue service to the Country Acres Subdivision in Wayne County. In Docket Nos. W-274, Subs 71 and 72, Heater asked the Commission to permit it to retain 100 percent of the gain on sale. Order Determining Regulatory Treatment of Gain on Sale and Loss on Abandonment of Facilities, May 21, 1993. 83rd Report, N.C. Utilities Commission Orders and Decisions at 653 (1993). The Commission affirmed the rationale it had relied upon in the 1990 CWS cases and ruled that the gain should be shared 50/50 between shareholders and ratepayers. The Commission ruled that the evidence was not appreciably different to warrant a different result. However, four members of the Commission filed concurring or dissenting opinions wherein they expressed concerns that past decisions may have discouraged or certainly not encouraged the sale of systems to municipal operators to the detriment of the public interest.

4. In 1993 and 1994, CWS again faced requests that it sell systems to a municipality. CMUD desired to acquire the Farmwood B and Chesney Glen systems in Mecklenburg County. In light of the differences of opinion expressed in the Heater Sub 71 and Sub 72 dockets, CWS again requested the Commission to address the gain on sale issue as a result of transfer applications filed in Docket Nos. W-354, Subs 133 and 134. At the hearing in the Farmwood B and Chesney Glen matters, CWS advocated that sales to municipalities should neither be discouraged or encouraged and that regulatory treatment denying the Company's shareholder the opportunity to retain the gain, including gain-splitting, discouraged sales. The Public Staff argued that the Commission should adhere to the ruling from the earlier cases and split the gain equally between the Company's shareholder and its remaining ratepayers.

5. The Commission in its September 7, 1994 Order in Docket Nos. W-354, Subs 133 and 134 held that CWS's shareholder should retain 100 percent of the gain. The Commission determined that "[w]ith the benefit of hindsight, the Commission can now see that the policy to split the gains or losses on sales of water and/or sewer systems has had a negative impact on the public good." The Commission cited the harmful consequences of its decision with respect to the Beatties Ford, Genoa, and Riverbend cases. The Commission also cited as beneficial the progression of ownership first from developers to private utilities and second to municipalities and concluded that if economic incentives are removed so that this succession of ownership becomes inadvisable, customers are denied those benefits. Further, if companies are prevented from retaining the gain on sale, a substantial incentive is removed for those companies to buy systems from developers or small, undercapitalized operators in the first instance. The Commission noted that the Public Staff's primary support for its position was that the Commission previously had decided to split the gain and that CWS had presented no new evidence to distinguish the facts in those cases from the prior cases. The

Commission ruled that its prior orders constituted inadequate precedent upon which the Public Staff could rely so heavily. The Commission also articulated the public interest principles it would follow in addressing future gain on sale requests.

6. The Public Staff has appealed the Commission's order in the Farmwood B and Chesney Glen dockets to the North Carolina Court of Appeals.

7. CWS next filed a request with the Commission in Docket No W-354, Sub 140 to relinquish its certificate to serve the Mallard Crossing Subdivision in Mecklenburg County and to permit CWS to sell that system to CMUD. Under its contract with the City of Charlotte, CWS would experience a capital gain on the sale. CWS requested on December 29, 1994, a determination from the Commission of the regulatory treatment the Commission would authorize for that gain. CWS made reference to the Commission's holding in Docket Nos. W-354, Subs 133 and 134 (the 1994 Farmwood B and Chesney Glen cases) and asked the Commission to apply the rationale it had articulated in those cases of permitting the stockholder to retain 100 percent of the gain, absent overwhelming and compelling evidence to the contrary. On January 23, 1995, the Public Staff recommended that the transfer be approved but that a ruling on the gain on sale issue should be deferred until CWS's first rate case after a final decision in the cases on appeal. CWS asked that the Commission refuse to defer indefinitely the gain on sale decision. By order of February 3, 1995, the Commission denied the Public Staff's motion to defer and granted CWS's request that 100 percent of the gain on sale be given to the Company's shareholder. The Commission recited its conclusion from its order in the Farmwood B and the Chesney Glen cases that the public interest favored granting the stockholder 100 percent of the gain on sale. On February 17, 1995, the Public Staff again requested the Commission to defer its decision on the gain on sale issue. By order issued March 14, 1995, the Commission denied the Public Staff's request that the matter be held in abeyance. On March 15, 1995, the Public Staff filed a motion for an evidentiary hearing. On April 12, 1995, the Commission denied the Public Staff's request for a hearing. The Commission held the Public Staff's motion to be untimely. The Commission ruled that the time for the Public Staff to ask for a hearing or to challenge the standard was at the time of the Staff Conference in January, not in March after the Commission already had acted on the various requests before it. The Commission ruled that the Public Staff waived its right to request a hearing by remaining silent on the issue on January 23, 1995. The Public Staff has appealed the Commission's decision in the Mallard Crossing docket to the North Carolina Court of Appeals.

8. The facts with respect to CWS's Farmwood Section 18, Hidden Hills and Habersham applications are not materially different from those with respect to the Company's Farmwood B application.

DISCUSSION OF EVIDENCE AND CONCLUSIONS

These cases now before the Commission in these two dockets mark the latest in a line of cases addressed by the Commission since 1990 in which the issue has been the regulatory treatment of the gain or loss on sale upon the partial liquidation of a water utility. The Commission's position has

evolved over the years, and the current position is that expressed by the Commission's order of September 7, 1994, in CWS's Farmwood B and Chesney Glen cases in Docket Nos. W-354, Subs 133 and 134. In that order, the Commission determined that the shareholder should retain 100 percent of the gain. The Commission has followed the decision of September 7, 1994, in the gain on sale cases it has decided since that date.

The Public Staff has disagreed with the Commission's decisions to permit the shareholder to retain the entire gain on sale and has appealed each such decision to the North Carolina Court of Appeals. In these dockets, the Public Staff has requested a hearing in order to present evidence to convince the Commission to alter its position and permit remaining ratepayers to retain at least a portion of the gain. The hearing conducted in these dockets was scheduled to permit the Public Staff to present such evidence.

Based upon procedural orders issued early in these cases, the burden of presenting a prima facie case was placed upon CWS. CWS witness Daniel presented the same testimony in this case that he presented in Farmwood B. Mr. Daniel testified that the Commission should follow its most current precedent on this issue. As CWS's witness presented the same testimony the Commission found satisfactory in the past and as Mr. Daniel merely requested the Commission to adhere to the position it had annunciated in the past, the Commission finds that CWS has met its prima facie burden.

The Public Staff testimony consists primarily of a reiteration of arguments the Public Staff has advocated in the past on the gain on sale issue. The Public Staff recites the history of the gain on sale issue within the water industry since 1990, cites cases addressing the gain on sale issue in the electric, telephone and gas industries in North Carolina, lists considerations relied upon by state regulatory commissions addressing these issues, and sets forth conclusions the Public Staff advances through which it takes issue with the reasoning articulated by the Commission in past orders establishing the current gain on sale policy.

On cross-examination, Public Staff witness Fernald was asked to identify the parts of the Public Staff's case that are new in this proceeding. Witness Fernald responded that she had presented the CMUD line extension policy, information from the Riverbend negotiations, and the National Regulatory Research Institute (NRRI) survey results to show that in many other jurisdictions a policy is followed permitting the ratepayers to keep or share the gain on sale. The Public Staff presents the CMUD line extension policy to argue that the price CMUD is willing to pay to acquire a system is determined based on the cost to parallel the system, and the Commission's gain on sale position will have no impact on those factors.

The Commission determines that the Public Staff has failed to present evidence of sufficient probative value to persuade the Commission to alter its current position on the gain on sale issue. The NRRI study data are insufficient. At most, the study shows that some jurisdictions have adopted positions different from this Commission's. However, this Commission's position has developed to address the unique factors existing in this State with respect to public interest issues applicable to the

water industry here. This Commission has long been concerned over the "troubled water system problem." We have sought, with a significant degree of success, to facilitate the orderly transfer from developers to investor-owned utilities and from investor-owned utilities to municipalities and governmental entities.

Ms. Fernald could cite nothing from the NRRI study as a basis relied upon by another state in rendering decisions in this area that has not been raised or argued in the past before us.

The NRRI study classifies states on the basis of the most recent decisions in the state on the gain on sale issue prior to the time the study was conducted. The study classifies North Carolina as a "split the gain" state. The NRRI classification for North Carolina is incorrect in several respects. The Commission's past decisions to split the gain on sale applied only for water utilities in a partial liquidation context. The Commission has issued a number of decisions on gain on sale issues in electric, gas and telephone cases in which the ratepayers retained all the gain. These cases are still valid precedent in those contexts, and to the extent NRRI classifies North Carolina as a split the gain state, the classification is incomplete and misleading.

Also, after the study was completed, the Commission departed from the split the gain decision and adopted its current position of permitting the stockholder to keep 100 percent of the gain. For North Carolina, the NRRI study is outdated. The NRRI study has serious deficiencies with respect to its classification of North Carolina. As these are deficiencies we can readily observe, we are reluctant to rely on conclusions that might be drawn from the study concerning the policy in effect in other states.

Ms. Fernald's discussion of the CMUD line extension policy constitutes insufficient evidence to persuade the Commission to depart from its current position and public interest determination. The CMUD line extension policy has been in effect since prior to 1990 when the Beatties Ford case was before the Commission. In fact, Earl Lineberger, CMUD's chief engineer, testified in the Beatties Ford case. The CMUD line extension policy has influenced CMUD's actions for a number of years, and the role it plays in the acquisitions at issue in these dockets is no different from the role it has played in past cases.

The Commission has reviewed the information submitted by the Public Staff from CWS's negotiations with the Town of Riverbend as confidential exhibits. Nothing contained in these exhibits justifies alteration of the Commission's position as articulated in the Farmwood B case. Indeed, part of the correspondence indicates that negotiations between the parties were postponed until the Commission issued its order of September 7, 1994, in Farmwood permitting the stockholder to retain 100 percent of the gain on sale.

The Commission concludes that the Public Staff has presented no new evidence in this case to persuade the Commission to depart from its current position that it is in the public interest to allow water and/or sewer utility shareholders to retain 100 percent of the gain on sale. The Commission likewise rejects the Public Staff's arguments that suggest that the Commission's stated reasons for its

current position are incorrect. The Public Staff argues that the Commission's gain on sale position has no influence on the decision of entities like CMUD and CWS to establish the price at which water systems are sold. The Public Staff argues that the market forces establish price, each entity seeking to maximize its economic position, irrespective of the Commissions's position.

The evidence proves the invalidity of the Public Staff argument. In Beatties Ford, a higher purchase price was negotiated after the Commission determined to split the gain on sale. In Farmwood B, the purchase price would have increased by $58,000 if the Commission had required a splitting of the gain. In the Riverbend matter, the sale to New Bern fell through after the Commission announced its gain splitting decision. After the Commission in 1994 determined that shareholders should retain all of the gain, negotiations have proceeded between CWS and the Town of Riverbend for the sale of the Riverbend system.

In addition to this evidence, the Public Staff's argument has serious logical inconsistencies. When a municipality approaches a utility like CWS seeking to acquire a water system, the utility retains the option of refusing to sell. Obviously, the Commission's position on whether the utility will retain all of the profit will have a dramatic impact on the utility's decision on whether it will sell. Market price is defined as the price for which a willing seller will sell and a willing buyer will buy. If the Commission's position on gain on sale converts a willing seller into an unwilling one, market price drops from "X" to "O". The Public Staff's assertion that the Commission's position will not influence market price is illogical.

While a municipality's ability to parallel permits it to exert considerable pressures on the utility to sell on terms favorable to the municipality, there are serious limitations on this pressure. In many occasions, the municipality's ability to parallel may be nonexistent or severely limited. The Public Staff asserts that New Bern had no authority to parallel CWS in Riverbend. Property owners may have entered into restrictive covenants obligating them to take service exclusively from the utility. Paralleling results in the damaging of streets and the disruption of neighborhoods. Lawns and property must be dug up. Water users must incur costs to transfer service. Municipalities assess substantial connection fees when water users switch from the utility to the municipality. The magnitude of these fees may prohibit the water user from switching even if to switch would reduce the monthly usage charge. CWS witness Daniel testified that the City of Winston-Salem had experienced this problem when it paralleled one of CWS's systems. The Commission determines that the factors influencing the decision of parties to sell water systems and affecting price are far more complex and sophisticated than the Public Staff's analysis suggests. We are not persuaded that our determination with respect to gain on sale plays no role in this context.

The Public Staff has addressed issues such as whether gain on sale should be allocated depending on whether assets sold had been included in rate base, whether ratepayers had protected investors from the risk of owning property, and past Commission precedent on gain on sale issues. Also, the Public Staff has addressed certain public interest considerations. The Public Staff acknowledges that these issues are those that have been presented before by the parties and that have been addressed by the Commission. The Commission was aware of the Public Staff positions on

these issues when it issued its decision in the Farmwood B case. As the Public Staff presents nothing new in advancing these issues again, the Commission declines to alter its ruling as espoused in Farmwood B as a result of the Public Staff's arguments. Ms. Fernald admits, for example, that "the risks in this case are the same risks that the Commission considered in Docket No. W-354, Subs 82, 86, 87 and 88, and Docket No. W-274, Subs 71 and 72, when it determined that the risks are shared equally between the stockholders and the ratepayers." The Commission finds that no evidence, much less overwhelming and compelling evidence, has been presented in this proceeding to warrant the departure from the Commission's current gain on sale position and therefore concludes that the Company should retain 100 percent of the gain on sale. In so concluding, the Commi ion believes that its current position better serves and promotes the public interest and should be followed in these dockets.

IT IS THEREFORE, ORDERED as follows:

1. That 100 percent of the gain on the sale of the public water utility systems owned by CWS which serve the Farmwood 18, Hidden Hills and Habersham Subdivisions in Mecklenburg County, North Carolina, shall be assigned to CWS's stockholder.

2. That CWS shall file reports with the Commission and Public Staff concerning the calculations of the gain and the workpapers supporting the calculations. Any party disagreeing with the calculations of the gain may contest the amount of the gain in CWS's next general rate case.

3. That CWS shall file journal entries related to the gain including the removal of the plant and associated accounts from CWS's books and records consistent with the provisions of this Order.

ISSUED BY ORDER OF THE COMMISSION.

This the 29th day of March 1996.

NORTH CAROLINA UTILITIES COMMISSION

Geneva S. Thigpen

(SEAL)

Geneva S. Thigpen, Chief Clerk