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January 30, 2001

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

Re: Docket No. 001502-WS

Dear Ms. Bayo:

Enclosed for filing in the above-referenced docket are the original and 15 copies of Comments by Hugh Larkin, Jr. and Mark Cicchetti on behalf of the Office of Public Counsel. A diskette in Wordperfect format is also submitted.

Please indicate the time and date of receipt on the enclosed duplicate of this letter and return it to our office.

Sincerely,

Charles J. Beck,
Deputy Public Counsel

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ORIGINAL

ACQUISITION WORKSHOP

REPORT OF HUGH LARKIN, JR.

ON BEHALF OF THE

FLORIDA OFFICE OF PUBLIC COUNSEL

INTRODUCTION/BACKGROUND

What is an Acquisition Adjustment?

An acquisition adjustment is essentially the difference in the purchase price paid to acquire a utility asset or group of assets and the depreciated original cost of those assets at the date of acquisition. It is the difference between the purchase price paid, including acquisition costs, and the rate base determined as of the date of transfer. If an acquiring utility pays less than the net book value of the assets, a negative acquisition adjustment exists.

The Commission's stated policy concerning the treatment of acquisition adjustments for ratemaking purposes has been that, absent "extraordinary circumstances," a subsequent purchase of a utility system at a premium or discount does not affect the rate base calculation:

> An acquisition adjustment results when the purchase price differs from the rate base calculation. It is Commission policy that in the absence of extraordinary circumstances a subsequent purchase of a utility system at a premium or discount shall not affect the rate base calculation.
> (90 FPSC 6:22)

The Citizens strongly recommend that this policy be revised with regard to negative acquisition adjustments.

Why Current Policy Should be Revised

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When a negative acquisition adjustment exists, the acquiring utility purchased the assets at less than the net book value. If the negative acquisition adjustment is not reflected, the stockholders of the purchasing entity will receive a return on amounts they have not funded. They did not fund the full amount of the depreciated original cost rate base. In some situations, they may have paid significantly less than that amount. The acquiring utility will effectively, and in actuality, earn a return on assets in which it has no investment. In several cases, the result has been that the acquiring entity has been allowed to earn a return on amounts that have hugely exceeded its actual investment. The Citizens have strongly recommended on numerous historic occasions that negative acquisition adjustments be reflected for ratemaking purposes. They have consistently recommended that in instances in which the acquiring utility's actual investment is less than the net book value of the system, the return earned by the acquiring utility be based on its actual purchase price, plus acquisition costs. Those arguments have been largely ignored.

Factors Causing Purchase Price to be Less than Book Value

Numerous factors can lead to the actual arms-length negotiated purchase price being significantly less than the net book value of an acquired system. For example, the purchased assets may have deteriorated at greater than the depreciation rate used has reflected. The assets may have deteriorated in value far greater than the books have indicated. The assets may not have been properly maintained. This is often caused by the prior owners' primary motivation being the sale of real estate, not the utility business. The prior owner may have been concerned more with marketing real estate and not maintaining a water system. These factors may cause the utility to be troubled. The system may be in extreme disrepair from years of neglect. If an

acquiring entity is able to purchase a system at an amount below the net book value, there is obviously a reason for that. In effect, by not allowing for a negative acquisition adjustment in calculating the revenue requirement, the utility's captive customers are essentially forced to pay more for a system on an on-going basis than the system is actually worth. The acquiring entity would be paying what it felt, based on an arms-length transaction, the assets are worth, yet charging customers based on a differing, higher amount. In addition, ratepayers will be required to pay higher maintenance costs and potentially higher system addition costs to bring the neglected system up to a proper standard.

Extraordinary Circumstances Test

The Commission's current policy is that absent extraordinary circumstances, the purchase of a utility at either a premium or discount should not impact the rate base calculation. Historically, the notion of extraordinary circumstances has been near impossible to meet. The main cause of this impossibility is the fact that the Commission has never set a definition for the term. What exactly qualifies as an extraordinary circumstance, and to what extent must the circumstance be extraordinary? In fact, the notion of extraordinary circumstance has not be used consistently. Acquiring utilities have brought forth the argument in numerous cases in Florida that they were purchasing a "troubled" system. They have used this "troubled" system argument as a means of avoiding recognition of a negative acquisition adjustment in rates. Should not the fact that a utility is troubled qualify that the circumstance is extraordinary? Apparently not, based on past rulings. It has been virtually impossible for customers to prove than an acquisition meets the extraordinary circumstance test. The vague notion of extraordinary circumstance should be

dismissed when setting a going-forward acquisition adjustment policy. It is a moving target or theory that is near impossible to achieve, particular when extraordinary is an abstract concept that is impossible to quantify or substantiate.

PROPOSED NEW NEGATIVE ACQUISITION ADJUSTMENT POLICY

The Commission has stated that the purpose of its policy "...is to create an incentive for larger utilities to acquire small, troubled utilities." (90 FPSC 8:307) There indeed are some situations in which it is desirable for a larger, well run utility to acquire small utilities. This is particularly true with respect to small troubled utilities. However, the current policy is far too generous. It sets no limit on the level of excess earnings an acquiring utility can achieve on its actual amount invested or the amount of additional maintenance cost that ratepayers must pay. The Citizens are recommending that a new policy be adopted with regard to negative acquisition adjustments that would balance both the interests of the acquiring utility and the interests of the ratepayers of the utility being acquired. The Citizens recommend that a new "sharing" approach be adopted by the Commission.

In recent years, the Commission has adopted several incentive plans under which it has embraced the notion of sharing excess earnings between a Company's customers and its shareholders. For example, in Docket No. 920260-TL, the Commission approved a Stipulation and Agreement Between the Office of Public Counsel and Southern Bell Telephone and Telegraph Company. That agreement called for the sharing of earnings within certain ROE ranges between shareholders and ratepayers, and a refund to ratepayers of amounts exceeding an ROE cap. In that case, the sharing mechanism was in effect for a four year period. Prior to that

point, the Commission had approved in Docket No. 880069-TL a rate stabilization plan for Southern Bell under which revenues were shared between customers and shareholders after earnings exceeded the top range set for ROE.

In Order No. PSC-99-2131-S-EI, the Commission approved a Stipulation under which Gulf Power Company would share revenues between customers and shareholders between certain levels and to refund all revenues above the sharing level to ratepayers. A sharing approach should be considered when dealing with the acquisition of water utilities at a cost less than net book value.

In situations in which a troubled utility is being purchased, the Citizens propose that the negative acquisition adjustment be split or shared equally between customers and the acquiring company. This would still provide the acquiring company an incentive to proceed with the acquisition; they would still be earning a return on an amount that exceeds their actual investment, possibly significantly so. However, consistent with other sharing mechanisms adopted by the Commission, there should be limits placed on the potential level of return on equity the acquiring entity can earn on its actual investment. In other incentive plans adopted by this Commission, earnings or revenues between certain levels have been shared between ratepayers and shareholders, with amounts exceeding set caps being returned entirely to ratepayers.

Under the Citizens' proposal, the actual return on equity on the amount of actual investment would not be permitted to exceed 150% of the leverage graph ROE. For example, if the leverage graph formula resulted in an allowed return on equity of 10%, the amount of return on equity would not be permitted to exceed a 15% return on the Company's actual investment in the acquired assets. This would be the cap.

For calculating rate base, the starting point would be the amount recorded on the books of the acquired utility. A 50% factor would then be applied to the amount of unamortized negative acquisition adjustment related to the purchase. Likewise, depreciation expense would be based on the level of plant included on the books of the acquired entity, and 50% of the annual amortization expense associated with the negative amortization adjustment would be reflected as a reduction of depreciation expense. Once the resulting revenue requirement is determined, a quick test would need to be performed. This would be done by including the full amount of unamortized negative acquisition adjustment in the rate base calculation and 100% of the amortization of the acquisition adjustment in the net operating income calculation. Applying the full negative acquisition adjustment would result in the actual investment of the acquiring utility being reflected. A rate of return would then be applied to rate base which includes return on equity based on 150% of the leverage graph formula. Rates would then be set based on the lower of the two calculated revenue requirement amounts. This will ensure that the ratepayers are not paying a return on equity of over 150% of the calculated leveraged graph amount on the actual investment of the acquiring utility. This would effectively and adequately balance the interests of both the ratepayers and the acquiring utility. It would also still provide an incentive for larger utilities to acquire smaller troubled utilities. They would be permitted to potentially earn up to 150% of the leverage graph return on equity on their actual investment.

Other Provisions of Proposed Policy

Certain additional provisions should be included as part of any new negative acquisition policy. First and foremost, the utility being acquired should be a troubled utility. If the utility

being acquired is well-run, well-maintained, in compliance with environmental requirements and customer satisfaction is high, there is no need to put additional incentives in place to encourage other utilities to buy the system. In those situations, there is no need to allow the acquiring utility to recovery a return on equity on amounts that exceed their actual investment. No additional incentive should be necessary.

On a similar plane, the acquiring utility must be required to demonstrate that customers would be better off as a result of the purchase. If the acquiring utility can not demonstrate this, the full negative acquisition adjustment should be reflected in calculating rate base. Ratepayers should not be forced to provide the acquiring utility an incentive above the actual investment level if they do not receive some benefit in return. Examples of factors that should be taken into consideration in determining if ratepayers are better off as a result of the acquisition include the following:

- Will service quality improve as a result of the acquisition? In answering this question, one should also take into consideration whether there was any problem with the quality of service to begin with.
- Will net operating costs decline? This could occur from overhead being spread over a larger customer base. The answer must also take into consideration any additional, new costs that may be allocated from the larger acquiring entity.
- Will the new entity be better able to attract capital that is needed for system improvements?
- Will the overall cost of capital decline as a result of the acquisition?
- Will more professional and experienced management result in better service to the customers and/or lower costs for the customers?

At a future date, such as three to five years after the initial acquisition takes place, an evaluation should be made to ensure that the customers were, in fact, better off. The utility would be required to prove that customers were better off subsequent to the purchase. They would need to demonstrate that the assertions it made at the time of purchase actually transpired. If it is then

determined that ratepayers were not in actuality better off, then the full unamortized negative acquisition adjustment should be reflected. No sharing should be allowed in such circumstances. It would not be fair or reasonable to require ratepayer to pay an incentive via paying a return on amounts higher than the actual investment if they received nothing in return. If the acquiring utility does not make improvements to the system or increase customer satisfaction via higher quality of service at lower cost, an incentive should not be put into place to encourage such sales. This would put potentially acquiring utilities on notice that they will not be permitted to achieve higher incentive levels of return if they do not actually make improvements.

Under the Citizens' proposed policy, both ratepayers and shareholders of acquiring utilities would be in a win-win situation. Customers of troubled utilities would be assured a better level of service, and shareholders will be able to earn a return on amounts that exceed their actual investment. In fact, they may potentially receive returns of up to 150% of the leverage graph ROE level on their actual investment. This recommended sharing would be a more than reasonable compromise that would be in all parties interest as opposed to a select group.

Brief Summary of Citizens Proposal

- Negative acquisition adjustment is shared 50/50 between ratepayers and shareholders as a means to still encourage the purchase of small troubled utilities.
- The amount of sharing will be limited such that customers do not pay a return on equity exceeding 150% of the leverage graph formula on the acquiring utility's actual investment in the system.
- The acquired utility must be considered troubled prior to the allowance of any sharing,

otherwise the full negative acquisition adjustment should be reflected.

- The acquiring utility must provide evidence demonstrating that the customers will be better off as a result of the purchase, otherwise the full negative acquisition adjustment should be reflected.
- At a future point in time (such as 3 to 5 years after acquisition), a review should be done to ensure that the customers actually were better off. If not, the sharing would immediately end and the full negative acquisition adjustment would be reflected.

RESPONSES TO QUESTIONS POSED BY THE COMMISSION

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

The primary goal should be to insure that the interests of both the ratepayers of the acquired entity and shareholders of the acquiring utility are taken into consideration, and a fair balance between the two is achieved. In the cases of utilities acquiring small troubled water and wastewater systems at a cost which is below the net book value of the acquired assets, an incentive mechanism could be used. However, a reasonable sharing and cap should be put into place to ensure that the acquiring utility does not receive excessive levels of return on its actual investment. The Citizens' proposed policy would accomplish this goal.

2. **Should the Commission still be promoting acquisitions?**

In the case of small troubled water and wastewater utilities, there are valid arguments for

promoting acquisitions by larger, well-run utilities. This is particularly true in cases in which the quality of service is poor and the system has been neglected and run-down. However, reasonable limits should be set on the level of return on equity on actual investment the acquiring utility is permitted to achieve.

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?**

No, the same general rules should apply to all three situations. However, it is highly doubtful that a large utility would be considered "troubled" to any reasonable degree. Consequently, since any incentives for acquisitions should be limited to the acquisition of troubled utilities, it is doubtful that situation number two would apply.

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

Yes. The Commission should adopt the incentive/sharing mechanism recommended by Citizens. This method was addressed in previous sections of this report. It would allow for a fair and reasonable balance between the ratepayers of the entity being acquired and the shareholders of the acquiring utility, while still incorporating significant incentives for the acquisition.

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?

The Uniform System of Accounts sets forth accounting requirements for book purposes. Utilities are required to record acquisition adjustments on their books under the USOA. As a general rule, the amortization period should be set over the remaining life of the assets being purchased. However, there may be special circumstances that would cause a different amortization period to be reasonable. Consequently, special exceptions to the general rule could be considered on a case by case basis if warranted.

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?**

No, it would not. The recommendation sponsored by Citizens is a more reasonable approach as it balances both ratepayer and shareholder interests, while still providing a reasonable incentive for the acquisition of troubled utilities.

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

The acquisition adjustment policy recommended by Citizens should be adopted. This policy was laid out previously in this report.