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JACK SHREVE
PUBLIC COUNSEL

April 2, 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 Citizens' Post Workshop Comments.

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

Charles J. Beck,
Deputy Public Counsel

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Proposed Rule 25-30.0371, Acquisition Adjustment	Docket 001502-WS Filed: April 2, 2001

CITIZENS' POST-WORKSHOP COMMENTS

The Citizens of Florida (Citizens), by and through Jack Shreve, Public Counsel, file these post-workshop comments regarding the Commission's policy on acquisition adjustments for water and wastewater companies.

On January 30, 2001, Citizens filed comments by Hugh Larkin, Jr., and Mark Cicchetti supporting a proposal to generally share negative acquisition adjustments on a 50-50 basis between customers and a utility. This sharing would take place when a larger company purchases a smaller, troubled water or wastewater utility for an amount less than the book value of the purchased utility.[1] The witnesses appeared at a workshop held on February 7, 2001, to discuss this proposal and answer questions.

[1] The comments of Hugh Larkin, Jr., and Mark Cicchetti contain a more complete description of the proposal.

The Commission's Current Policy

The Commission currently does not recognize a negative acquisition adjustment unless customers prove the existence of "extraordinary circumstances." Since the Commission rarely finds the presence of such circumstances, purchasing utilities earn returns on rate bases far in excess of their investment. Ratepayers fund the resulting excessive profit on the companies' actual investment through rates approved by the Commission.

In a recent case, for example, a subsidiary of Utilities, Inc., purchased the assets of Econ Utilities, Inc. (Econ) for a small fraction of the amount shown on the books of Econ. Later, when the purchasing company was earning a return of approximately 25% on its actual investment, the company filed a petition for a rate increase to boost its return on actual investment to approximately 50%. It was able to do this only because the company used the value of the assets on the books of Econ for the purpose of setting rates, rather than its own investment in the utility. Current Commission policy not only condones this practice; it actually encourages it.

The only way customers can avoid this result is to show "extraordinary circumstances" related to the purchase. Historically, it has been nearly impossible to show this condition. Larkin comments, page 3; Cicchetti comments, page 3. The Commission has never defined the term "extraordinary circumstances" and appears to use the term inconsistently. The Commission rationalizes its policy by stating that it encourages purchases of troubled utilities, but circumstances rarely qualify as extraordinary. In a recent case, a company was found to be troubled, undercapitalized, admitted that it neglected preventative maintenance, was concerned that it would not pass an environmental inspection, was sold at an enormous discount to book value -- but none of these conditions were considered "extraordinary" by the Commission. Cicchetti comments, page 3; Cicchetti, Tr. 140.

The Commission's current practice can also provide perverse incentives to purchasing utilities. Making substantial improvements to a purchased utility may show the existence of extraordinary circumstances, so a purchasing utility may hesitate to make the needed improvements. Such an incentive runs contrary to the purpose of the acquisition adjustment policy. Cicchetti comments, page 4.

Public Counsel's Proposal

Public Counsel's proposal to split negative acquisition adjustments with utilities is a win-win proposition for both purchasing utilities and customers. Since splitting the acquisition adjustment would be the norm, this policy would do away with the need to regularly litigate whether a purchase involves extraordinary circumstances. Moreover, since the policy provides benefits for both the utility and customers, it should make cases less contentious.

The purchasing utility would receive an above market return on its investment. In addition to the purchase price, rate base would include half of the negative acquisition adjustment, up to a point where the return on the company's actual investment is 150% of the market rate. Considering the fact that water and wastewater service is a true monopoly, the opportunity to receive up to a 50% premium on a fair return would be a strong incentive to a purchaser.[2]

Customers would receive a benefit equal to half of the negative acquisition adjustment. Customers would still be required to pay a return on the purchasing utility's actual purchase price plus one half of the negative acquisition adjustment. Additionally, customers might pay higher operational expenses resulting from lack of prior maintenance (Cicchetti, Tr. 138, 148) and additional costs to restore the system's quality (Larkin, Tr. 164). Nevertheless, customers would be better off than under the current Commission policy which is so heavily skewed in favor of the utilities.

Staff's Proposal

Staff asked the parties to comment on the possibility of recognizing negative acquisition adjustments while writing off negative acquisition

[2] The utilities' sense of entitlement to exorbitant returns was evidenced by comments offered during the workshop. Despite the fact that the Public Counsel's proposal would allow companies to collect a return that substantially exceeds the actual cost of equity, Mr. Frank Seidman characterized the proposal as a penalty. Seidman, Tr. 183. When an earnings premium is described as a penalty, the utilities' entitlement mentality has gone too far. The ability to earn a premium above a properly measured cost of equity is not a penalty. Burgess, Tr. 184.

adjustments over a relatively short period of time. One proposal would amortize the negative acquisition adjustment above-the-line over a 5 year period. Willis, Tr. 107. If the Commission were to consider a slower amortization rate, such as 6 to 10 years, it might put the amortization below-the-line. Willis, Tr. 190.

Citizens believe this proposal would be an improvement over current policy. In essence, the proposal would provide greater rate stability to customers of the purchased utility and would likely delay rate increases that might otherwise be sought by the purchasing utility. However, a 50-50 split of negative acquisition adjustments for the purchase of troubled utilities provides a fairer sharing of the benefit from the acquisition adjustment. A 50-50 split allows both the company and customers to share the benefit on a continuing basis. Under the accelerated amortization proposal, the benefit for customers phases out over the accelerated time period. For this reason, Citizens suggest that 50-50 sharing of the negative acquisition adjustment is a better policy.

<u>Positive Acquisition Adjustments</u>

Citizens favor a 50-50 split of a negative acquisition adjustment, subject to certain limits, in order to provide an incentive for larger companies to purchase troubled water and wastewater companies. Providing a higher than market return on the purchaser's investment serves a public purpose only when customers would otherwise receive substandard water and wastewater service from a troubled company. *See* Burgess, Tr. 172.

No such incentive is needed in cases where there is a positive acquisition adjustment. Purchase of a utility at more than book value is simply a business decision by the purchaser that does not need an extra incentive. Burgess, Tr. 173. The risk of recovering the premium over book value should be on the utility that pays it and should not be shifted to the ratepayer. Larkin, Tr. 163.

Companies sometimes argue that the Commission should allow positive acquisition adjustments because purchase of smaller utilities by larger utilities brings efficiencies to both companies. The Commission should be wary of such arguments. In docket 950495-WS, Citizens' witness Kimberly H. Dismukes analyzed the impact on two utilities after their purchase by Southern States Utilities, Inc., n/k/a Florida Water Services Corporation. As shown by the attached excerpt from her testimony in that case, the cost of the two acquired systems actually increased after purchase. Southern States had argued that its acquisition program was beneficial to customers and allowed the company to spread its fixed costs over a larger body of customers, thereby reducing the costs per unit to the customers. Ms. Dismukes tested this theory by examining the Company's administrative and general expenses over the period 1991 to 1996. Her analysis showed that as Southern States increased in size, so did the cost per customer. This is the opposite of what one would expect if economies of scale had the effect claimed by the company.

There is no need to change the Commission's current policy with respect to positive acquisition adjustments for water and wastewater utilities. Since companies commanding a premium over book value would ordinarily be well-run, efficient companies, there is no reason to require customers to pay the increased cost above book value.

Respectfully submitted,

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of Florida

DOCKET NO. 001502-WS
CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of the foregoing has been furnished by U.S. Mail or hand-delivery to the following parties on this 2nd day of April, 2001.

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ATTACHMENT TO COMMENTS

HEARING TRANSCRIPT

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variable expenses for the associated decline in consumption related to its conservation proposal. Schedule 3 of my exhibit shows the amount expenses that should be reduced if the Commission adopts SSU's proposal as well as the amount expenses that should be reduced if the Commission adopts my proposal. As shown, under my recommendation, test year expenses should be reduced by $33,372.

VI. **Acquisition Program**

Q. Please turn to the next section of your testimony. Would you address SSU's acquisition program and its affect on customers?

A. Yes. SSU has an aggressive acquisition program underway. It is in the process of attempting to acquire several systems. In its strategic growth plan SSU suggested that even though:

> the market today is considered a 'sellers' market, the opportunities are such that Southern States should add 50,000 customers to its current customer base within five years. SSU can achieve customer growth by adopting an aggressive acquisition attitude, and soliciting resources from our parent Minnesota Power. We must consider paying more than rate base for utilities that fit our growth needs and accomplish our financial goals. [Response to Citizens Document Request 161.]

SSU's report elaborated further with respect to the types of systems it expects to target:

> This report recommends that an immediate full scale effort be placed on the acquisition of the targeted FPSC A&B utilities in Florida. However, included with this acquisition effort is a commitment to the smaller utilities that are strategically located or otherwise a natural fit into SSU family of systems. The report details our acquisition strategy outside Florida in the southeast corridor states. It list[s] our acquisition target states, from the first to last, and our reasoning behind our choices. [Ibid.]

It is clear from SSU's strategic plan that SSU is not planning on buying small run down systems that are considered by some to be nonviable. In fact, its strategic plan and its divestiture plan suggests just the opposite. Contrary to some beliefs, SSU is not the savior for small run-down nonviable systems.

Q. Does Southern States suggest that its acquisition program is beneficial to its customers?

A. Yes. Southern States has continually argued that by acquiring more systems it can reduce its costs on a per unit basis. In other words, as SSU grows it can spread its fixed costs over a larger customer base. In the instant case, Mr. Vierima testified that in addition to economies of scale and other efficiencies offered by Southern States, its size enables it to hire specialists who concentrate their efforts on certain limited fields of expertise and identify areas where costs can be decreased or quality of service improved. [Testimony, p. 10.]

Q. Have you examined any evidence that suggests that SSU's acquisition program is not necessarily beneficial to customers?

A. Yes, I have. First, as shown on Schedule 21, I examined the impact of SSU's acquisition of Buenaventura Lakes on the costs of this system on a before and after acquisition basis. I compared the stand alone cost of Buenaventura Lakes to the cost of providing service under SSU's ownership. As depicted on this schedule, SSU's acquisition of this system actually increased the cost to the customers of Buenaventura Lakes--it did not decrease, as would be expected if SSU's acquisition offered it the economies of scale SSU so often touts. As shown on this schedule, the cost to operate Buenaventura Lakes on a stand alone basis in 1996 dollars is $1,957,883. This compares to the cost after acquisition by SSU of $2,503,780, also in 1996 dollars. In other words, instead of decreasing costs, SSU's acquisition of this system increased its operating costs by $545,897--or 28%.

The most alarming aspect of the increase is depicted under the category administrative and general expenses. This would normally be the area of expenses were a reduction would be reflected since these costs are relatively fixed and SSU should be able to provide service at less cost than a stand alone system. Contrary to my expectation, SSU's acquisition of Buenaventura Lakes increased administrative and general expenses by $494,532---an increase of 123%. Clearly there were no economies of scale to the customers of Buenaventura Lakes after it was acquired by SSU.

Q. Have you reviewed any other information concerning Buenaventura Lakes which suggests that either SSU has not properly identified the potential cost savings as a result of acquiring Buenaventura Lakes, or that others could operate it more efficiently?

A. Yes. The City of Kissimmee was interested in purchasing this system. It ultimately concluded that the system should not be purchased because the asking price was too high and consequently it would not produce a positive cash flow. Nevertheless, the City prepared a study to examine the cost of providing service to the customers on a stand alone basis as well as if it were acquired by the City. This analysis showed that while the cost to operate the system would increase, it would only increase by $32,000--not over $500,000. It is also worthwhile to note that if the City had acquired this system, customers rates would have decreased not increased as requested by SSU in the instant case. Specifically, if this system had been acquired by the City, the rates for these customers would have been $1.19 per 1,000 gallons for water and $4.03 per 1,000 gallons for wastewater. This compares to SSU's proposed rates of $2.16 and $4.74, respectively. The base facility charge would have also been lower. The BFC for water under the City's tariffs is $2.23 and for wastewater it is $8.05. This compares to SSU's request of $9.17 and $17.59, respectively.

SSU also did a preliminary analysis of the cost to operate Buenaventura Lakes if it was acquired by SSU when it was pursuing the system. Contrary to the amount included in SSU's test year expenses, SSU projected that it could reduce Buenaventura's administrative and general expenses by one-half. In the instant case, SSU only removed 21% of Buenaventura Lakes administrative and general expenses prior to adding SSU's administrative and general expenses[6] to Buenaventura Lakes. If 50% of the costs were reduced as originally estimated by SSU, an adjustment of $307,000 would be needed as opposed to SSU's adjustment of only $127,327.

Q. Perhaps the acquisition of Buenaventura and the impact on costs is an anomaly. Did you examine any other recent acquisitions?

A. Yes. I made a similar comparison for SSU's acquisition of Lehigh Utilities in 1991. This analysis is presented on Schedule 22, and it reflects a similar result. As shown, on a stand alone basis, Lehigh's costs for its water operations were $803,241. After acquisition by SSU, its costs were $908,906 for an increase resulting from SSU's acquisition of $105,665. The same result occurs for the wastewater side of the operations. On a stand alone basis, Lehigh's operating costs were $686,013. However, after acquisition by SSU its wastewater operating costs increased to $822,610--an increase of $136,597.

Q. Have you examined any other data that shows, contrary to SSU's assertions, that there may not be administrative and general economies of scale associated with SSU's larger size?

A. Yes, I have. Schedule 23 examines SSU's administrative and general expenses and

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[6] It is the addition of SSU's allocated administrative and general expenses that causes the costs for the Buenaventura Lakes systems to increase so dramatically.

customer expenses per customer in 1991 compared to the expenses in 1994, 1995, and 1996. As shown on this schedule, and contrary to expected results, SSU's administrative and general and customer expenses have actually increased on a per customer basis. In 1991, the cost per customer of its administrative and general and customer expenses was $54.18. This cost increased to $70.26 in 1994, to $74.03 in 1995, and to $76.78 in 1996. From 1991 to 1996 SSU's number of customers increased by 6,207. Despite this increase in the number of customers, the actual cost per customer increased. This result is the opposite of what one would expect if there were the economies of scale alleged by SSU. In fact, this schedule suggests that there are diseconomies of scale associated with SSU's larger size and the acquisition of new systems.

Q. Your analysis suggests that SSU's customers have not benefited from SSU's acquisition program. How can the Commission protect SSU's customers from these inefficiencies?

A. I recommend that the Commission reduce SSU's adjusted test year expenses to account for the diseconomies of scale or inefficiencies that I have identified. To develop this adjustment, I allowed SSU to recover the cost per customer of its administrative and general expenses as incurred in 1991. I then multiplied this cost, $54.18, times SSU's 1996 average number of customers to arrive at a 1991 level of expenses adjusted for the current number of customers. This produced an expense level of $8,929,022. To this amount I added inflation for the years 1992 through 1996. This produced an allowable or efficient 1996 level of administrative and general and customer expenses of $10,257,661. From this amount I subtracted the amount of administrative and general and customer expenses SSU is requesting in the instant proceeding, to arrive at a gross inefficiency adjustment of $2,395,104. Applying the FPSC allocation factor to this amount results in an adjustment of $1,818,842. From this amount I also subtracted other adjustments that I recommend and those of other consultants that reduce the inflated level of SSU's 1996 expenses relative to the 1991 level of expenses. For example, in 1991 SSU did not incur the same level of conservation expenses as requested in the instant proceeding. Likewise, I have taken into consideration the payroll/wage adjustment recommended by Mr. Katz as well as the other adjustments that I recommend that reduce 1996 expenses. By removing the impact of these other adjustments I have ensured that there would be no double counting of other adjustments with respect to this adjustment. As shown on Schedule 23, after taking these other adjustments into consideration, I recommend that the Commission reduce test year expenses by $243,773 to account for SSU's diseconomies of scale or other inefficiencies.

Q. Have you made any other adjustments for SSU's acquisition efforts?

A. Yes, I have. These two adjustments are reflected on Schedules 24 and 25 of my exhibit. As shown on Schedule 24, I have reduced test year salaries by $175,928 to reflect the portion of SSU's salaries devoted to SSU's acquisition efforts. SSU books the costs of its acquisition efforts to an account that is recorded below the line. However, for purposes of the projected test year SSU failed to recognize the full amount of costs that should be recorded below the line. SSU estimated that $30,585 would be recorded below the line for its acquisition salary-related efforts. This amount, however, is substantially less than what was recorded below the line in 1994 and is substantially less than what should be recorded below the line in 1996.

Schedule 24 shows each person that expended time on SSU's acquisition efforts in 1994 and the percentage of their time devoted to this effort. To arrive at the amount to remove from the 1996 test year, I used the percentage of time actually devoted in 1994 applied to each person's 1996 base salary, with three exceptions. The exceptions include the three individuals that work in the corporate development section of SSU. This is the department at SSU that is primarily responsible for SSU's acquisition efforts. According to Mr. Sweat, he spends approximately 90% of his time on SSU's acquisition efforts. Therefore, instead of utilizing the percentage actually recorded in 1994 for Mr. Sweat and his subordinates, I used Mr. Sweat's current estimate of the time he expends on SSU's acquisition program. Since SSU intends to increase its acquisition efforts relative to 1994 it is only reasonable that a larger portion of Mr. Sweat's salary and his subordinates' salaries be recorded below the line in 1996. My estimate of the additional salaries that should be removed from test year expenses and recorded below the line is most likely quite conservative. I have not increased any of the percentages of other persons in SSU that work on the acquisition of new systems, despite SSU's increased effort in this area. As shown on this schedule, my adjustment reduces test year expenses by $175,928.

The next adjustment that I recommend is similar. As shown on Schedule 25, I have removed from test year expenses 90% of the amount of material and supplies, transportation, and miscellaneous expenses charged to Mr. Sweat's responsibility center. Since the majority of Mr. Sweat's time is devoted to SSU's acquisition program it is only logical to conclude that the same percentage of expenses should likewise be charged below the line. The adjustment that I recommend reduces test year expenses by $10,742.

VII. Expense Adjustments

Q. Please turn to the seventh section of your testimony. What other adjustments do you recommend?

A. I am recommending several other adjustments. These are shown on Schedules 26 through 36. The first adjustment shown on Schedule 26 removes from the test year the salary of the Company's public relations/governmental relations employee. In response to Citizens's interrogatory 114, SSU stated that for the projected test year it did not record below the line any salaries related to lobbying. With respect to the salary of its employee designated for its governmental/lobbying efforts, SSU responded: "The 1995 budget contains no below the line salary expense for lobbying although the budget does include a charge of $92,000 for lobbying costs to be performed by outside consultants. The 1995 budget was prepared prior to Mr. Smith's hiring at SSU, and therefore, his labor being included in lobbying costs was not anticipated." [Response to Citizens Interrogatory 114.]