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April 2, 2001

Ms. Blanca S. Bayo, Director
Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
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RECORDS AND REPORTING

Re: Docket No. 001502-WS

Dear Ms. Bayo:

Enclosed herewith for filing in the above-referenced docket on behalf of Florida Water Services Corporation ("Florida Water") are the original and fifteen copies of Florida Water's Post-Workshop Comments.

Please acknowledge receipt of these documents by stamping the extra copy of this letter "filed" and returning the copy to me.

Thank you for your assistance with this filing.

Sincerely,

Martin P. McDonnell for
Kenneth A. Hoffman

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DOCUMENT NUMBER-DATE
04064 APR-26
FPSC-RECORDS/REPORTING

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Proposed Rule 25-30.0371,)
Acquisition Adjustments)

Docket No. 001502-WS

Filed: April 2, 2001

FLORIDA WATER SERVICE CORPORATION'S
POST-WORKSHOP COMMENTS

Florida Water Services Corporation ("Florida Water") hereby submits its post-workshop comments in the above-referenced docket.

Background

Following the provision of notice and the submission of comments by interested parties, on February 7, 2001, the Florida Public Service Commission ("Commission") held a workshop with Florida's investor-owned water and wastewater utilities and the Office of Public Counsel ("OPC") to address various acquisition adjustment issues affecting the water and wastewater utilities industry in Florida. At the conclusion of the workshop, the Commission indicated that it intends to develop a proposed rule addressing acquisition adjustments. To facilitate that effort, the Commission asked the participants at the workshop to submit comments regarding the issues and proposals discussed at the workshop including:

1. The filed comments of OPC;
2. Commissioner Jaber's proposal of conditioning the inclusion of a positive acquisition adjustment by an agreement to defer the pursuit of a rate increase for a specific number of years;
3. Commission Staff's suggestion to recognize a negative acquisition adjustment and amortize the adjustment over five years;
4. Commissioner Palecki's concern as to whether the policy of promoting acquisition adjustments is a proper directive of the Legislature or the Commission; and

DOCUMENT NUMBER-DATE

04064 APR-20

FPSC-RECORDS/REPORTING

5. A proposed acquisition adjustment rule.

Florida Water's Basic Position

As Florida Water stated in its prefiled comments and testified at the workshop, the fundamental principle underlying a policy that promotes acquisitions is that the consolidation of water and wastewater systems in Florida produces an overall benefit to the customer. Any rule developed by the Commission should be symmetrical and even-handed in addressing the appropriate regulatory treatment for negative and positive acquisition adjustments and should ensure finality of Commission decisions that address proposed acquisition adjustments.

As Florida Water explained in its written comments and elaborated on at the workshop, the water and wastewater industry is a rising cost industry with a continuing need for increased investments and increasing costs of environmental compliance. Since the enactment of the Safe Drinking Water Act ("SDWA") of 1986, rising costs and increasingly stringent environmental and water quality standards make it difficult for smaller utilities to remain financially viable and to provide environmentally compliant water and wastewater services. The promotion of acquisition and consolidation of utility systems benefits the customers of the acquired system who may be saddled with a utility that lacks the resources, professional staff and/or desire to provide high quality, environmentally compliant service. Such utilities often fail to make or simply lack the resources to make the necessary investments to upgrade the facilities or install new facilities necessary to provide safe sufficient and reliable service.

The promotion of acquisitions and consolidation in the water and wastewater industry benefits the customers of utilities who lack the resources to provide high quality service on a long term basis. As reflected in Florida Water's comments and as discussed at the workshop by Mr.

Perry, consolidation also can bring rate stability, lower financing costs, improved service, improved customer communications with the utility, improved environmental compliance, improved operations, professional and sophisticated management and operations, and removal of the risk of abandonment to the customers of the acquired utility. At the same time, consolidation can bring economies of scale and lower costs per customer and enhance revenue stability to the acquiring utility. (Tr. 36-38).

If the Commission fails to implement a rule that promotes acquisitions, the results will be detrimental for the private water and wastewater industry as well as Florida's consumers. It is an undeniable fact that utilities that are saddled with facilities and service that are in a declining state and have dim prospects for future provision of high quality, environmentally compliant service will become candidates for either abandonment or purchase by a professionally run utility. As the Commission has recognized dating back to 1983, professionally run utilities need to have sufficient regulatory incentives to purchase such utilities particularly where it is clear that additional investments will be necessary. After all, as Mr. Perry emphasized, utilities that require investments to improve the level of service are going to require those investments either by the existing owner - - who may lack the interest or the resources - - or the acquiring utility who can do so at a lower cost of operation. (Tr. 39). Larger, professionally run utilities who seek to expand their customer base and revenue stability through growth will decline acquisition opportunities and the above mentioned benefits that come therewith if regulatory policy promotes negative acquisition adjustments or fails to promote positive acquisition adjustments. Absent a policy or rule that addresses these issues, as Commission staff testified to at the workshop, utilities and their customers who suffer from

disinterested management, high cost financing, and/or inadequate financial resources will remain subject to a lower quality of service and the risk of abandonment. (Tr. 167-8).

Despite the stated desire of this Commission to "promote" consolidation in the water and wastewater industry, the actual Commission policy on acquisition adjustments since approximately 1983 has been that absent "extraordinary circumstances," acquisition adjustments are not recognized in rate base. Consistent with that approach, in 1990, the Commission held:

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 ... 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.¹

Subsequently in Order No. 25729 issued February 17, 1992, this Commission stated 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 Department

¹See, Order No. 23376 issued August 21, 1990.

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.

Florida Water believes that the Commission's acquisition adjustment policy has been only partially effective. Indeed, the records of Commission proceedings and orders reflect that dating back to 1988, in over 100 acquisition adjustment decisions, the Commission has imposed only 4 negative acquisition adjustments and granted only 4 positive acquisition adjustments. While the limited number of negative acquisition adjustments have arguably served to benefit customers of acquired troubled utilities, the lack of positive acquisition adjustments based on the existing policy fails to sufficiently promote the benefits that come with consolidation of two professionally run utilities or a professionally run utility and a troubled utility.

If the Commission continues to believe that it is an appropriate goal to promote consolidation in this industry and recognizes that the continued viability of Commission-regulated utilities is now and will increasingly be dependent on regulatory policies which promote growth, achievement of economies of scale, and reasonably priced, environmentally compliant services, then now is the time to move toward a policy or rule which will achieve these benefits.

As explained by Florida Water's President, Dr. John Cirello, when Florida Water considers an acquisition, it looks at current costs, the purchase price of the system, and the future investments necessary to meet environmental rules and regulations. (Tr. 29). Moreover, it is Florida Water's experience that the "market" for water and wastewater utilities today is consistently set at or near the replacement cost of the facilities. In other words, notwithstanding the book value of the facilities of the selling utility, purchase price demands are consistently placed at or near the replacement cost

of the facilities. As Dr. Cirello testified, competition driven by foreign investment in Florida and Florida's governmental utilities are driving prices up - - in many cases to two and three times book value at or above replacement costs. (Tr. 17-18). Governmental utilities are not subject to the regulatory policies of the Commission such as acquisition adjustment policies and used and useful ratemaking treatment. A pro-acquisition policy is necessary to help Commission regulated utilities "level the playing field" when competing to acquire existing systems and allow for the growth necessary to spread fixed costs over a larger customer base and pay for the application of new treatment and management methods. (Tr. 17-20).

Florida Water requests the Commission to give serious consideration to the approach taken by the North Carolina Utilities Commission. Florida Water's affiliate, Heater Utilities, provides water and wastewater services in North Carolina and South Carolina. As testified to by Bill Grantmyre, Heater's President, and Jerry Tweed, Heater's Vice President and Director of Regulatory Affairs, the North Carolina Commission has granted Heater positive acquisition adjustments in six cases over the last two and one-half years. (Tr. 48-49). The basic test in North Carolina is that the purchase must be an arms length transaction, the purchase must be prudent, and the acquiring utility must demonstrate benefits for the acquired customers. (Tr. 50). The North Carolina Commission approved in full a positive acquisition adjustment of the Mid-South Water Systems by Heater in May 1999, approving the inclusion of the purchase price of \$9 million in rate base. Mid-South had been a troubled water company with serious operational problems. Since the acquisition, Heater has spent approximately \$2.5 to \$3 million each year upgrading Mid-South's systems. (Tr. 41-46).

The Heater/Mid-South acquisition demonstrates that regulatory policies which promote positive acquisition adjustments can play a key role even with troubled utilities. The 200 water

systems and 31 wastewater systems of Mid-South (Tr. 57) that were at risk prior to the acquisition are now part of the Heater group of utilities, have been the subject of significant investments, and can look forward to stable rates and quality service in the future.

Florida Water believes that any policy developed by the Commission regarding acquisition adjustments should include provisions which confirm that any decision made by the Commission concerning a proposed acquisition adjustment will be final and not subject to reconsideration and relitigation in future cases. Providing finality to such decisions will in turn provide certainty to the utility and its lenders concerning the stability of the utility's rate base and the rates that flow there from and will avoid the increased rate case expense that has historically been incurred by utilities regulated by the Commission through relitigation of acquisition adjustment decisions.

Based on the foregoing principles, as well as its written comments and testimony at the workshop, Florida Water hereby submits Exhibit "A" as a proposed rule in the event the Commission determines to move forward with rulemaking in this docket.

Comments of the Office of Public Counsel

As in the past, OPC opposes all positive acquisition adjustments and supports negative acquisition adjustments. Under OPC's asymmetrical approach, OPC offers to split negative acquisition adjustments on a 50/50 basis but opposes positive acquisition adjustments in full. (Larkin, Tr. 119-120). Reminiscent of past arguments which have been rejected by the Commission in the aforementioned orders, OPC once again argues that it is not appropriate to require customers to pay for the recovery of investments when a premium is paid over net book value while it is appropriate (although entirely inconsistent) for the utility to absorb a reduced rate base when a utility is purchased at a discount. (Larkin, Tr. 163).

Interestingly enough, Mr. Cicchetti, who testified on behalf of OPC, admitted that the Commission should promote consolidation in this industry and that his 50/50 approach to negative acquisition adjustments might not provide an adequate incentive to acquisition by professionally run utilities. (Tr. 149, 154-155). Mr. Cicchetti also conceded that transactions involving potential negative acquisition adjustments are fact driven and, therefore, his attempt to “settle” the issue of negative acquisition adjustments by offering a 50/50 split should not preclude the ability of parties and the Commission to evaluate negative acquisition adjustments on a case by case basis. (Tr. 144-145).

Insofar as positive acquisition adjustments are concerned, OPC offered very little other than its general opposition because, as Mr. Larkin put it, the utility is already getting something in return for the price paid above net book value. Mr. Larkin summarized, quite succinctly, OPC’s inconsistent approach in this docket:

MR. LARKIN: Here’s a simple rule. You’ve got a negative acquisition, let’s split it. Don’t look at anything else.

COMMISSION PALECKI: Would you be consistent with a positive acquisition?

MR. LARKIN: No. Because a positive acquisition, you’re paying more for that because there’s an incentive there. There’s something there that places the value of that system above its book value. There’s a piece of land; there is access to more customers; the rates are higher than what they should be. So there are reasons not to give positive acquisition adjustments.

(Tr. 120).

While admittedly inconsistent in his proposed treatment of negative and positive acquisition adjustments, Mr. Larkin’s attempt to provide justification for his approach is flawed. First, Mr. Larkin fails to mention that any tangible benefit acquired by a utility through the purchase of

property or land is of little value if excluded from rate base. Second, the implication that a utility picks up a windfall through the higher rates of the acquired utility is pure speculation and was certainly not the case in the Heater/Mid-South acquisition (Tr. 54-57). Finally, Mr. Larkin ignores the fact that competitive forces are driving the purchase price of utilities higher and that, as in the case of the Heater/Mid-South acquisition, a positive acquisition adjustment may be warranted and justified with the purchase of a troubled utility.

OPC's proposal should be rejected. The market place reality is that there are very few acquisitions at net book value and the ones that do take place typically require substantially new capital investments to meet environmental regulatory requirements. OPC's proposal to "share" negative acquisition adjustments and place a cap on returns would, in many cases, result in initial rate decreases and subsequent rate cases to recover the new capital investment. The Commission's existing policy has generally served to avoid this administrative nightmare, rate instability, and proliferation of rate case expense. Florida Water's proposed rule language would, instead, properly place the burden of demonstrating the existence of extraordinary circumstances on OPC and would appropriately allow these transactions to be addressed on a case by case basis.

Commissioner Jaber's Proposal

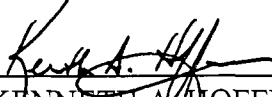
During the workshop, Commissioner Jaber questioned whether it would be appropriate to include a positive acquisition adjustment at the time of the purchase if the acquiring facility agrees not to seek a rate increase for a specific number of years after the acquisition. Commissioner Jaber's suggestion may be a viable alternative for an acquiring utility to exercise as an option if the acquiring utility deems appropriate. Florida Water maintains that the appropriate period of time that the acquiring utility should agree to defer rate relief should be three years after the initial acquisition.

Florida Water's position that Commissioner Jaber's proposal should only be an option for the acquiring utility is based upon marketplace forces that may preclude the acquiring utility from being able to wait three years for a rate increase. For example, if a utility were to make an acquisition at a price slightly above net book value, and be forced, because of environmental or other problems, to make a significant initial capital investment, the acquiring utility may wish to seek a rate increase immediately to cover its increased capital investment. On the other hand, if a utility were to make an acquisition at a price significantly above net book value, the acquiring utility may be satisfied to recognize the initial acquisition adjustment and agree not to petition the Commission for a rate increase for the requisite three years.

Staff's Proposal

During the workshop, Commission Staff offered the suggestion that the Commission immediately recognize a negative acquisition adjustment and allow that adjustment to be amortized over five years. This proposal may be appropriate if allowed as an option available to the acquiring utility and if the amortization period is established at three years. As noted above, if an acquisition is made at a price lower than net book value in today's market, it is undoubtedly because the acquired utility is in need of significant capital investment. As such, Florida Water's position is that any amortization should take place over a three year period, so that if need be, the acquiring facility can petition the Commission for rate relief after the three year amortization period, without suffering a negative acquisition adjustment.

Respectfully submitted this 2nd day of April, 2001.



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Flawater/comments.2

1 25-30.0371 - Acquisition Adjustment

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

8 (2) Water and wastewater utilities subject to regulation by the
9 Commission are authorized to file a petition with the Commission requesting:

10 (a) Approval of the purchase of the land and facilities of another water
11 or wastewater utility and the transfer of the certificate, if any, of the acquired utility;
12 and

13 (b) Inclusion of any positive acquisition adjustment in rate base.

14 (3) In determining whether to include a positive acquisition adjustment
15 in rate base, the acquiring utility shall bear the burden of demonstrating that the
16 anticipated benefits resulting from the acquisition justify the increase in rate base.
17 In considering whether the benefits resulting from the acquisition justify the
18 inclusion of the requested positive acquisition adjustment in rate base, the
19 commission shall consider, but not be limited to, the following factors:

20 (a) Whether the purchase price is below the replacement cost of the
21 acquired land and facilities.

22 (b) Whether the acquisition would provide lower rates or rate stability
23 over the long term to the customers of the acquired utility.

24 (c) Whether the acquisition would provide improved customer service,
25 improved environmental compliance, lower financing costs, improved management,



1 improved operations, and efficiencies, including economies of scale, to the customers
2 of the acquired utility and acquiring utility.

3 (4) In lieu of subsection (4), a utility shall be authorized to include 100%
4 of a positive acquisition adjustment in rate base at the time of transfer if the utility
5 agrees to amortize 100% of the positive acquisition adjustment into rate base over
6 three years. Such three year period shall begin on the date of commission approval
7 of the acquisition as requested by the acquiring utility.

8 (5) In determining whether to include a negative acquisition adjustment
9 in rate base, the party requesting the imposition of the negative acquisition
10 adjustment shall bear the burden of demonstrating the existence of extraordinary
11 circumstances justifying the imposition of the requested negative acquisition
12 adjustment.

13 (6) Any determination by the Commission regarding a requested positive
14 acquisition adjustment or requested negative acquisition adjustment shall not be
15 revisited or reconsidered by the Commission in a subsequent proceeding.

16
17 Flawater\acquisitionrule