



Public Service Commission

CAPITAL CIRCLE OFFICE CENTER • 2540 SHUMARD OAK BOULEVARD
TALLAHASSEE, FLORIDA 32399-0850

-M-E-M-O-R-A-N-D-U-M-

RECEIVED-FPSC
OCT -5 PM 1:34
RECORDS AND REPORTING

DATE: 10/5/00

TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYO)

FROM: DIVISION OF APPEALS (MOORE) *CTM*
 DIVISION OF ECONOMIC REGULATION (WILLIS HEWITT) *RTT*
 DIVISION OF LEGAL SERVICES (BRUBAKER) *CBH*
 DIVISION OF POLICY ANALYSIS & INTERGOVERNMENTAL LIAISON (MANN) *HM*

RE: DOCKET NO. 001502-WS - PROPOSED RULE 25-30.0371, ACQUISITION ADJUSTMENT

AGENDA: 10/17/00 - REGULAR AGENDA - RULE PROPOSAL - INTERESTED PERSONS MAY PARTICIPATE

RULE STATUS: PROPOSAL MAY BE DEFERRED

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\APP\WP\001502.RCM

CASE BACKGROUND

An acquisition adjustment is a regulatory convention by which the books of the utility are adjusted to reflect changes in the historical rate base valuation resulting from purchase prices that differ from original cost rate base valuations. Whether an acquisition adjustment is included in rate base is a decision made by the Commission. A positive acquisition adjustment may be recorded when the purchase price of the transaction is above the original cost rate base valuation. For example, if the original cost rate base valuation would be \$100, but an acquiring utility paid \$120 for the assets, a positive acquisition adjustment, if approved, would inflate the rate base valuation to \$120. The acquiring utility would then be permitted to earn a rate of return on the investment of \$120.

DOCUMENT NUMBER-DATE

12704 OCT-58

FPSC-RECORDS/REPORTING

A negative acquisition adjustment may be recorded when the purchase price of the utility is below the original cost rate base valuation. If approved, the negative acquisition adjustment reduces the rate base valuation to the level of the purchase price. In the above example with an original cost rate base valuation of \$100, but with a purchase price of \$80, a negative acquisition adjustment, if approved, would reduce rate base to the \$80 purchase price.

Since approximately 1983, the Commission has had a policy on acquisition adjustments for water and wastewater utilities that absent extraordinary circumstances, the purchase of a utility system at a premium or discount shall not affect rate base. In In re: Investigation of Acquisition Adjustment Policy, Order No. 25729, issued February 17, 1992, the Commission found that this policy has produced the intended result of creating incentives "for larger utilities to acquire small, troubled utilities." Investigation, Order No. 25729 at pages 1-2.

In Order No. 25729, the Commission explained why it believes its policy is appropriate and what benefits it believes are derived from the policy:

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 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, reduction in the high cost of debt due to lower risk, the elimination of substandard operation 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.

Order No. 25729 at pages 3-4.

The Commission has approved an adjustment in very few cases. The Commission has included a positive acquisition adjustment in cases where a larger utility bought a smaller troubled utility, where a purchase price determination was supported by a competitive bid process, and inclusion of a positive acquisition adjustment still allowed for lower rates and the promise of improved utility management. See Order No. 23111, issued June 25, 1990, in Docket No. 891110-WS; Order No. PSC-92-0895-FOF-WS, issued August 27, 1992, in Docket No. 920177-WS; and Order No. PSC-93-1819-FOF-WS, issued December 22, 1993, in Docket No. 930204-WS.

The Commission has recognized four negative acquisition adjustments since 1988, two of which were based on settlement agreements with OPC, a third based on a finding that a transfer involved a non-arms length, non-taxable transaction between related parties, and lastly, a case involving an adjustment that was used to correct "lost CIAC." See Order No. 22962, issued May 21, 1990, in Docket No. 881500-WS; Order No. PSC-93-0011-FOF-WS, issued January 5, 1993 in Docket No. 920397-WS; Order No. PSC-93-1675-FOF-WS, issued November 18, 1993, in Docket No. 920148-WS; and Order No. PSC-97-0034-FOF-WS, issued January 7, 1997, in Docket No. 960040-WS.

A notice of proposed rule development was published in the November 12, 1999, edition of the Florida Administrative Weekly. A workshop was held on December 2, 1999. Attending were representatives of Florida Cities Water Company, Florida Water Services Corporation, AquaSource Utility, Inc., and the Office of Public Counsel.

Staff has recommended Rule 25-30.0371 in order to codify existing Commission policy on acquisition adjustments in the water and wastewater industry. Staff in the Division of Policy Analysis and Intergovernmental Liaison are, however, continuing to investigate what if any incentives can and should be considered for acquisitions of small water and wastewater systems by larger, more financially viable companies.

Attachment A is the recommended rule. Attachment B is the memorandum regarding the Statement of Estimated Regulatory Costs. Attachment C is a background paper prepared for the March 30, 1999, Internal Affairs meeting.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission propose Rule 25-30.0371, F.A.C., governing acquisition adjustments for water and wastewater utilities?

RECOMMENDATION: Yes. The Commission should propose Rule 25-30.0371, F.A.C.

STAFF ANALYSIS: Chapter 120, Florida Statutes, the "Administrative Procedure Act", provides that "[e]ach agency statement defined as a rule by s. 120.52 shall be adopted by the rulemaking procedure provided by this section as soon as feasible and practicable." §120.54(1)(a), Fla. Stat. (1999). Staff recommends that the Commission propose the attached rule in order to codify its policy and comply with this statute. The rule implements section 367.071(5), Florida Statutes, which authorizes the Commission to establish the rate base for a utility when it approves a sale, assignment, or transfer, and section 367.081(2)(a), Florida Statutes, requiring the Commission to fix rates and to consider the cost of providing service including a fair return on the investment of the utility in property used and useful in the public service. In addition, section 367.121(1)(a) and (b) provide the Commission with the power to prescribe fair and reasonable rates and charges, and to prescribe a uniform system and classification of accounts for all utilities.

Section (1) of the attached rule defines "acquisition adjustment" as "the difference between the purchase price of utility system assets to an acquiring utility and the net book value of the utility assets" and describes when a positive or negative acquisition adjustment exists. Section (2) provides that such an adjustment shall not be included in rate base absent proof of extraordinary circumstances.

Sections (3) and (4) address positive and negative acquisition adjustments respectively and both provide that the entity that believes such an adjustment should be made has the burden to prove the existence of extraordinary circumstances. This is consistent with the Commission's decision in In re Wedgefield Utilities, Order No. PSC-98-1092-FOF-WS, issued August 12, 1998. In addition, sections (3) and (4) list certain factors the Commission will consider to determine whether there are extraordinary circumstances justifying a positive or negative adjustment.

For a positive acquisition adjustment (where the purchase price is greater than the net book value of the utility's assets),

section (3) of the rule provides that the Commission will consider anticipated improvements in quality of service, anticipated compliance with regulatory mandates, anticipated rate reductions, and anticipated cost efficiencies. For a negative adjustment, section (4) of the rule provides for the Commission to consider the anticipated retirement of the acquired assets and the condition of the assets acquired. For both negative and positive adjustments, these factors are listed by way of an example, and other evidence may be offered.

Section (5) of the rule authorizes the Commission to subsequently modify an acquisition adjustment if the circumstances that initially justified it do not materialize, or if they are eliminated or changed within five years. Five years is believed to be a reasonable time in which to evaluate the circumstances justifying an adjustment. The Commission took this action in a docket involving Chesapeake Utility Corporation. The Commission approved a positive acquisition adjustment for Central Florida Gas Company to reflect expected savings from the company's acquisition by Chesapeake. Order No. 18716, Docket No. 870118-GU. The Commission in a subsequent rate review found that the predicted savings never materialized and removed the acquisition adjustment from rate base. Order No. 23166, issued July 10, 1990, in Docket No. 891179-GU.

Staff believes that unless extraordinary circumstances exist, a buyer should step into the shoes of the seller. Rates will remain unchanged at the time of transfer, regardless of whether the buyer pays a premium or purchases the utility at a discount. Even though the new owner earns a return on \$100 of plant when he may only have \$50 invested, for example, staff believes that the assets placed into service are still worth \$100 (assuming net book value) and that the transfer price is more a measure of industry risk and responsibility than it is a measure of asset valuation.

In the past, the Commission has decided to rely on historical costs and has not readjusted rate base in these circumstances. If historical costs are ignored, two problems are created. First is the creation of uncertainty in the market. Parties negotiating the sale of a utility would be uncertain of what value the Commission would place on the rate base of the acquired system. This could have detrimental effects on the market for water and wastewater systems through the addition of uncertainty regarding the regulated valuation of utility assets. Secondly, standard imposition of an acquisition adjustment ignores the underlying characteristics of the industry. The owner of the typical small troubled utility that is sold for a discount has few, if any, options upon deciding to

get out of the business. The alternative to a sale at a discount may be abandonment or receivership. Incentives are needed in many cases to encourage takeovers that will benefit customers.

Staff believes that codification of the Commission's policy by rule will reduce costs in future proceedings by diminishing the controversy over acquisition adjustments and expediting transfer or rate case proceedings.

Statement of Estimated Regulatory Costs

A Statement of Estimated Regulatory Costs was not prepared because there should be no additional costs other than the cost to promulgate a rule. There should also be no significant negative impacts on utilities, small businesses, small cities or small counties.

ISSUE 2: If no requests for hearing or comments are filed, should the rule amendments as proposed be filed for adoption with the Secretary of State and the docket be closed?

RECOMMENDATION: Yes.

STAFF ANALYSIS: Unless comments or requests for hearing are filed, the rules as proposed may be filed with the Secretary of State without further Commission action. The docket may then be closed.

1 25-30.0371 Acquisition Adjustment

2 (1) For the purpose of this rule, an acquisition adjustment is
3 defined as the difference between the purchase price of utility
4 system assets to an acquiring utility and the net book value of the
5 utility assets. A positive acquisition adjustment exists when the
6 purchase price is greater than the net book value. A negative
7 acquisition adjustment exists when the net book value is greater
8 than the purchase price.

9 (2) An acquisition adjustment shall not be included in rate
10 base absent proof of extraordinary circumstances.

11 (3) Any entity that believes a full or partial positive
12 acquisition adjustment should be made has the burden to prove the
13 existence of those extraordinary circumstances. In determining
14 whether extraordinary circumstances have been demonstrated, the
15 Commission will consider evidence provided to the Commission such
16 as anticipated improvements in quality of service, anticipated
17 compliance with regulatory mandates, anticipated rate reductions,
18 and anticipated cost efficiencies.

19 (4) Any entity that believes a full or partial negative
20 acquisition adjustment should be made has the burden to prove the
21 existence of those extraordinary circumstances. In determining
22 whether extraordinary circumstances have been demonstrated, the
23 Commission will consider evidence provided to the Commission such
24 as the anticipated retirement of the acquired assets and the
25 condition of the assets acquired.

CODING: Words underlined are additions; words in ~~struck through~~ type are deletions from existing law.

1 (5) Any full or partial acquisition adjustment, once made by
2 the Commission, may be subsequently modified if the extraordinary
3 circumstances do not materialize, subsequently are eliminated or
4 changed within five years of the date of the order approving the
5 acquisition adjustment.

6 Specific Authority: 350.167(2), 367.121(1)(f), FS.

7 Law Implemented: 367.071(5), 367.081(2)(a), 367.121(1)(a)(b), FS.

8 History: New _____.

9
10
11
12
13
14
15
16
17
18
19
20
21
22
23
24
25

CODING: Words underlined are additions; words in ~~struck~~
~~through~~ type are deletions from existing law.

MEMORANDUM

August 31, 2000

TO: DIVISION OF APPEALS (MOORE)

FROM: DIVISION OF ECONOMIC REGULATION (HEWITT) *MS* *EB* *RM*

SUBJECT: STATEMENT OF ESTIMATED REGULATORY COSTS FOR PROPOSED RULE 25-30.0371, F.A.C., ACQUISITION ADJUSTMENT

Rule 25-30.0371, F.A.C., Acquisition Adjustment, would codify the Commission's policy of not allowing a positive or negative adjustment to utility system asset values when purchased by a jurisdictional utility except with proof of extraordinary circumstances. If, when a full or partial acquisition adjustment is granted by the Commission and the extraordinary circumstances are not sustained, then the adjustment could be modified. Although this modification has not been past policy, eliminating an unsubstantiated benefit should not be considered a cost.

The Florida Administrative Procedures Act (APA) requires an agency to codify policy into rules or face sanctions, fines, or other costs. Therefore, without this proposed rule, this agency could have higher costs.

The APA encourages an agency to prepare a Statement of Estimated Regulatory Costs (SERC). However, there should be no additional costs other than the costs to promulgate a rule and no significant negative impacts on utilities, small businesses, small cities, or small counties. Therefore, a SERC will not be prepared for the proposed rule at this time.

cc: Mary Andrews Bane

acqadjmm.cbh



Public Service Commission

-M-E-M-O-R-A-N-D-U-M-

DATE: March 24, 1999

TO: WILLIAM D. TALBOTT, EXECUTIVE DIRECTOR

FROM: CHARLES H. HILL, DIRECTOR, DIVISION OF WATER AND WASTEWATER

RE: ACQUISITION GOALS AND ACQUISITION ADJUSTMENTS

CRITICAL INFORMATION: ACTION IS NEEDED.

STAFF SEEKS DIRECTION FROM THE COMMISSION ON THE SUBJECT OF INITIATING RULEMAKING ON ACQUISITION ADJUSTMENTS AND CHANGES TO THE MOU WITH DEP TO INCORPORATE THE RELEVANT GOALS DISCUSSED IN THE ATTACHED WHITE PAPER.

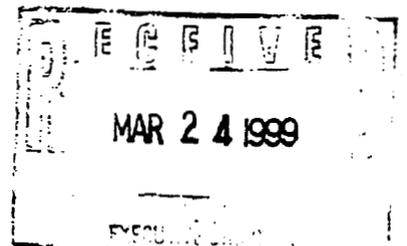
PLEASE PLACE ON THE MARCH 30, 1999 INTERNAL AFFAIRS.

At the July 21, 1998 agenda conference, Commissioner Clark requested that staff bring proposed rule language, relating to acquisition adjustments, to the Commission. The staff believes that the attached language (Attachment A) is language which best represents the Commission's past stated goals and objectives for the water and wastewater industry. Similar language was initially proposed in 1992 as part of a larger water and wastewater rulemaking package and the Commission chose not to adopt the rule at that time. There are several new members on the Commission since that time and for that reason staff prepared the attached white paper (Attachment B) as background.

Staff is bringing this to the Commission for general direction on the subject of acquisition adjustments before we initiate rulemaking. The rule language contained on Attachment A is offered for discussion purposes. We believe this language would codify what the Commission's practice and policy has been on this matter. However, staff is prepared to initiate rulemaking on whatever language the Commission would like contained in an acquisition adjustment rule. Once we obtain some general direction from the Commission, we will pursue rulemaking through the established procedure.

In addition, it is anticipated that the Commission will soon be updating its memorandum of understanding (MOU) with the Department of Environmental Protection (DEP) relating to capacity development issues. Staff believes it is appropriate that some language relating to its position on industry consolidation and acquisitions be included in the MOU when the capacity development issues are addressed. The attached white paper discusses the Commission's stated objectives as represented in Order No. 25729. If the Commission agrees with these objectives (pages 2-3, Attachment B), staff will pursue changes to the MOU to include these objectives.

cc: Dr. Mary Bane, Deputy Executive Director, Technical
James Ward, Deputy Executive Director, Administrative
Division of Legal Services (Davis, Jaber)
Division of Appeals (Smith)



25-30.0371 Rate Base Established at Time of Transfer. This rule applies to any utility purchased by a utility regulated by this Commission.

(1) For the purposes of this rule and Sections 25-30.037 and 25-30.038, rate base is defined as the net book value of the utility assets involved. Net book value is calculated as Utility Plant In Service net of Accumulated Depreciation, Construction Work in Progress, Contributions In Aid of Construction, Advances for Construction and Accumulated Amortization of Contributions In Aid of Construction. The Commission shall also consider the condition of the utility assets purchased in deciding if a purchased asset should be removed from the rate base calculation.

(2) In the absence of extraordinary circumstances, a purchase of a utility system at a premium or discount shall not affect the rate base calculation. The rate base shall be unaffected as a result of the transfer.

(3) In calculating negative and positive acquisition adjustments the following factors may be considered by the Commission:

(a) Acquisition costs (i.e., legal and administrative costs, outstanding fines, etc.),

(b) The condition of the plant (i.e., real worth of assets).

CODING: Words underlined are additions; words in struck through type are deletions from existing law.

ACQUISITIONS AND ACQUISITION ADJUSTMENTS

I. Introduction

The composition of the water and wastewater industry in Florida is an amalgam of large municipal and county systems, many mid-sized city or community-owned systems, a few large investor-owned systems, some mid-sized investor-owned systems and many investor-owned and co-operatively owned small systems. Only investor-owned utilities are under PSC jurisdiction and only those in counties which choose to be regulated by the state. As of now 37 counties have chosen to have the PSC regulate investor owned water and wastewater utilities.

Since the enactment of the Safe Drinking Water Act (SDWA) of 1986, the water and wastewater industries have had to meet increasingly stringent environmental and water quality standards. Thus, the industry has become one of rising costs. In addition, the water and wastewater industries have a higher capital investment to revenue ratio than other utility services. Together, these factors result in high and rising costs for water and wastewater utilities.

As a direct result of high and rising costs, a large segment of the industry comprised of utilities serving less than 500 connections (roughly $\frac{1}{2}$ of the total number of regulated companies in Florida) are in jeopardy of not being able to sustain their operations without serious environmental or water quality problems. Thus, it is common for larger utilities, both regulated and unregulated, to acquire smaller utilities that may have significant environmental and water quality compliance issues. Even if these smaller systems do not have compliance problems as yet, there are other factors that tend to work against their ability to sustain safe, efficient and cost effective operation for the long term. The difficulties facing smaller utilities are well documented and we will not address them at length here.

The proliferation of smaller systems in years past, combined with the effects of the SDWA, have created an environment where consolidation of smaller water systems seems to be the most appropriate method to address the issues of environmental and water quality compliance as well as financial viability. In addition, issues such as conservation, reuse, service quality and affordability, are generally easier to address for larger utilities than for smaller ones. As a result of these factors, acquisitions are a common event in the water and wastewater industry.

II. Acquisition Adjustments

An acquisition adjustment is a regulatory convention by which the books of the utility are adjusted to reflect changes in the historical rate base valuation resulting from purchase prices that differ from original cost rate base valuations. The need to develop this separate accounting treatment is largely a consequence of certain abuses in the utility industry during the acquisition and merger period of the 1920's and 30's. The decision to include an acquisition adjustment in rate base must be made by the Commission. For example, if the original cost rate base valuation would be \$100, but an acquiring utility paid \$120 for the assets, a positive acquisition adjustment, if approved, would inflate the original cost rate base valuation to \$120. The acquiring utility would then be permitted to earn a rate of return on the investment of \$120. It has been argued that in certain situations such an adjustment provides incentive for the acquisition of troubled or run down utilities by larger and more able utilities.

A negative acquisition adjustment is recorded when the purchase price of the transaction is below the original cost rate base valuation. If approved, the negative acquisition adjustment reduces the rate base valuation to the level of the purchase price. In the above example, assume a purchase price of \$80. An approved negative acquisition adjustment would reduce rate base to the \$80 purchase price. The rationale in this instance is to not permit an acquiring utility to earn a return on a value greater than its actual investment.

A. Current Practice

Current commission policy with regard to acquisition adjustments was formalized in a generic proceeding by two orders, PAA Order No. 23376, issued 8/21/90 and Final Order No. 25729, issued 2/17/92. The Commission stated the following:

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 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.

Also in Order No. 25729, the Commission goes on to elaborate why it believes its practice is appropriate and what benefits it believes are derived from this practice:

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 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, reduction in the high cost of debt due to lower risk, the elimination of substandard operation 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.

B. Review of Cases

The Commission has addressed this matter in many cases individually and at least twice as a generic investigation at the behest of the Office of Public Counsel (OPC). As recently as March 1998 the Commission addressed this issue, in Dockets No. 960235-WS and 960283-WS, both dockets involved Wedgefield Utilities acquisition of Econ Utilities. The Commission found in that case that no adjustment was necessary. As part of the testimony received in the case, Mr. Frank Seidman, a consultant for Wedgefield, compiled an analysis of every case, from 1988 to 1997, for which acquisition adjustment was an issue.

1. Negative Acquisition Adjustments

A review of those cases indicated that the Commission had addressed the issue of positive acquisitions 99 times from January 1988 to December 1997. In that ten year period, 31 orders addressed negative acquisitions. On only 3 occasions did the Commission record a negative acquisition adjustment for regulatory purposes.

In 16 cases that the Commission did not make a negative acquisition adjustment it considered the following factors:

1. Is the system in such poor condition that it needs replacement?
2. Was the purchase prudent in light of jurisdictional status, growth potential and per customer operating costs?
3. Are there benefits due to the purchaser's ability to attract capital at lower costs, economies of scale and managerial and operational expertise?
4. Is the purchaser making improvements in the public interest?

In addition, the Commission found that it was not necessary to show hardship on the part of the seller, that the purchase price to rate base relationship was not an extraordinary factor, and that the failure of the previous owner not to maintain the system and considerable expenditures by the new owners were not extraordinary circumstances and were not reasons to include a negative acquisition adjustment in rate base.

Other factors raised by dissenting opinions were that purchasers should be aware of and consider the "incentive" purpose of the Commission policy, that uniform rates not result in cross subsidies, that the purchaser be a large utility with expertise in utility operations and that customers not pay for anything twice. The Commission has frequently been reluctant to approve acquisitions that may lead to immediate and substantial rate increases to acquired customers even when it appears to be in the long term best interests of the customers. In addition, the Commission has been equally concerned about the subsidy issue between existing customers and acquired customers when the acquired utility requires significant rehabilitation. A judgement is

ATTACHMENT B

required on the part of the Commission as to whether public interest is better served by consolidation and whether this goal outweighs the Commission's desire to mitigate inherent subsidies between customer groups.

In one of the three cases in which the Commission granted a negative acquisition adjustment, the purchase of Beacon 21 by Laniger Enterprises, Docket No. 881500-WS, it determined in its initial decision that a negative adjustment was not necessary. OPC protested the case and in a subsequent settlement the utility agreed to a negative acquisition adjustment. In accepting the settlement the Commission noted that the negative acquisition adjustment was contrary to established practice. Since this was a settlement, no issues of fact were addressed.

In the second of the three cases, the Commission decided in a staff assisted rate case that extraordinary circumstances supported a negative acquisition adjustment. Those circumstances were: 1) that the transfer of utility assets involved a three-party nontaxable exchange in which two of the parties were considered virtually the same; 2) that the developer fully recovered its investment in the utility through the exchange; and 3) that without the adjustment the developer would allegedly double recover its investment.

In the third case of a negative acquisition adjustment the Commission reversed its decision in a transfer case. In a subsequent rate case, OPC argued that the utility was in "bad shape" at purchase, the prior owner did not maintain the utility, the prior management was neglectful and that a negative acquisition adjustment would insulate the customers from the failures of prior management. The Commission agreed with OPC and cited customer testimony, the need for repairs and improvements at the time of transfer, and the lack of responsibility of management. One Commissioner dissented for three reasons: 1) the Commission had already rendered its decision on this issue in a previous order, 2) the OPC witness had testified that the purchase was not extraordinary, and 3) in the absence of extraordinary circumstances, the prior decision should remain undisturbed. The dissent in this case was consistent with past Commission policy and practice.

In the 12 remaining cases the Commission did not make the adjustment based solely on its statement of existing policy and no party raised the issue of extraordinary circumstances.

2. Positive Acquisition Adjustments

There were 68 cases which dealt with or appeared to deal with purchase price above rate base. Of these, only three had positive acquisition adjustments included in rate base. All but 10 of the orders relied solely on the statement of the Commission's acquisition adjustment policy as the basis for not making an acquisition adjustment to rate base.

Generally the Commission has identified the following benefits when granting a positive acquisition adjustment:

1. Elimination of financial pressure due to the inability of the old owner to attract capital;
2. Ability of the new owner to attract capital;
3. Reduction in the high cost of debt due to the lower risk of the new owner;
4. Elimination of substandard operating conditions;
5. Ability of the new owner to make necessary improvements;
6. Ability of the new owner to meet DEP standards;
7. Reduced costs due to economies of scale and the ability of the new owner to buy in bulk;
8. Introduction of more experienced management;
9. Elimination of generally disinterested developer ownership.

The Commission also recognized that customers of the utility indeed benefit from a better quality of service under the acquiring utility.

The utility witness in the Wedgefield case, Mr. Carl Wenz testified that, "As you may be aware, Utilities, Inc., or its subsidiaries, have purchased several utilities in Florida. The Commission's policy regarding acquisition adjustments has entered into all those decisions. Without the Commission's long established policy on acquisition adjustments, many of the purchases, including this one, would probably not even have been

considered....The Commission's long-standing policy on acquisition adjustments has been understood and relied upon while bargaining in good faith , and at arm's length for these troubled utilities acquired over the years....The policy has worked as it was intended."

Another possible incentive component of the Commission's current practice reveals itself when multiple transactions occur. If a purchasing utility is able to acquire a smaller system at a price below rate base it may be able to justify paying more than rate base for the next acquired system. At least one utility has expressed this opinion, informally, to staff in the past.

The question of whether the policy as stated in Order No. 25729 has accomplished the stated goals is subject to debate. Since 1992, the year the order was issued, the Commission has approved sixty-three transfers and twenty-three transfers of majority organizational control. The most frequent purchaser of other additional systems has been Utilities Inc. The number of systems the Commission regulates has decreased from 1363 in 1995 to 1304 in 1998. The number of utility companies has decrease from 384 in 1995 to 339 in 1998. The ratio of systems per company has increased from 3.55 in 1995 to 3.85 in 1998. This would seem to indicate a general consolidation trend in the industry. The most active utilities in volume of acquisitions since 1992 have been Utilities, Inc. and, more recently, Aquasource, Inc. Aquasource has made all of its acquisitions in 1998 and 1999. Including pending approvals they have acquired approximately 11 utilities.

B. Acquisition Practices of Other States

Subsequently, the staff consulted other Commissions and held workshops to discuss other possible acquisition incentives. A summary of relevant findings in other states as well as comments filed by various parties in staff workshops and the rule proceeding follows.

1. New York

In 1994 the New York Department of Public Service (NYDPS) adopted a policy statement to encourage acquisitions of smaller troubled systems by larger systems. It included in its policy a number of options to provide incentives for such acquisitions. Acquisition adjustments were among a list of possible incentive mechanisms. The NYDPS stated its intention to foster acquisitions and mergers if such transactions would address the following goals:

1. Improve the ability of small water companies to provide service;
2. Improve customer service;
3. Make it easier to comply with current and future regulations;
4. Avoid drastic rate increases;
5. Bring the rates of merged systems into parity;
6. Improve and consolidate management and operation; and
7. Promote conservation (NYDPS, 1994).¹

The NYDPS also provides for acquisition incentives if there is clear customer benefit. A water company must demonstrate long run viability and be able to provide safe and adequate service. Acquisition incentives will be considered based on the following factors:

1. Whether the acquiring company has the ability to adequately manage, serve customers, comply with regulations and finance capital improvements.
2. Whether the impact on customers resulting from the acquisition is as beneficial or more beneficial than realistic alternatives.
3. Whether the terms of the acquisition will permit future beneficial solutions, such as municipalization.
4. Whether customer benefits are expected to be commensurate with the incentives for the acquisition or merger.
5. Whether meaningful customer participation has been obtained through effective public involvement.²

¹ New York Department of Public Service Statement on Policy of Acquisition Incentive Mechanisms for Small Water Companies, August 8, 1994.

² Ibid.

The NYDPS also expressed its willingness to consider additional incentives where proposals are made to consolidate several water systems at once.

The actual incentives to be considered were identified by category and are listed below:

1. Rate Base

a. Where purchase price is less than the rate base of the utility being acquired, we will consider allowing rates to reflect the full rate base of the acquired company.

b. Where the purchase price is greater than the rate base, [the NYDPS] will consider allowing the rates to the purchase price premium. Such an adjustment could be justified by improved service, realized cost efficiencies and economies of scale.

c. Where capital expenditures are required for service improvement or compliance reasons, we will consider allowing projected improvement costs to be reflected in rates immediately, subject to later review.

d. When the acquired company has little or no rate base we will consider allowing a proxy rate base equivalent to the rate base per customer of the acquiring company.

2. Depreciation

Where circumstances warrant, accelerated depreciation or depreciation on projected improvement costs subject to later reconciliation may be permitted.

3. Amortization

Amortization may be considered as a means of recovering the reasonable costs of acquisition and/or the recovery of a purchase premium. The term of the amortization should consider adverse customer impact.

In addition, the following incentives may be considered in special cases for good cause shown:

4. Operating Ratio

This mechanism may be used [for rate setting] in cases where rate base mechanisms may be less effective.

5. Rate of Return

When accompanied by appropriate justification, it may be beneficial to allow a premium on the overall rate of return as an acquisition incentive.

6. Delayed Recovery

Where acquisition costs or improvement costs, or the effects of rate equalization may cause adverse customer rate impact a phase-in recovery or delayed recovery may be appropriate rather than lose the opportunity for consolidation.

7. Lease/Buy-out

When the overall benefit of an acquisition is uncertain and a trial takeover of management, operation, and ownership appear to be beneficial we may consider leased company operation with an option to buy as a way to provide incentive.³

A recent contact with the NYDPS revealed that despite strong initial interest in the acquisition incentive program in 1994 only one utility has since petitioned for incentives under the program. That utility is Aquasource Utilities, Inc. Aquasource is also currently acquiring systems in Florida and Texas, as well. Aquasource has entered into an agreement with NYDPS that will freeze current rates for a period of four years after which rates may be increased by a factor based on the cost of the GDP (similar to PSC index) for each of the next 7 years.

The NYDPS has also been approached by Aquasource to consider future rate setting for its systems based on average plant cost per

³ Ibid.

customer plus a reasonable expense to determine water and wastewater rates.

2. Pennsylvania

Pennsylvania has also adopted a policy of encouraging industry consolidation and acquisitions if the proposed transaction meets the following thresholds:

1. The acquisition is in the public interest;
2. The acquisition will not effect the viability of the acquirer;
3. The acquired system has less than 3,300 connections, is not currently viable, is in violation of statutory and regulatory standards, and has failed to timely comply with any order of the DEP or PUC;
4. The acquired system's customers will receive improved service in a reasonable time frame;
5. The purchase price is fair and reasonable and conducted through arms' length negotiations;
6. Single tariff pricing should be implemented to the extent reasonable. Phased in implementation of rates may be appropriate if necessary to address affordability.⁴

The specific incentive mechanisms to be considered include:

1. Rate of Return Premiums

Additional rate of return basis point may be awarded for certain acquisitions or improvement costs based on sufficient support filed by the utility in a rate proceeding;

2. Acquisition Adjustment

When acquisition costs exceed depreciated original

⁴ National Association of Water Companies Source Book of Regulatory Techniques for Water Utilities, June, 1997, p 1.1-11.

cost, a reasonable excess may be included in rate base and amortized over 10 years;

3. Deferral of Acquisition Improvement Costs

In cases where improvement costs are too great to be absorbed by rate payers at one time, rate recovery may be in phases.

4. Plant Improvement Surcharge

Extraordinary improvement costs may be temporarily offset by surcharging the customers of the acquired system. If those improvements benefit only the customers of the acquired system the improvement costs may be allocated to those customers on a greater than average (but less than 100%) basis to the new customers for a reasonable period of time.⁵

The Pennsylvania policy also states that other incentives may be considered if they meet the outlined criteria. Requests for incentives will be considered on a case by case basis in the context of a rate case. The burden of proof lies with the acquiring utility. There has been no recent activity in the state of Pennsylvania relating to acquisition policy and to date staff has been unable to discover any specific cases where the policy has been applied.

3. California

The California Public Utilities Commission (CPUC) began workshops in 1997 to investigate the dynamics of acquisitions and mergers of water utilities in its state. One of the issues before the Commission was the use of original cost to establish rate base versus replacement cost new less depreciation (RCNLD) in acquisition cases. Before the CPUC could conclude its investigation, the California legislature enacted HB 1268 permitting "fair market value" (as determined by actual purchase price) rate base valuation if less than RCNLD.

⁵ Ibid, p12.

ATTACHMENT B

California Public Utilities Code Section 2718-2720 is the Public Water System Investment and Consolidation Act of 1997. The legislature found:

1. Public water systems face replacement and upgrade costs due to the Safe Drinking Water Act and state regulations and requirements;
2. Increasing amounts of capital necessary to fund public water system investment;
3. Scale economies are achievable;
4. Providing incentives to achieve economies will provide benefits to rate payers.⁶

In order to encourage investment and consolidation in public water systems, Section 2720 provides:

1. The Commission (CPUC) shall use "fair market value" when establishing rate base for distribution systems of public water systems acquired by a water corporation;
2. If "fair market value" is greater than RCNLD the Commission may include the difference in the rate base for rate purposes if additional amounts are fair and reasonable. Fairness and reasonableness determinations may consider whether the acquisition will improve reliability, compliance, efficiencies, and economies of scale that would not otherwise be available and the impact to consumers will be fair and reasonable.

The CPUC has processed several cases implementing the policy outlined in the statute. There have been four cases which have served to shape the existing CPUC policy. Each case has involved the Dominguez Services Corporation, a Class A water utility providing service to approximately 37,250 customers in several areas in California. In the case of acquisition of Rancho Del Paradiso Water Company (Rancho) by Dominguez, Dominguez purchased Rancho for \$13,688 based on its own appraisal of RCNLD of \$21,919. Dominguez requested that rate base be established at \$13,688. The Ratepayer Representation Branch (RRB), the California equivalent of Florida's OPC, protested the proposed acquisition order stating

⁶ Ibid, 1999 Update 1, pp 1.2-9, 1.2-10.

that the rate base value should be established at the original cost less depreciation of \$8987. During negotiations RRB provided a RCNLD appraisal of \$4797. Dominguez demonstrated that when surcharges for assumed outstanding debt were included in the calculation of revenue requirements the difference in the rate base valuations were minimal. A settlement was reached establishing rate base at \$13,000. Dominguez also asserted that its access to lower financing, efficiencies of operation and economies of scale would bring benefits to Rancho customers.⁷

The acquisition of Armstrong Valley Water Co. (Armstrong) by Dominguez followed a similar course with the RRB intervening to object to the proposed "fair market value" rate base valuation. In this case Dominguez requested a rate base of \$196,090 based on a RCNLD appraisal of \$208,064. RRB countered with present rate base at \$160,476. In addition, RRB requested a revised RCNLD appraisal as well as a condition that the Department of Health Services issue a Water Supply Permit. Subsequently, Dominguez obtained a statement from the Department of Health Services stating that Dominguez possessed adequate financial, technical and managerial capability to operate Armstrong and the Water Supply Permit was issued. The parties agreed that rate base would be established at \$175,000 based on a revised RCNLD appraisal of \$178,540.⁸

The acquisition of Lucerne Water Co. (Lucerne Water Co.) by Dominguez was for a purchase price of \$713,214 which was less than its own RCNLD appraisal of \$903,286. The RRB RCNLD appraisal was \$812,247. The book value of Lucerne was \$470,043. Since the "fair market value" did not exceed RCNLD appraisals of either party it did not require the threshold established by statute to justify a "fair market value" rate base valuation. Dominguez intended to replace some 10,000 feet of undersized steel mains and install an additional clarifier. These improvements will improve reliability and improve the system's ability to comply with health and safety regulations. The order states that based on the cost of future operations, Dominguez should be authorized to purchase the assets of Lucerne; rate base should be established at the purchase price of \$713,214; and authority to approve the acquisition should be withheld pending an assurance by the Department of Health Services

⁷ Order of the Public Utilities Commission of the State of California, Application 20 & 21, filed February 19, 1998, Decision 98-11-018 (November 5, 1998).

⁸Ibid.

that Dominguez possesses the adequate financial, managerial, and technical capability to provide proper service.⁹

III. Proposed Rule and Workshops

In 1991, the staff prepared and brought before the Commission a proposed rule attempting to codify the acquisition practice stated in Order No. 25729. That language is attached as Attachment A. In that docket, 911082-WS, the comments and testimony filed by the parties reflect a unanimous sentiment on the part of the industry that the proposed rule and the Commission's policy as stated in the Order No. 25729 is appropriate.

It should be noted that paragraph (3) of the previously proposed rule addresses the burden of proof relating to proposed negative acquisition adjustments. In the previously discussed Wedgefield case, the Commission found that while the burden of proof relating to the existence of extraordinary circumstances clearly rests with the applicant, the burden relating directly to the need for a negative or positive acquisition adjustment may shift absent a demonstration by an opposing party that such circumstances do not exist (Order No. PSC-98-1092-FOF-WS). Staff is recommending that the provision relating to burden of proof be removed if the Commission chooses to pursue rule making on this matter.

The only party to oppose the rule proposal was OPC. Their stated objection to the proposed rule was that it does not believe that purchasing utilities should be allowed to earn a return on so-called "phantom" investment when purchase price is below rate base of the acquired utility. It believes a negative acquisition adjustment is appropriate in such cases absent a showing by the acquiring utility that it should not be made. However, in comments to that proceeding, OPC did concede that as an additional incentive for acquiring troubled systems it would agree to splitting the difference between purchase price and rate base with 80% accruing to the benefit of the customers and 20% to the acquiring utility. OPC does not believe there is any circumstance where a positive acquisition adjustment would be appropriate. The Commission

⁹ Order of the PUC of the State of California, Application 19, filed February 19, 1998, Decision 98-11-019 (November 5, 1998).

previously rejected this notion in Order No. 25729.

The Commission directed staff to conduct workshops on acquisition policy prior to adopting the rule. The comments received during two workshops reinforced the notion that the industry believes the policy as stated in Order No. 25729 is appropriate. The only additional comment gained from the workshop were that the issue of greatest concern to the industry as it related to acquisitions was the Commission's used and useful practices. Of primary concern was that subsequent to acquisitions the used and useful percentage applied to the acquired systems did not enable the utility to earn a fair return on their investment. Since the workshops were directed primarily at the topic of acquisitions, the staff did not pursue further exploration of the used and useful issue at that time.

The staff also sought comment on other acquisition incentives such as those considered by the New York and the Pennsylvania Commission's. Several utilities pointed out that rate of return premiums on the rate base of small utilities did not generate sufficient dollars to create a meaningful incentive. Rate equalization was viewed positively by United Water and Florida Water Services and Utilities, Inc. raised the issue of possible temporary certificates in the event of a protest to a proposed transfer.

Another significant issue was raised by Utilities, Inc. When they noted that due to the ability of one individual to protest a transfer, a lengthy delay in completing the transfer could occur. Utilities, Inc. argued that such delay had caused them to lose out on some acquisitions because governmentally owned systems had been able to consummate a transaction much faster. OPC did not comment during the workshops.

IV. Summary

A key element in each of the acquisition policies for the above mentioned states, including Florida, is a positive statement as to the desired goal for the industry. That goal as articulated by each state is to consolidate the industry thereby achieving the additional goals of safe, adequate, reasonably priced service for the long term. It should be noted that in order to be successful in attaining such goals it requires a broader approach than just focus on acquisition incentives. The Commission has recognized this concept when it has approved rate equalizations at the time of transfer. It has done so when it has been demonstrated to be in

the best interests of both the acquiring utility and its customers and the acquired utility and its customers.

The above discussion reveals that the Florida policy of not recognizing acquisition adjustments, either positive or negative, in the absence of a showing of extraordinary circumstances does constitute an incentive for acquisition of troubled systems when they can be purchased at a discount to established rate base value. However, this incentive is somewhat conservative compared to those incentives provided by the states of New York, Pennsylvania and California.

In addition, the above analysis demonstrates that with the exception of a very few isolated cases, the Commission has consistently decided acquisition adjustment issues in accordance with Order No. 25729. It is staff's belief that such consistent application certainly constitutes the basis for proceeding to rulemaking. Furthermore, during the Econ Utilities/Wedgefield case, staff was directed to initiate rule making on the issue of acquisition adjustments.

V. Possible Alternatives

There are a variety of scenarios whereby transfers occur and to which acquisition policies and incentives might apply. In formulating an acquisition policy for moving forward the Commission must consider the direction it wishes to take the industry and the level of involvement it wishes to have in encouraging that direction.

As articulated in Order No. 25729, the Commission has stated its desire to encourage consolidation of the industry and has done so by its policy of upholding existing rate base at time of transfer regardless of purchase price. Staff believes that this is an appropriate policy to continue and the language in Attachment A is staff's preferred language.

OPC has consistently supported the notion that the Commission should always make a negative acquisition adjustment when purchase price is below established rate base and never make a positive acquisition adjustment when purchase price exceeds established rate base. What are the likely outcomes of doing this? Clearly, customers of the acquired system are, in the short run, experience not change in the case of purchase price above established rate base. This is consistent with the Commission's existing policy.

However, in the case of purchase price below established rate base, the impact to the customers is uncertain. In the short run, the customers of the acquired system would experience no change and may be better off since rates would not change and any future increases would be mitigated by the amount of the negative acquisition adjustment. However, in the long run such a policy will have a dampening effect on future acquisitions of small utilities. The result of stifling future acquisitions will be that the public interest as expressed by better management, greater financial flexibility and more professional operation will be denied the customers of other small utilities. In addition, the customers of the unacquired utility may suffer in the long run by decisions to delay and/or defer needed investment. Therefore, the OPC position is clearly in opposition to the stated goals of the Commission relating to consolidation of the industry. Should the Commission determine that consolidation is not longer desirable, the OPC position would become a viable option.

Another possible option is for the Commission is to have a policy that provides neither an incentive nor a disincentive to acquire smaller systems. In so doing, the Commission may force county or municipal systems to acquire smaller systems. This has occasionally happened in the case of receiverships and abandonments, where no willing buyer steps forward to take over a troubled system. On occasion circumstances result in this unfortunate outcome. This scenario usually takes some time and puts customers in the position of receiving substandard service or causes unnecessary detrimental environmental impacts. However, if the goal of the Commission is to force most if not all small troubled systems into the hands of governmental bodies, then such a strategy may be appropriate.

VI. Recommendations

Staff's recommended option is to adopt the attached rule language with the modification that paragraph (3) be removed. Staff believes that that language best reflects the Commission's existing practice. Staff also believes that rate equalization and alternative rate making schemes, such as operating ratios, could be employed in certification transfers, where applicable, to strengthen acquisition incentives.

Staff also recommends that some language that reflects the Commission's goals and objectives relating to industry consolidation be included in the anticipated update of the Commission's Memorandum of Understanding with the DEP. The

ATTACHMENT B

Commission's economic ratemaking treatment of acquisition adjustments and rate equalization in certificate transfer cases plays a role in the overall statewide consolidation of the water and wastewater industries. It is anticipated that language addressing capacity development issues will be included in such a revision and the Commission's stated objectives as shown on pages 2 & 3 of this paper should be included in the MOU in some form.

25-30.0371 Rate Base Established at Time of Transfer. This rule applies to any utility purchased by a utility regulated by this Commission.

(1) For the purposes of this rule and Sections 25-30.037 and 25-30.038, rate base is defined as the net book value of the utility assets involved. Net book value is calculated as Utility Plant In Service net of Accumulated Depreciation, Construction Work in Progress, Contributions In Aid of Construction, Advances for Construction and Accumulated Amortization of Contributions In Aid of Construction. The Commission shall also consider the condition of the utility assets purchased in deciding if a purchased asset should be removed from the rate base calculation.

(2) In the absence of extraordinary circumstances, a purchase of a utility system at a premium or discount shall not affect the rate base calculation. The rate base shall be unaffected as a result of the transfer.

(3) When a negative acquisition adjustment occurs, it is a utility's burden to prove that the negative acquisition adjustment should not be imposed and instead be given to sellers rate base.

(4) In calculating negative and positive acquisition adjustments the following factors may be considered by the Commission:

(a) Acquisition costs (i.e., legal and administrative costs, outstanding fines, etc.),

(b) The condition of the plant (i.e., real worth of assets).

CODING: Words underlined are additions; words in struck through type are deletions from existing law.