BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Proposed Rule 25-30.0371,) **Acquisition Adjustments)**	**Docket No. 001502-WS**

WORKSHOP
FOR
PSC-REGULATED WATER AND WASTEWATER UTILITIES
AND OTHER INTERESTED PERSONS

COMMENTS OF

THE OFFICE OF PUBLIC COUNSEL

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GENERAL COMMENTS CONCERNING ACQUISITION ADJUSTMENTS FOR WATER AND WASTEWATER UTILITIES

A reasonable and fair acquisition adjustment policy is crucial to achieving the goal of adequate, fairly priced water and wastewater service for water and wastewater utilities under the jurisdiction of the Florida Public Service Commission ("FPSC"). The FPSC should also consider a broader approach to the problem of "troubled" companies that includes providing incentives to minimize the long-term costs to ratepayers while balancing the interests of ratepayers and stockholders.

The water and wastewater industry under the jurisdiction of the FPSC is characterized by a large number of small companies. Approximately one-half of all companies regulated by the FPSC serve less than 500 connections. Many of these small systems are developer related. Historically, residential growth in Florida has consisted of a relatively high proportion of subdivision development which has led to the high number of small, developer-owned water and wastewater companies.

Many of the "troubled" water and wastewater utilities under FPSC jurisdiction have been small, developer-owned companies. Some reasons small, developer-owned systems run into trouble include: under-capitalization, owner indifference, and lack of management expertise. This is not

entirely surprising because many developers mostly are interested in profitably completing the development project and not in the long-term management of the water or wastewater utility. Due to these circumstances, customers of small, under-capitalized, developer-owned water and wastewater systems can face the prospect of purchasing a home at a market price, experiencing declining water and wastewater service adequacy (both operationally and environmentally) due to a lack of maintenance and investment, and eventually, being hit with a large percentage rate increase as a new owner of the utility makes needed improvements and charges compensatory rates.

To address the problems associated with 'troubled" utilities and to provide an incentive to larger companies to purchase "troubled" systems, the FPSC has followed the practice of not making acquisition adjustments, negative or positive, unless there are extraordinary circumstances. Because the FPSC does not make acquisition adjustments except where extraordinary circumstances are proven, the purchasing company can earn a return on not just the purchase price but on the full rate base. Additionally, the purchasing company receives the benefit of depreciation on the full rate base.

The Commission's approach has much merit because larger firms usually are better capitalized, have greater management expertise, can provide economies of scale, and can better meet environmental and water quality requirements. However, while the Commission's practice has much merit, it is based on undefined standards, allows purchasing companies to earn grossly excessive returns, provides perverse incentives that can be costly to ratepayers, and does nothing to help keep the problems from being created. For example, the standard of "extraordinary circumstances" is an

undefined, arbitrary test that appears contradictory. In a recent case, a company was found to be "troubled," undercapitalized, admitted it neglected preventive maintenance, was concerned it would not pass an environmental inspection, sold at an enormous discount to book value - and yet, its' circumstances were not considered extraordinary! Consequently, it appears these circumstances define an ordinary utility. However, it is not logical to assume that an ordinary utility is "troubled," undercapitalized, and mismanaged.

Furthermore, because there is no cap to limit excessive returns associated with acquiring a "troubled" utility, a purchasing company can receive a windfall return. If the purchase price is significantly below book value (which has occurred), the purchasing company could earn returns on equity of 50% or greater. Such long-term returns are unprecedented in a regulatory environment and no evidence has been presented that such extremely high returns are required to produce the results desired by the FPSC.

As shown in the ***Stocks, Bonds, Bills and Inflation Yearbook***, published by Ibbotson Associates, the total return for small company stocks (which are of higher risk than regulated utilities and are therefore expected to earn higher returns) was 17.7% for the period 1926-1997. Providing a return on equity premium of 50% above the returns earned by small companies, as an incentive to purchase a "troubled" company, would produce a return of less than 27%. Allowing returns for regulated companies that are three or four times greater than the returns earned by riskier, small, unregulated companies is excessive. Therefore, it is necessary to establish a cap on the incentive to

acquire "troubled" companies to minimize undue enrichment and to be more fair to ratepayers.

The Commission's current practice also can provide unintended consequences through perverse incentives. For example, the Commission has imposed a negative acquisition adjustment (see Notice of Workshop, page 9) citing, in part, the need for repairs and improvements at the time of transfer. However, if a purchasing utility believed that making improvements to increase service quality could trigger the imposition of a negative acquisition adjustment (to ensure ratepayers are not charged twice to receive adequate service), then there is an incentive for the purchasing company to forego making the improvements which is counter to the intent of the acquisition adjustment policy.

Secondly, the balance sheets of many small, developer-owned systems show the companies' assets are financed through contributions-in-aid-of-construction ("CIAC"), relatively high-cost debt, and a minimum amount of equity capital or negative equity capital. A low amount of equity capital or negative equity capital is an indication the owner does not have a substantial vested financial interest in the company. When the owner of a company does not have a meaningful financial interest in the company, the owner is less motivated to ensure the company remains operationally and financially viable. Requiring a meaningful minimum amount of equity, or a personal guarantee, would ensure that an owner had a vested interest in keeping the utility financially viable and therefore be more motivated to operate appropriately and meet maintenance as well as environmental and water quality requirements. Also, higher equity ratios should translate into lower debt costs. The lack of a vested interest in the water or wastewater utility by the developer-owner can create a cycle of

undercapitalization, disinterest, declining service quality, and eventual sale of the utility system at a discount (with a potential associated windfall to the purchaser). Through this cycle, the developer is made whole through sale of the development at market prices, the "white-knight" purchaser receives a premium on the discounted purchase price of the utility assets through depreciation and return on the full rate base, while the customers pay higher than necessary capital costs for poor or declining service quality.

The Commission's policy regarding acquisition adjustments has much merit but is based on undefined arbitrary standards, allows excessive returns for purchasing companies, and, in instances, provides perverse incentives. Recommendations to help refine the Commission's practice to achieve the Commission's stated goals are outlined in the following sections.

RECOMMENDED TREATMENT OF ACQUISITION ADJUSTMENTS

To provide an incentive to larger, well managed companies to purchase "troubled" water and wastewater companies, while balancing the interests or ratepayers and stockholders, it is recommended the Commission adopt a negative acquisition adjustment policy that splits negative acquisition adjustments 50-50 between ratepayers and the purchasing company. The 50-50 split would be capped at the point the company's return on equity, based on the actual purchase price, is 150% of the leverage graph return on equity. In other words, the purchasing company's return

would be limited to a 50% premium on its equity return. This cap will help ensure the company is substantially rewarded but is not allowed a grossly excessive return. Amounts associated with the above criteria would be presumed to be reasonable subject to rebuttal.

In addition to the recommended refinements to the Commission's acquisition adjustment policy, the Commission should consider taking a broader policy approach to minimize the likelihood of utilities becoming "troubled." This can be accomplished by requiring a minimum equity investment standard or a personal guarantee. When the owner of a company does not have a meaningful financial interest in the company, the owner is less motivated to ensure the company remains operationally and financially viable. Requiring a meaningful minimum amount of equity, or a personal guarantee, would ensure that an owner had a vested interest in keeping the utility financially viable and therefore more motivated to operate appropriately and meet maintenance as well as environmental and water quality requirements. By requiring a meaningful financial interest in a system, developers may look to the larger established water and wastewater utilities to provide service and thereby avoid the vicious cycle of undercapitalization, disinterest, declining service quality, and rate shock.

By making the acquisition adjustment policy refinements listed above, the undefined, arbitrary standards, excessive compensation, and perverse incentives associated with the Commission's current practice would be substantially eliminated while maintaining considerable incentives for "troubled" companies to be acquired.

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The following section addresses the Commission's questions listed in the Notice of Workshop.

RESPONSES

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

A. The goal of the Commission's water and wastewater acquisition policy should be to minimize long-term costs to ratepayers while balancing the interests of ratepayers and stockholders.

Q. Should the Commission still be promoting acquisitions?

A. Yes, where justified.

Q. 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?

A. No.

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

A. With the refinements and recommendations cited above, the Commission's policy should

be sufficient.

Q. 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?

A. The commission does not need to change its accounting treatment for acquisition adjustments.

Q. 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?

A. No.

Q. What should the future acquisition policy of this commission be?

A. The Commission should adopt a negative acquisition adjustment policy that splits negative acquisition adjustments 50-50 between ratepayers and the purchasing company. The 50-50 split would be capped at the point the company's return on equity, based on the actual purchase price, is 150% of the leverage graph return on equity. In other words, the purchasing company's return would be limited to a 50% premium on its equity return. This cap will help ensure the company is substantially rewarded but is not allowed a grossly excessive return. Amounts associated with the

above criteria would be presumed to be reasonable subject to rebuttal.

EXPERIENCE AND QUALIFICATIONS OF MARK A. CICCHETTI

I received a Bachelor of Science degree in Business Administration in 1980 and a Master of Business Administration degree in Finance in 1981, both from Florida State University. Upon graduation I accepted a planning analyst position with Flagship Banks, Inc., a bank holding company. As a planning analyst, my duties included merger and acquisition analysis, lease-buy analysis, branch feasibility analysis, and special projects. In 1983, I accepted a regulatory analyst position with the Florida Public Service Commission. As a regulatory analyst, I provided in-depth analysis of the cost of equity and required overall rate of return in numerous major and minor rate cases. I reviewed and analyzed the current and forecasted economic conditions surrounding those rate cases and applied financial integrity tests to determine the impacts of various regulatory treatments. I also co-developed an integrated spreadsheet model which links all elements of a rate case and calculates revenue requirements. I received a meritorious service award from the Florida Public Service Commission for my contributions to the development of that model.

In February 1987, I was promoted to Chief of the Bureau of Finance. In that capacity I provided expert testimony on the cost of common equity, risk and return, corporate structure, capital structure, and industry structure. I provided technical guidance to the Office of General Counsel regarding the development of financial rules and regulations. In addition, I authored the Commission's rules regarding diversification and affiliated transactions, chaired the Commission's Committee on Leveraged Buyouts, supervised the finance bureau's regulatory analysts, co-developed and presented a seminar on public utility regulation to help educate the Florida Public Service Commission attorneys, and provided technical expertise to the Commission in all areas of public utility finance for

all industries.

In February 1990, I accepted the position of Chief of Arbitrage Compliance in the Division of Bond Finance, Department of General Services. As Manager of the Arbitrage Compliance Section, I was responsible for assuring that over $16 billion of State of Florida tax-exempt securities remained in compliance with the federal arbitrage requirements enacted by the Tax Reform Act of 1986. I provided investment advice to trust fund managers on how to maximize yields while remaining in compliance with the federal arbitrage regulations. I designed and implemented the first statewide arbitrage compliance system which included data gathering, financial reporting, and computation and analysis subsystems.

In July 1990, I founded Cicchetti & Company. Through Cicchetti & Company I provided financial research and consulting services, including the provision of expert testimony, in the areas of public utility finance and economics. Topics I have testified on included cost of equity, capital structure, corporate structure, regulatory theory, cross-subsidization, industry structure, the overall cost of capital, incentive regulation, the establishment of the leverage formula for the water and wastewater industry, reconciling rate base and capital structure, risk and return, and the appropriate regulatory treatment of construction work in progress, used and useful property, construction cost recovery charges, and the tax gross-up associated with contributions-in-aid-of-construction.

In January, 2001, I joined C.H. Guernsey & Company as a consultant and manager of the Tallahassee office. C.H. Guernsey & Company is a diversified, private practice, professional engineering, architectural and consulting business corporation operating nationwide. The company offers comprehensive services for systems of electrical power, telecommunications, natural gas, water, wastewater, district heating/cooling, airports, streets, industrial facilities, commercial and

institutional buildings.

I previously have been certified by the Florida Public Service Commission as a Class B Practitioner in the areas of finance and accounting.

In June, 1985, I published an article in Public Utilities Fortnightly titled "Reconciling Rate Base and Capital Structure: The Balance Sheet Method." In September, 1986, I was awarded third place in the annual, national, Competitive Papers Session sponsored by Public Utilities Reports, Inc., in conjunction with the University of Georgia and Georgia State University, for my paper titled "The Quarterly Discounted Cash Flow Model, the Ratemaking Rate of Return, and the Determination of Revenue Requirements for Regulated Public Utilities." An updated version of that paper was published in the June, 1989 edition of the National Regulatory Research Institute Quarterly Bulletin. I subsequently served twice as a referee for the Competitive Papers Sessions. On June 15, 1993, I published an article on incentive regulation in Public Utilities Fortnightly titled "Irregular Incentives."

I am a past President and past member of the Board of Directors of the Society of Utility and Regulatory Financial Analysts ("SURFA"). I was awarded the designation Certified Rate of Return Analyst by SURFA in 1992. I am a member of the Financial Management Association International and I am listed in Who's Who in the World and Who's Who in America.

I have made public utility and finance related presentations to various groups such as the Southeastern Public Utilities Conference, the National Society of Rate of Return Analysts, the National Association of State Treasurers, and the Government Finance Officers Association.