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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Investigation of Acquisition Adjustment Policy )  
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Docket No. 891309-WS  
Filed: August 9, 1991

**COMMENTS OF SOUTHERN STATES UTILITIES, INC.,  
DELTONA UTILITIES, INC., AND UNITED FLORIDA  
UTILITIES CORPORATION ON ACQUISITION ADJUSTMENT POLICY**

Southern States Utilities, Inc. ("Southern States"), Deltona Utilities, Inc. ("Deltona"), and United Florida Utilities Corporation ("United") respectfully submit the following comments concerning the Florida Public Service Commission's ("Commission") investigation into its current acquisition adjustment policy. These comments are submitted with the permission of the Commission and supplement the oral presentations made on July 29, 1991.

**I. INTRODUCTION**

This proceeding was initiated to determine whether the Commission's acquisition adjustment policy, a policy adopted in 1983, should be amended. The Office of the Public Counsel ("Public Counsel" or "OPC") as the Petitioner in this cause bears the burden of establishing the need and justification for modification of the Commission's existing policy. Public Counsel has failed to meet its burden and has, for the most part, simply reiterated arguments previously rejected by the Commission in PAA Order No. 23376, issued August 12, 1990 in this docket. Public Counsel has made no evidentiary demonstration that ratepayers have been harmed under the Commission's current policy.

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Public Counsel also has failed to identify any precedent, from this State or any other jurisdiction, which supports the implementation of its proposed policy. What Public Counsel did confirm was that the acquisition of small utilities by large utilities is desirable and the Commission should give large utilities an incentive to acquire small systems. Southern States, Deltona and United maintain that the Commission's policy has served to provide maximum benefits to ratepayers and should remain unchanged.

## II. CURRENT POLICY

The Commission's current policy is most recently reflected in PAA Order No. 23376, issued August 21, 1990, which states as follows:

[A]bsent extraordinary circumstances, the purchase of a utility system at a premium or a discount shall not affect the rate base calculation.

See 90 FPSC 8:306. In other words, absent extraordinary circumstances, in the form of demonstrated benefits or harm to customers, the difference between the net book value of an acquired utility's rate base and the purchase price of the assets composing such rate base is not recognized by this Commission for ratemaking purposes. In formulating and implementing the above policy, the Commission has provided and continues to provide incentives for larger utilities to acquire distressed systems. Id. The policy allows an acquiring utility the opportunity to earn a fair and reasonable rate of return on the rate

base of the acquired system, regardless of whether it pays a price greater than or less than this rate base.<sup>1</sup>

The Commission has allowed positive acquisition adjustments in the past. The orders reflecting these adjustments have addressed varied circumstances. In Order No. 15925, issued April 2, 1986,<sup>2</sup> the selling utility had a negative rate base and the Commission allowed the purchaser a positive acquisition adjustment to a break even position. The Commission has also allowed a positive acquisition adjustment where the purchasing utility demonstrated that the acquisition was likely to result in significant cost savings to the customers through reductions in operating expenses. See Order No. 18716, issued January 1, 1988<sup>3</sup> and Order No. 16517, issued August 25, 1986.<sup>4</sup> In another instance, the purchasing utility could improve the selling utility's systems and

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<sup>1</sup>Indeed, as discussed during the oral presentations, a purchase price equal to net book value would be a coincidence. The amount paid for the selling utility's assets may be influenced by a number of factors including the percentage of used and useful property purchased, the potential growth of the system, etc. Tr. 10.

<sup>2</sup>See In re: Application for Transfer of Certificate No. 180-W from Leisure Properties, Inc., to the South Waterfront Park Homeowners' Association, Inc., in Volusia County, Florida, 86 FPSC 4:40 (1986).

<sup>3</sup>See In re: Petition of Central Florida Gas Company to Increase its Rates and Charges, 88 FPSC 1:301 (1988).

<sup>4</sup>See In re: Application of General Waterworks Corporation for Approval of Transfer of Certificate Nos. 144-W and 140-S and Utility Facilities from Lucina Utilities Co. in Duval County to Jacksonville Suburban Utilities Corporation, 86 FPSC 8:250 (1986).

bring them into compliance with DER requirements at a significantly lower cost of capital with minimum impact to ratepayers. See Order No. 23111, issued June 25, 1990.<sup>4</sup>

In sum, the Commission's current policy essentially results in limiting the rate base of the acquiring utility to net book value. Positive acquisition adjustments may be allowed only where the utility demonstrates significant benefits to the customers. This is normally demonstrated by a reduction in operating expenses and/or enhanced quality of service due to the acquisition. Negative acquisition adjustments, on the other hand, must only be required where the Commission finds that the customers would be harmed by virtue of the acquisition.

### III. BENEFITS OF CURRENT POLICY

The current acquisition adjustment policy provides numerous benefits to ratepayers. Over the years, the Commission has witnessed and recognized the problems caused by or associated with small or developer driven systems. These problems have historically included: (1) low service quality; (2) financial pressure due to inadequate revenue; (3) inability to attract capital and high cost of capital due to associated risk; (4) inadequate and inexperienced staff; (5) substandard operating conditions, non-compliance with DER requirements and difficulty in making the necessary improvements; (6) higher operating costs and rates due to the lack of economies of

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<sup>4</sup>In re: Application for Transfer of Certificate Nos. 475-W and 411-S from St. Johns North Utility Corp. to Jacksonville Suburban Utilities Corp. and for a Limited Proceeding to Adjust Rates, 90 FPSC 6:386.

scale and a small customer base; and, (8) in the case of developer systems, a general disinterest in utility operations due to a primary focusing on selling real estate, making profits, and moving on to the next development.

In order to avoid or at least minimize the above problems, the regulatory treatment of acquisition adjustment policy must focus upon insuring that customers are not harmed. As the Commission recognized in its PAA order in this docket, customers normally derive certain benefits when distressed systems are purchased by larger utilities. Such benefits include: (1) improved reliability and quality of service; (2) lowered long-term operations costs; (3) cost savings to customers via economies of scale resulting from a larger customer base; (4) increased ability to attract capital for improvements; (5) a lower overall cost of capital; and, (6) a greater degree of professionalism and more experienced managerial, financial, technical and operational resources. See 90 FPSC at 8:307.<sup>4</sup>

Accordingly, rather than allow the customers of small, problematic utilities to suffer from increasingly poor service and higher rates, the Commission for a number of years has followed its current policy which provides both an incentive to larger utilities to

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<sup>4</sup>Other states also recognize the benefits received by customers of smaller, distressed systems. The Connecticut Department of Public Utility Control permitted a positive acquisition adjustment to rate base and a concomitant increase in rates where customers of an acquired utility could expect a 17.8 percent increase in rates over a six year period as opposed to a possible 460 percent rate increase if all needed plant improvements would have been completed in the same six year period by the distressed, acquired company. Decision, issued June 20, 1990 in Docket No. 89-10-03. Similarly, in Mississippi, acquisition cost in excess of net book value can be recovered in rates when the present owner is unwilling or unable to upgrade service. Order Approving Sale, issued December 31, 1986 in Docket No. U-4917.

purchase these systems and protection to the customers from adverse impact in the acquisition process.<sup>7</sup> In addition, by refusing to impose negative acquisition adjustments, absent extraordinary circumstances, the Commission avoids or minimizes deterioration of the purchasing utility's rate of return and does so with no adverse impact to the ratepayers of the system (it is beyond dispute that if the acquisition did not occur, ratepayers would continue to pay rates established, in part, according to the net book value of the existing plant which is used to provide utility service). If this incentive is removed, large utilities will be discouraged from acquiring small systems which will leave the customers of such systems in the hands of entities which have no desire or no capacity to be in the utility business. With regulation becoming even more stringent, and financial requirements to comply with such regulation burgeoning, the ability of "Mom and Pop" utility providers to meet regulatory requirements has become increasingly difficult. The no adverse impact criteria fully protects all ratepayers from the potentially devastating effects of these developments by giving large utilities with access to the necessary capital an incentive to take the risk associated with investing significant capital in a small and perhaps run down utility system. Moreover, Public Counsel's assertion that "double counting" occurs under the current policy is false. If a system is in need of improvements or upgrading, such improvement or upgrade must be made regardless

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<sup>7</sup>This incentive approach has been embraced by the State Corporation Commission of Kansas which set rate base at the net book value of utility assets for ratemaking purposes even though such assets were acquired at \$8.3M below book value. Such treatment "shares the benefit of the acquisition with the customer while allowing the purchaser a return on the historic cost of the plant acquired." Order, issued June 17, 1986 in Docket No. 148, 312-U, 85-KPLG-455-R.

of whether the system is acquired. What Public Counsel ignores is that when a large utility acquires a small system, customers benefit from the large utility's lower cost of financing the work.

#### **IV. CHALLENGE TO CURRENT POLICY**

The Public Counsel claims that the Commission's current policy yields inconsistent results. Simply put, this is not true. Further, as discussed below, it is Public Counsel's proposed policy modification which is expressly inconsistent. Public Counsel argues that when a purchasing utility acquires assets below net book value, the purchase price must be used in the rate base because: (1) this is the amount actually paid by the purchasing utility; and (2) use of net book value would result in an artificial increase to rate base. Public Counsel insists that acquisition adjustment treatment must begin with actual purchase price when considering a negative acquisition adjustment. On the other hand, Public Counsel abandons its principle that the Commission must begin with the actual purchase price when considering a positive acquisition adjustment, and instead, argues that policy reasons dictate the use of net book value for the acquired assets. Adoption of Public Counsel's position that a negative acquisition adjustment artificially increases rate base, necessarily leads one to conclude, for the sake of consistency, that Public Counsel's treatment of positive acquisition adjustments results in an artificial decrease in rate base. The application of Public Counsel's proposal results in an inconsistent use of actual purchase price (depending on whether net book value is higher or lower) and

would serve to defeat the incentives to rescue distressed systems currently provided to larger utilities under the Commission's existing policy.

The obvious inconsistency with Public Counsel's approach was emphasized by Commissioner Easley during the oral presentations. During the presentations, Public Counsel attempted to couch its position in statutory terms, i.e., that under Section 367.081(2)(a), Florida Statutes, ". . . the investment of the utility in property used and useful in the public service . . ." means actual purchase price for potential negative acquisition adjustments and net book value for potential positive acquisition adjustments. As recognized by Commissioner Easley, acceptance of Public Counsel's position requires the use of two different, inconsistent definitions of the statutory term "investment" -- actual purchase price for negative acquisition adjustments and net book value for positive acquisition adjustments. (Tr. 24)

During the oral presentations, Public Counsel attempted to justify this inconsistency by arguing that actual purchase price is prudent "per se" when less than net book value but must be proven to be prudent when more than net book value. Public Counsel also argues that Section 367.081(2)(a), Florida Statutes, limits the Commission's authority to provide a rate of return on the "investment" of the "the utility," i.e., the actual purchase price paid (except, of course, if actual purchase price exceeds net book value). (See Tr. 8-9; 22-27) Public Counsel cited no precedential authority in support of these theories, and as recognized by Chairman Beard (Tr. 67), these arguments conflict with prior unchallenged Commission decisions which have allowed positive acquisition adjustments and the Commission's broad authority to interpret and



implement its statutory authority in a manner which serves the long term best interests of the ratepayers.

Public Counsel next asserts that the Commission should treat acquisition adjustments similar to the way in which it applies the O&M benchmark. This analogy fails for two reasons.

First, the O&M is merely a flashpoint of reference used by the Commission in considering the prudence of an expenditure. (Tr. 46) Expenditures which exceed the flashpoint of customer growth plus inflation must be justified under this principle. Public Counsel ignores the critical fact that none of the policy questions underlying regulatory treatment of acquisition adjustments are present in an O&M benchmark determination. For example, if a utility's actual operating expenses are below the benchmark, the Commission normally deems the expenditure prudent and uses the actual amount for ratemaking purposes unless a specific expenditure is an issue in the case. In such cases, there is no adverse impact on the ratepayers. If, however, the Commission modifies its policy to limit rate base to purchase price when purchase price is below net book value, customers will suffer as acquisitions of distressed utilities will be few and far between, and such customers will suffer from a poor quality of service and higher rates, and possibly even termination of service due to continued non-compliance with environmental regulations.

Second, Public Counsel's attempt to analogize an O&M benchmark amount to net book value of an asset in addressing negative acquisition adjustments fails on factual grounds. For example, if the benchmark amount for labor expense is \$100 and the

actual expenditure was \$60, the \$60 amount will be used for ratemaking purposes -- however, \$40 was not spent in this case to provide service to the ratepayers. If, on the other hand, the net book value of an asset is \$100 and the actual purchase price is \$60, then (absent extraordinary circumstances) the Commission appropriately uses \$100 as the rate base amount for the acquiring utility -- here, the full net book value of \$100 has been invested in facilities used to provide service to ratepayers.

Finally, Public Counsel takes the position that a utility should bear the burden of proving the right to include net book value for ratemaking purposes when a purchase is made at a price below net book value. However, OPC argues that with a positive acquisition adjustment, the utility's burden of proof should not start with the purchase price but with the lower net book value. OPC's position again is inconsistent and would provide the disincentives which the Commission has sought to avoid.

The Commission's policy has worked well and has served to further the acquisition of distressed systems for the benefit of ratepayers in the state. The arguments set forth by OPC are the same arguments that have previously been rejected by the Commission in PAA Order No. 23376, issued August 12, 1990. The Commission should continue to implement its current policy with the predominant issue being whether or not the customers are harmed by the transfer. If a transfer is found to be in the public interest, and the purchase price exceeds the net book value, no harm will be occasioned to the ratepayers by the use of the lower net book value. However, if the utility can demonstrate significantly improved service or reduced operating expenses, then a positive acquisition adjustment may be appropriate. Alternatively, where purchase price

is less than net book value, if the customers, Commission staff, or OPC demonstrates that the acquisition will cause harm to the ratepayers, i.e., that rates will be higher than they would otherwise have been under the selling utility, or that quality of service will deteriorate under the purchasing utility, then it may be appropriate either to impose a negative acquisition adjustment or not approve the transfer at all. Absent extraordinary circumstances, the original cost valuation most closely represents the actual amount of dollars that have been invested in the facilities of the selling utility and the purchasing utility which are used and useful in providing service to the ratepayers.<sup>4</sup>

In addition, the issue of acquisition adjustments should be addressed and resolved in the transfer proceeding. This will allow utilities to structure purchases so that they will know from the outset if an acquisition adjustment will be imposed for ratemaking purposes and remove the uncertainty related to this issue in the future.

## V. OTHER JURISDICTIONS

Counsel for Southern States, et al. has undertaken an analysis of acquisition adjustment policies applied by other state commissioners. Having reviewed statutes and regulatory orders from at least 35 other states, and having spoken with staff members of the remaining states' regulatory commissions, the following conclusions are drawn:

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<sup>4</sup>This principle has been expressly adopted by the Arkansas Public Service Commission in Docket No. 86-048-U, Order No. 17, at pg. 9 (issued March 23, 1987).

1. The Florida Public Service Commission's current acquisition adjustment policy is in conformity with a majority of the other states. As a general rule, most states only give rate base treatment to the net book value of an acquired asset. Both positive and negative adjustments are generally not permitted. In Utah, for example, only depreciated book value is included in an acquiring utility's rate base. Exceptions to this rule are considered "unusual" and evaluated on a case by case basis. Public Service Commission Utah Order, Docket No. 82-035-13.

2. Some states strictly limit ratemaking treatment of acquired assets to net book value. For example, staff testimony in a recent Missouri Public Service Commission docket reveals that the state has utilized net original cost as a basis for valuation of rate base for many years without granting ratemaking treatment to negative acquisition adjustments. Where utility assets are acquired far below net book value they are recorded at book value rather than purchase price. Rebuttal Testimony of C. Featherstone, Case No. EM-91-213. Similarly, Vermont is an original cost jurisdiction which uses the net book value of acquired property to determine the amount upon which a return should be earned. Net book value is not considered by the Vermont Public Service Board to be the fair market value of the acquired asset but, rather, the net investment. Thus, as a general matter, book value is used to determine rate base. Order, issued July 7, 1988 in Docket No. 5396; see also, Massachusetts Department of Public Utilities, D.P.U. #88-67, Order issued September 30, 1988 at p. 26.

3. Many states have specific criteria which must be met prior to inclusion of a positive acquisition adjustment in the acquiring utility's rate base. In Minnesota, for

example, a utility must show that (1) it has generated benefits to ratepayers; (2) that the benefits are quantifiable; and (3) that the benefits would not have been realized by the ratepayers without the acquisition. Minnesota Public Utilities Commission order, issued July 12, 1991 in Docket No. G-010/GR-90-678. In Tennessee, the transfer of a system at greater than net book value may be considered in the public interest if the buyer can demonstrate an ability to (1) service the existing customer more efficiently than the present owner; and (2) achieve an identifiable cost savings sufficient to offset the impact of increasing the book value of the existing system. Tennessee Public Service Commission order, issued February 13, 1987 in Docket No. U-86-7442. Similarly, while the Iowa Department of Commerce considers a list of relevant factors, a rebuttable presumption against inclusion in rate base of acquisition costs in excess of net book value exists. Final Decision and Order, issued June 17, 1988 in Docket No. RPU-87-3. Similar specifically articulated criteria which must be met to support inclusion of a positive acquisition adjustment in rate base are utilized by state utility commissions in Illinois, Indiana, Michigan, Mississippi, Nebraska, Pennsylvania, and South Dakota.

4. Negative acquisition adjustments are rarely made to the rate base of an acquiring utility. For the most part, the various state commissions provided information regarding treatment of positive acquisition adjustments because the issue arises more frequently.

While the issue of acquisition adjustments is usually treated on a case by case basis, we discovered three states that have statutes specifically addressing the issue: Alaska, Pennsylvania, and Washington. The statutes are in general agreement with

Florida's acquisition adjustment policy. For example, in Alaska, the commission is guided by acquisition cost, or if lower, the original cost of the person first devoting the property to public service, less accrued depreciation, plus materials and supplies and a reasonable allowance for cash working capital when acquired. Alaska Statutes Section 42.05.441 (b).

The orders, statutes and policies of other states demonstrate that the current Florida Public Service Commission policy is consistent with the acquisition adjustment treatment of the great majority of other states. Public Counsel's argument that a negative acquisition adjustment should be made to the acquiring utility's rates is one that is sparingly and infrequently embraced by other state commissions. Quite to the contrary, the other jurisdictions recognize the incentives and customer benefits provided by a policy which uses net book value as the minimum rate base amount.

## VI. CONCLUSION


The only proponent of the policy change under consideration, Public Counsel, has not presented any evidence that customers of acquired utilities have ever been harmed under the Commission's existing policy. Indeed, Public Counsel admits that the acquisition of small utilities by large utilities is desirable and large utilities should be given an incentive to do so. Public Counsel totally ignores the benefits these customers derive when served by larger, professional utility companies with the technical expertise, financial wherewithal and desire to provide safe high quality utility service to them. These

facts should not be undervalued given the increasing costs of meeting new and more stringent environmental and other regulatory requirements. In light of these facts and for the reasons set forth above, the Commission's current acquisition adjustment policy should remain unchanged.

The Commission's current ratemaking treatment of potential acquisition adjustments ensures that customers are not harmed by the acquisition. Positive acquisition adjustments should be allowed when the acquiring utility demonstrates significant benefits to customers. The utility should bear the burden of proving the appropriateness of a positive acquisition adjustment. On the other hand, negative acquisition adjustments should be limited to transfers where the Commission finds that customers will be harmed by virtue of the acquisition. The customers or Public Counsel should bear the burden of establishing the justification for a negative acquisition adjustment. In all cases, the issue of acquisition adjustment should be resolved in the transfer proceedings.

Respectfully submitted,

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## CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing Comments of Southern States Utilities, Inc., Deltona Utilities, Inc., and United Florida Utilities Corporation on Acquisition Adjustment Policy was furnished by U. S. Mail to the following parties of record this 9th day of August, 1991:

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