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Management & Regulatory Consultants, Inc.

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January 30, 2001 Hand Delivered

Ms. Blanca S. Bayo, Director
Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

Re: Docket No. 001502-WS
Workshop In Re: Proposed Rule 25-30.0371

Dear Ms. Bayo:

Enclosed find an original an fifteen(15) copies of COMMENTS OF FRANK SEIDMAN ON BEHALF OF UTILITIES, INC.,

Very truly yours,

Frank Seidman

cc: Ben Girtman
Carl Wenz

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION
WORKSHOP
DOCKET NO. 001502-WS
PROPOSED RULE 25-30.0371
ACQUISITION ADJUSTMENTS

COMMENTS OF
FRANK SEIDMAN
ON BEHALF OF
UTILITIES, INC.

SUBMITTED JANUARY 30, 2001

1. What goals do you believe the Commission should be trying to achieve through a water and wastewater industry acquisition policy?

RESPONSE: The existing Commission policy has as its primary goal, to create an incentive for larger utilities to acquire smaller, troubled utilities. The purpose of that goal is for customers to receive a better quality of service at reasonable rates. The goal of providing an incentive is still a valid one and should be continued. But providing incentives for acquisitions is only one part of any policy. Separate and apart from encouraging acquisitions, the acquisition policy should assure that for any acquisition that does take place, the Commission will treat the purchasing utility with consistency and finality. Therefore, I suggest that an acquisition policy have three goals:

Goal 1. Encouragement - A policy should encourage the acquisition of utility systems when it is in the public interest.

Goal 2. Consistency - An acquisition policy should be consistent in the ratemaking treatment of a utility, regardless of ownership; consistent between ratemaking treatment and the governing statutes; and consistent with the policy that has been developed and applied by this Commission for nearly 20 years.

Goal 3. Finality - A policy should provide for finality in its application so that the Commission order that determines and sets out the treatment of an acquisition adjustment can be depended upon to be the basis for ratemaking on a going forward basis. Utilities make acquisition decisions with knowledge of, and reliance on, the governing statutes, rules and policies. The findings of the Commission regarding an acquisition adjustment and determination of rate base, as set out in a final order approving transfer, must become a known factor upon which the utility can depend in mapping its economic future. The ability of a utility to depend on policy and on the findings in a Commission order are a necessary part of any incentive in pursuing acquisitions. If the findings in such an order are treated by the Commission as temporary and subject to reversal or modification, then any incentive is lost and the policy becomes a shell with nothing in it.

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2. Should the Commission still be promoting acquisitions?

RESPONSE: The Commission has never really "promoted" acquisitions, nor should it do so as a matter of policy. Promotion is different from encouragement. Promotion conjures up active participation by the Commission in arranging for or soliciting sales and purchases. Encouragement provides a regulatory atmosphere wherein beneficial acquisitions will occur, when, without encouragement, they might not. There have been, and may continue to be, occasions when the Commission staff is aware of a utility being in trouble, such as when a utility is placed in receivership. In those cases, that Commission staff, being aware of the situation, may "promote" the purchase of a system by a reliable operator in order to assure continuity of service for that utility's customers. That is a relatively infrequent occurrence and should not be discouraged. But as a matter of policy, the Commission should not be "promoting" sales and purchases of utilities.

The Commission should, however, through its policies , continue to encourage acquisitions within the industry that are in the public interest. The public interest is a legal requirement of any acquisition approved by the Commission. Specifically, Section 367.071(1), Florida Statutes, reads, in part:

> No utility shall sell, assign, or transfer its certificate of authorization, facilities or any portion thereof, or majority organizational control without determination and approval of the commission that the proposed sale, assignment, or transfer is **in the public interest** and that the buyer, assignee, or transferee will fulfill the commitments, obligations, and representations of the utility. [Emphasis added]

Every order of this Commission approving an acquisition contains a finding that the transaction is in the public interest.

3. Is there a need for different policies for (1) large utilities acquiring large utilities, (2) large utilities acquiring small utilities or (3) small utilities acquiring small utilities?

RESPONSE: No. There is a need for only one policy on acquisitions, but there is nothing wrong with exploring several means of encouraging or providing incentives under that policy. The Commission staff, in the notice for this workshop, has summarized purported incentives for acquisitions in other states. On review, none seem to work as well as the existing acquisition policy in Florida.

4. Should the Commission be looking at different incentives to encourage acquisitions, such as rate of return (i.e.; modification of the equity leverage graph), in place of or in conjunction with the current acquisition policy?

RESPONSE: The Commission should not be looking to replace current acquisition policy. It has proved to be quite effective over many years. If the Commission wants to explore other means of encouraging acquisitions that are in the public interest, any such means should be in addition to, and

not in replacement of, those available under current policy. As pointed out in Response No. 3, the Commission staff has summarized purported incentives for acquisitions in New York, Pennsylvania and California. According to the staff's summary, New York's program, instituted in 1994 has resulted in one acquisition and Pennsylvania's and California's programs, adopted in 1997 have resulted in zero and four acquisitions, respectively. Under Florida's existing policy, approximately 100 acquisitions took place over the ten year period between 1988 and 1997. Florida's policy has succeeded because it is simple, it is known before an acquisition is considered, and it has been reliable in the past. The policies in other states appear to be more in the form of guidelines, the outcome of which will not be known until long after the transfer.

5. Should the Commission be addressing the accounting treatment for acquisition adjustments? Should the amortization period for acquisition adjustments relate to the composite remaining life of the assets purchased?

RESPONSE: No. Addressing accounting treatment at this time and within this rule does not appear to be critical to the codification of acquisition adjustment policy. The Uniform System of Accounts (USOA) provides guidelines for the accounting treatment of acquisitions. The Commission's acquisition policy addresses ratemaking treatment of acquisitions. With regard to the amortization period, equating it to the composite life of the acquired assets is appropriate as a default period, but provisions should be made for a utility to be able to support a different amortization period, if the acquiring utility believes it is appropriate.

6. With respect to negative acquisition adjustments, would it be appropriate to recognize the unamortized acquisition adjustment balance in rate base with the amortization expense recognized below the line at the time the utility files a request for a rate increase, as an alternative to the present policy?

RESPONSE: No. Below the line amortization of an above the line negative acquisition adjustment would <u>not</u> be an appropriate <u>alternative</u> to present policy. <u>IF</u>, however, for whatever reason, the unamortized balance of a negative acquisition adjustment is recognized as a reduction to rate base, then it is preferable to recognize the amortization expense below the line. At least that way, the utility will have the cash flow benefit of depreciation expense on the full rate base with which to fund plant replacements. But barring some extraordinary circumstance, there is no reason that rate base should be reduced by a negative acquisition adjustment.

The current Commission policy, "Absent extraordinary circumstances, the purchase of a utility system at a premium or discount shall not affect rate base," is built on a very solid foundation. In Order No. 25729 (attached), concluding the Commission's generic investigation on acquisition adjustment policy in Docket No. 891309-WS, the Commission stated:

> We do not think that Section 367.081(2)(a), Florida Statutes, limits us from including

in rate base only that which an acquiring utility has invested in the system, i.e., the purchase price., as OPC asserts. **This Commission has consistently interpreted the "investment of the utility" as contained in Section 367.081(2)(a), Florida Statutes, to be the original cost of the property when first dedicated to public service, not only in the context of acquisition adjustments, but elsewhere as well.** [Emphasis added]

The Commission's policy, to limit modifications to an original cost rate base to extraordinary circumstances, reinforces the original cost provisions of the statute, is the very best protection the customer has against the whims of "fair value" ratemaking, and preserves the continuity of rate base, regardless of ownership.

I cannot think of any circumstance that would warrant a reduction in rate base to less than original cost. Indeed, the Commission stated in Order No. 25729, **"The customers of the acquired utility are not harmed by this policy because generally, upon acquisition, rate base has not changed, so rates have not changed."**

To the contrary, severe consequences will result from reducing rate base by a negative acquisition adjustment. The amount of rate base determines the cash flow to a utility that is available through return and the recovery of at least depreciation and property tax expense. Used and useful factors applied to a rate base already reduced by a negative acquisition adjustment would further reduce the cash flow available to a utility. The purchase price paid by an acquiring utility does not change the actual cost of assets in the ground serving the public. It does not change the cost to replace those assets. If the funds necessary to replace those assets do not come from this cash flow, where will they come from? They will come totally from invested capital at the rate of return on the higher replacement cost plus an income tax multiplier on the total cost. In addition, rates based on a rate base reduced by a negative acquisition adjustment do not reflect the actual cost incurred to make service available. As a result, the rates will understate the true cost of necessary plant and its associated costs, and will be in conflict with the state of Florida's policy to conserve scarce water resources. Reducing rates below those based on actual original cost encourages greater consumption of water, something that the Commission, the water management districts, and the Department of Environmental Protection have sought to discourage.

7. With respect to the positive acquisition adjustments, should the acquiring utility have to prove that the synergies caused by the acquisition more than offset the acquisition adjustment?

RESPONSE: Current policy is, "Absent extraordinary circumstances, the purchase of a utility system at a premium or discount shall not affect rate base." Whatever party proposes a positive or negative acquisition adjustment should be responsible for supporting the extraordinary circumstances that warrant it. Whether a utility should have to prove "synergies" caused by the acquisition offset a positive acquisition adjustment may be reaching too far. Order No. 25729, which is the generic order

confirming current policy, identifies several benefits to the customer that the Commission believes warrant its policy. It may be difficult to associate specific dollars with those benefits. It must be remembered that, by statute, the Commission must find that an acquisition is in the public interest before it approves it. The Commission has knowledge of the acquisition arrangements, including price, when it considers an application for transfer. What is important is that the Commission is convinced that the beneficial factors identified in Order No. 25729 will reasonably occur when it approves the acquisition.

8. What should the future acquisition adjustment policy of this Commission be?

RESPONSE: The future acquisition adjustment policy should be a continuation of the existing policy, "Absent extraordinary circumstances, the purchase of a utility system at a premium or discount shall not affect rate base." It is important to continue this policy for several reasons:

As an incentive, the existing policy in Florida has worked, whereas the acquisition policies in New York, Pennsylvania and California appear not to have. Utility acquisitions have occurred and continue to occur at the average rate of nearly ten per year. The Commission has found these acquisitions to be in the public interest and the customers have benefitted from this policy.

The existing policy limits the justification for modifications to an original cost rate base to extraordinary circumstances, thereby reinforcing the original cost provisions of the statute. That is the very best protection the customer has against the whims of "fair value" ratemaking. It preserves the continuity of rate base, regardless of ownership, providing stability to the utility and the customer.

The existing policy preserves the original cost of assets as the basis for ratemaking. This provides the funds necessary to provide adequate service to the customer. It also results in rates based on cost, which sends the appropriate economic signal to ensure conservation of our water supply and protection of our ecosystem, as required by law. A negative acquisition adjustment results in rates that are below the actual cost of providing service. That is contrary to the state policy to promote conservation and discourage the waste of water and related resources.

The existing policy, through the opportunity to justify a positive acquisition adjustment, provides a means to recover costs that are cost effective and provide benefits to the customer.

A simple, stable and reliable policy is the best incentive for utilities to make acquisitions in the public interest.

ADDITIONAL COMMENTS ON PROPOSED RULE 25-30.0371

In addition to my responses to the specific questions raised in the Workshop Notice, there are several factors that I believe need to be taken into consideration in drafting a rule regarding acquisition adjustment policy.

1. The rule, as proposed, is titled "Rate Base Established at Time of Transfer." It then sets out a procedure for considering an acquisition adjustment as part of the rate base calculation. It does not address the situation wherein rate base is not set at time of transfer, but will be addressed at a later time. **The rule should be equally applicable regardless of whether the acquisition issue is initially addressed at the time of transfer or subsequent to it.**

2. In many transfer orders in which rate base is established and in which an acquisition adjustment is addressed, the order includes the statement, "The rate base calculation is used purely to establish the net book value of the property being transferred and does not include normal ratemaking adjustments of working capital calculations and used and useful calculations." There is concern that this sentence may be incorrectly misinterpreted to mean that the issues of rate base and acquisition adjustment have been addressed only for purposes of the transfer and not for purposes of setting rates. That sentence merely points out that ratemaking adjustments such as used and useful and working capital have not been considered. But such transfer orders do determine the net value of assets and the inclusion or exclusion of an acquisition adjustment in rate base have with finality and can be used as a starting point for any subsequent rate proceeding. If that were not the case, what would be the purpose of determining rate base at the time of transfer? **The rule should make it clear that when a finding has been made that extraordinary circumstances do not exist, either in a final transfer order or in a PAA transfer order that has become final, rate base in any subsequent rate proceeding shall be unaffected by an acquisition adjustment.** This finality is necessary if an acquisition policy is to have any meaning.

3. **Consistent with prior Commission practice, the rule should provide that the rate base of a utility acquired by a stock purchase shall not be affected by an acquisition adjustment.**

4. **Proposed Rule subsection 25-30.0371 (3) should be deleted in its entirety.** It contradicts the established policy regarding acquisition adjustments that is correctly stated in proposed Rule subsection 25-30.0371 (2). According to both established policy and proposed Rule subsection 25-30.0371 (2), absent extraordinary circumstances, a purchase of a utility shall not affect the rate base calculation. The premise for this policy and proposed rule is that the default status is the rate base of the seller and that if one wants to change that rate base, one must prove that extraordinary circumstances exist. As the Commission stated in Order No. 11266, the purchaser shall stand in the shoes of the seller. Proposed Rule subsection 25-30.0371 (3) turns this around and places the burden on a utility to prove why it should not

stand in the shoes of the seller. In Order No. PSC-98-1092-FOF-WS, the Commission addressed the issue of burden of proof. The Commission stated, "Once the utility makes an initial showing that there are no extraordinary circumstances, the burden of persuasion shifts to the opposing party to demonstrate that extraordinary circumstances are present. If the opposing party meets the burden of persuasion, the ultimate burden of rebutting the opposing party's allegations rests upon the utility."

5. **The following substitute language is recommended as preferable to that proposed in either the December 21, 2000 Notice of this Workshop or the October 5, 2000 Staff Recommendation for the October 16, 2000 Regular Agenda:**

25-30.0371. Ratemaking Treatment of Acquisition Adjustments

(1) This rule applies to the purchase of the assets of a utility by a utility regulated by this Commission. The purchase of the stock of a utility shall not result in an acquisition adjustment to rate base.

(2) For the purpose of this rule, an acquisition adjustment is defined as the difference between the purchase price of the utility system assets acquired and the net book value of the purchased assets. The net book value is the original cost of those assets net of accumulated depreciation, accumulated amortization and net contributions-in-aid-of-construction, all determined in accordance with the Uniform System of Accounts (USOA) and USOA Accounting Instruction 21.

(3) A positive acquisition adjustment exists when the purchase price of assets is greater than the net book value. A negative acquisition adjustment exists when the purchase price of assets is less than the net book value.

(4) Absent extraordinary circumstances, the purchase of a utility system at a premium or at a discount shall not affect the rate base calculation, and the rate base shall be unaffected as a result of the transfer.

(5) Any entity that believes a full or partial positive acquisition adjustment should be made a part of the rate base calculation has the burden to prove the existence of those extraordinary circumstances. In determining whether extraordinary circumstances have been demonstrated, the Commission will consider evidence such as anticipated improvements in quality of service, the ability to comply with regulatory mandates, the ability to obtain capital at reasonable rates and lower risk, the ability to eliminate substandard operating conditions, the ability to make necessary improvements, and the ability to contain or reduce costs.

(6) Any entity that believes a full or partial negative acquisition adjustment should be made a part of the rate base calculation has the burden to prove the existence of those extraordinary circumstances. In determining whether extraordinary circumstances have been

demonstrated, the Commission will consider evidence such as the anticipated retirement of the acquired assets and the ability of the acquired assets to function.

(7) When a finding has been made that extraordinary circumstances do not exist, either in a final transfer order or a PAA transfer order that has become final, rate base in any subsequent rate proceeding shall be unaffected by an acquisition adjustment.

A Publication of FALR, Inc. P.O. Box 385, Gainesville, FL 32602 (904) 375-8036

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Investigation of Acquisition Adjustment Policy	DOCKET NO. 891309-WS ORDER NO. 25729 ISSUED: 2/17/92

The following Commissioners participated in the disposition of this matter:

THOMAS M. BEARD, Chairman
BETTY EASLEY

ORDER CONCLUDING INVESTIGATION AND CONFIRMING ACQUISITION ADJUSTMENT POLICY

BY THE COMMISSION:

CASE BACKGROUND

On November 17, 1989, the Office of Public Counsel (OPC) filed a Petition to Initiate Rulemaking Proceedings or Alternatively to Issue an Order Initiating Investigation. OPC proposed a specific amendment to Rule 25-30.040(3)(o), Florida Administrative Code, regarding the treatment of acquisition adjustments in rate base.

By Order No. 22361, issued January 2, 1990, we denied OPC's request to initiate rulemaking and instead initiated an investigation of our policy on acquisition adjustments. As part of our investigation, we requested and received written comments from interested persons and held an informal workshop on March 28, 1990, to discuss the Commission's current policy and OPC's proposed changes. By proposed agency action (PAA) Order No. 23376 issued August 21, 1990, we declined to make any changes to our acquisition adjustment policy. On September 11, 1990, OPC filed a protest to Order No. 23376. Pursuant to Section 120.57(2), Florida Statutes, we afforded all parties the opportunity to be heard on this matter at an oral presentation on July 29, 1991. This Order contains our final disposition of this proceeding.

ACQUISITION ADJUSTMENT POLICY

Our policy on acquisition adjustments since approximately 1983 has been that absent extraordinary circumstances, the purchase of a utility system at a premium or discount shall not affect rate base. The purpose of this policy, as stated in PAA Order No. 23376, has been to create an incentive for larger utilities to

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acquire small, troubled utilities. We believe that this policy has done exactly what it was designed to do. Since its implementation, many small utilities have in fact been acquired by larger utilities, and we have changed rate base in only a few cases.

OPC charges that the relationship between rate base and utility investment is broken upon the sale of a utility. An acquiring utility must therefore establish the extent to which its own investment is prudent without regard to the seller's rate base or investment level. OPC believes that investors in the selling utility recover their investment through the sale of the utility; the buyer's investment is represented by the purchase price. By not allowing the buyer to increase rate base to equal the purchase price through a positive acquisition adjustment, OPC claims, the Commission is not allowing the buyer to earn a return on imprudent investment.

OPC seems to view positive and negative acquisition adjustments somewhat differently. For positive acquisition adjustments, OPC believes that appropriate standards must be established for the buyer to show, and for the Commission to evaluate, the prudence of the acquisition at a premium so the sale of a utility does not increase customer rates without any new assets being devoted to utility service. But for negative acquisition adjustments, OPC believes that the Commission has no alternative except to automatically impose an adjustment.

OPC asserts that if the negative acquisition adjustment is not imposed upon the buyer, the Commission is creating a mythical investment above the actual commitment of capital by the buyer. This error, OPC argues, is further compounded by the buyer's recovering depreciation expense on this mythical investment.

OPC also argues that this Commission does not have the statutory authority to give the buyer the rate base of the seller. Section 367.081(2)(a), Florida Statutes, refers to "the investment of the utility." OPC claims that the seller is not the "utility" referred to in this definition, the buyer is. Therefore, OPC concludes, the "investment of the utility" must be the prudent investment made by the buyer.

The other parties to this proceeding, Southern States Utilities, Inc., Deltona Utilities, Inc., United Florida Utilities Corporation, and Jacksonville Suburban Utilities Corporation

(collectively, the utility companies) make several arguments in response to OPC. First, they point out that OPC suggests an inconsistent use of purchase price. Where a negative acquisition adjustment pertains, the investment of the utility means the purchase price paid by the buyer, but where a positive acquisition adjustment is considered, the investment of the utility means the net book value, or rate base, of the seller. The utility companies also argue that if the Commission were to adopt OPC's view, the incentive for larger utilities to rescue small, distressed utilities would be erased. Further, the utility companies assert that OPC's position conflicts with prior unchallenged Commission decisions allowing positive acquisition adjustments. In conclusion, the utility companies also argue that our current policy comports with our broad authority to interpret and implement our statutory authority in a manner which best serves the long term interests of the ratepayers.

On the point of statutory interpretation, we disagree with OPC. We do not think that Section 367.081(2)(a), Florida Statutes, limits us from including in rate base only that which an acquiring utility has invested in the system, i.e., the purchase price, as OPC asserts. This Commission has consistently interpreted the "investment of the utility" as contained in Section 367.081(2)(a), Florida Statutes to be the original cost of the property when first dedicated to public service, not only in the context of acquisition adjustments, but elsewhere as well. In our current policy on acquisition adjustments, we do not deviate from this interpretation, nor do we exceed our statutory authority. Furthermore, OPC has cited no authority to support its contention that we have misinterpreted the statute.

We still believe that our current policy provides a much needed incentive for acquisitions. The buyer earns a return on not just the purchase price but the entire rate base of the acquired utility. The buyer also receives the benefit of depreciation on the full rate base. Without these benefits, large utilities would have no incentive to look for and acquire small, troubled systems. The customers of the acquired utility are not harmed by this policy because, generally, upon acquisition, rate base has not changed, so rates have not changed. Indeed, we think the customers receive benefits which amount to a better quality of service at a reasonable rate. With new ownership, there are beneficial changes: the elimination of financial pressure on the utility due to its inability to obtain capital, the ability to attract capital, a

reduction in the high cost of debt due to lower risk, the elimination of substandard operating conditions, the ability to make necessary improvements, the ability to comply with the Department of Environmental Regulation and the Environmental Protection Agency requirements, reduced costs due to economies of scale and the ability to buy in bulk, the introduction of more professional and experienced management, and the elimination of a general disinterest in utility operations in the case of developer owned systems.

Some utilities that are actively acquiring troubled utilities have found that our policy has given them the ability to make some purchases at a premium because of the balancing effect created by purchases made at a discount. Thus, our current policy offers enough incentive for utilities to make multiple purchases at a discount and still purchase a troubled utility that can only be purchased at a premium.

At the July 29, 1991, oral presentations, OPC stated that any incentive for acquisition should be in the form of a higher rate of return. We do not believe that this would create the necessary incentive. To illustrate, if an acquired system with a net book value of $100,000 was purchased for $80,000 and we raised the return on equity by 200 basis points, a utility with 50% equity would benefit after taxes by approximately $470. If the award were 400 basis points, the incentive after taxes would be approximately $940. We do not think that this is an adequate incentive for the acquisition of any troubled system.

In consideration of the foregoing, we conclude this investigation of our acquisition adjustment policy without making any change thereto. We note that our staff has opened a docket, Docket No. 911082-WS, wherein rules on acquisition adjustments will be addressed.

It is, therefore

ORDERED by the Florida Public Service Commission that this investigation of current Commission policy on acquisition adjustments is concluded and that policy, as described in the body of this Order, is hereby confirmed. It is further

ORDERED that this docket is closed.

By ORDER of the Florida Public Service Commission, this 17th day of FEBRUARY, 1992.

STEVE TRIBBLE, Director,
Division of Records and Reporting

(S E A L)

MJF

NOTICE OF FURTHER PROCEEDINGS OR JUDICIAL REVIEW

The Florida Public Service Commission is required by Section 120.59(4), Florida Statutes, to notify parties of any administrative hearing or judicial review of Commission orders that is available under Sections 120.57 or 120.68, Florida Statutes, as well as the procedures and time limits that apply. This notice should not be construed to mean all requests for an administrative hearing or judicial review will be granted or result in the relief sought.

Any party adversely affected by the Commission's final action in this matter may request: 1) reconsideration of the decision by filing a motion for reconsideration with the Director, Division of Records and Reporting within fifteen (15) days of the issuance of this order in the form prescribed by Rule 25-22.060, Florida Administrative Code; or 2) judicial review by the Florida Supreme Court in the case of an electric, gas or telephone utility or the First District Court of Appeal in the case of a water or sewer utility by filing a notice of appeal with the Director, Division of Records and Reporting and filing a copy of the notice of appeal and the filing fee with the appropriate court. This filing must be completed within thirty (30) days after the issuance of this order, pursuant to Rule 9.110, Florida Rules of Appellate Procedure. The notice of appeal must be in the form specified in Rule 9.900 (a), Florida Rules of Appellate Procedure.