



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-

DATE: August 23, 2001

TO: DIRECTOR, DIVISION OF COMMISSION CLERK AND ADMINISTRATIVE SERVICES (BAYÓ)

FROM: DIVISION OF APPEALS (MOORE)
DIVISION OF ECONOMIC REGULATION (WILLIS HEWITT) *BA*
DIVISION OF LEGAL SERVICES (BRUBAKER) *PS*
DIVISION OF POLICY ANALYSIS & INTERGOVERNMENTAL LIAISON (SHAFFER) *BA*
DIVISION OF REGULATORY OVERSIGHT (DANIEL) *12 AP*

RE: DOCKET NO. 001502-WS - PROPOSED RULE 25-30.0371, FLORIDA ADMINISTRATIVE CODE, ACQUISITION ADJUSTMENTS

AGENDA: SEPTEMBER 4, 2001 - 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\001502A.RCM

CASE BACKGROUND

An acquisition adjustment is a regulatory convention by which the books of the utility are adjusted to reflect changes in the original cost 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 was \$100, and an acquiring utility paid \$120 for the assets, a positive acquisition adjustment, if approved, would increase the rate base valuation to \$120. The

DOCUMENT NUMBER-DATE

10468 AUG 23 01

FPSC-COMMISSION CLERK

acquiring utility would then be permitted to earn a rate of return on the investment of \$120.

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." Order No. 25729 at pages 1-2.

In Order No. 25729, the Commission explained why it believed its policy was appropriate and what benefits it believed were 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,

DOCKET NO. 001502-WS
DATE: August 23, 2001

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 acquisition 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 where 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 the Office of Public Counsel (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 staff workshop was held on December 2, 1999. Attending were representatives of Florida Cities Water Company, Florida Water Services Corporation (FWSC), Aquasource Utility, Inc. (AUI), and OPC.

Staff filed a recommendation on October 5, 2000, proposing to codify existing Commission policy on acquisition adjustments in the water and wastewater industry. The recommendation was deferred and

DOCKET NO. 001502-WS
DATE: August 23, 2001

instead a full Commission Workshop was noticed and held on February 7, 2001. Attending the workshop were representatives of FWSC, Utilities, Inc. (UI), United Water Florida (UWF), AUI, and OPC.

Staff's primary recommendation is for the Commission to adopt Rule 25-30.0371, F.A.C., which modifies existing Commission policy on acquisition adjustments in the water and wastewater industry. Staff's alternate recommendation is for the Commission to adopt Rule 25-30.0371, F.A.C. in order to codify existing Commission policy on acquisition adjustments in the water and wastewater industry.

Attachment A is a draft of the staff's primary recommended rule. Attachment B is the staff's alternative recommended rule. Attachment C is the memorandum regarding the Statement of Estimated Regulatory Costs for staff's primary rule draft.

DISCUSSION OF ISSUES

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

PRIMARY RECOMMENDATION: Yes. The Commission should propose staff's primary Rule 25-30.0371, F.A.C. which modifies existing Commission policy. (WILLIS, HEWITT, BRUBAKER, MOORE, SHAFER, DANIEL)

ALTERNATIVE RECOMMENDATION: Yes. The Commission should propose staff's alternative Rule 25-30.0371, F.A.C. which codifies existing Commission policy. (WILLIS, HEWITT, BRUBAKER, MOORE, SHAFER, DANIEL)

STAFF ANALYSIS OF COMMISSION WORKSHOP: All parties attending the workshop were requested to prefile comments before the workshop held on February 7, 2001. At the completion of the workshop, attendees were also requested to file post-workshop comments addressing:

1. The filed comments of OPC;
2. The proposal to condition not including a negative acquisition adjustment on an agreement by the utility to defer the pursuit of a rate increase for a specific number of years (Commissioner Jaber's proposal);
3. The proposal to recognize a negative acquisition adjustment when a company files its next rate case and accelerate the amortization of the adjustment above or below the line (Staff's proposal);
4. The concern as to whether the policy of promoting acquisition of small utilities is a proper directive of the Legislature or the Commission; and
5. A proposed rule.

A summary of each of the parties' positions and comments follows:

Office of Public Counsel:

OPC proposed that the Commission change its policy for both negative and positive acquisition adjustments. For negative acquisition adjustments, OPC proposes to split the negative acquisition adjustment on a 50/50 basis between the acquiring utility and the customers up to a cap. To apply OPC's method requires two calculations. The first calculation would be made by reducing rate base by 50 percent of the negative acquisition adjustment and then calculating a revenue requirement. The second calculation would be made by reducing rate base by 100 percent of the negative acquisition adjustment and then calculating a revenue requirement by applying an equity return based on 150 percent of what the current leverage graph produces. The utility would then have rates set based on the lower of the two revenue calculations.

This sharing would only take place for those utilities identified as troubled companies. For those companies found not to be troubled, 100 percent of the negative acquisition adjustment would be applied.

OPC believes that this proposal would benefit both the utilities and the consumers. It believes this policy will eliminate the need to regularly litigate whether a purchase involves extraordinary circumstances and should make cases less contentious. OPC believes that the opportunity to earn up to a 50 percent premium on a fair return would be a strong incentive to a purchaser of a troubled company. Customers may end up paying higher rates resulting from lack of maintenance and additional cost to restore the system's quality, but customers would be better off than under the Commission's current policy which OPC believes heavily favors the utilities.

For positive acquisition adjustments, OPC has proposed that the Commission continue with the current policy. OPC stated that 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. No such incentive is needed in cases where there is a positive acquisition adjustment. It believes that purchase of a utility at more than book value is simply a business decision made by the purchaser that does not need an extra incentive.

OPC also commented on the proposal made by staff during the workshop. OPC believes that the proposal would be an improvement over current policy. It believes that 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. Under staff's proposal, however, the benefit for the customers phases out over the accelerated time period. Therefore, according to OPC, its suggested 50/50 sharing of the negative acquisition adjustment is a better policy.

Florida Water Service Corporation:

FWSC believes that 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. The company also believes that any rule developed by the Commission should be symmetrical and evenhanded in addressing the appropriate regulatory treatment for negative and positive acquisition adjustments and should ensure finality of Commission decisions that address proposed adjustments.

FWSC believes that the Commission should be promoting the acquisition and consolidation of water and wastewater utilities because it ultimately benefits the customers. The utility believes the benefits would be:

1. Better resources, professional staff and/or a desire to provide high quality, environmentally compliant service on a long-term basis;
2. Bring rate stability, lower financing cost, improved service, improved customer communications with the utility, improved environmental compliance, improved operations, professional and sophisticated management and operations, removal of the risk to the customers of abandonment of the acquired utility; and
3. Bring economies of scale and lower costs per customer and enhance revenue stability to the acquiring utility.

The utility believes that the failure to implement a rule that promotes acquisitions will be detrimental for the private water and wastewater industry as well as for Florida's consumers.

FWSC believes that the Commission's current policy has been only partially effective. This is mainly due to the lack of positive acquisition adjustments which the company believes fails to promote the benefits that come with consolidation of two professionally run utilities or a professionally run utility and a troubled utility. FWSC states that purchase price demands are consistently placed at or near the replacement cost of facilities. Competition driven by foreign investment in Florida and Florida's governmental utilities are driving prices to two or three times book value. The utility believes that 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 large customer base and pay for the application of new treatment and management methods.

FWSC desires the Commission to adopt the approach taken by the North Carolina Utilities Commission (NCUC). The company commented that the NCUC had developed standards to review the inclusion of positive acquisitions. These standards are 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. The company submitted a proposed rule with its post workshop comments that offers this language. The utility is also requesting that the Commission include provisions in the rule that make any decision on a proposed acquisition adjustment final and not subject to reconsideration and relitigation in future cases.

FWSC also provided comments to OPC's suggested rule revisions. The utility states that OPC 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 for the utility to absorb a reduced rate base when a utility is purchased at a discount. The 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 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. FWSC argues that the Commission's existing policy has generally served to avoid this administrative nightmare, rate instability and proliferation of rate cases. FWSC's proposal would, according to the company, place the burden of demonstrating the existence of extraordinary

circumstances on OPC or the party requesting that a negative acquisition adjustment be made, and would appropriately allow these transactions to be addressed on a case-by-case basis.

As far as Commissioner Jaber's and staff's proposal, FWSC believes that they might be viable alternatives for the acquiring utility but only as an option. The company believes that under Commissioner Jaber's proposal, the deferral of rate relief should be no more than three years after the initial acquisition. As to staff's proposal, the company believes that the amortization period should be no more than three years.

Utilities, Inc.:

UI prefers the adoption of a rule that implements the current policy and puts finality into the decisions of the Commission. When the Commission issues a final order, affected parties should be able to rely on it. Utilities make significant decisions based upon the expected finality of that order. UI believes that it has been amply demonstrated that the Commission's current policy works. If there are refinements to that policy that are necessary, UI believes that they must be demonstrated as being necessary. It believes that changing the entire Commission policy on this subject would be counterproductive.

UI also provided comments on OPC's proposed method. It believes that the method would reverse the effect of current Commission policy and discourage rather than encourage the purchase of troubled systems. It would also result in rates that reflect less than the cost incurred in making service available. UI believes that this would discourage conservation in opposition to the expressed intent of existing Florida Statutes.

UI also provided comments on Commissioner Jaber's proposal as well as staff's. To the extent that either of these proposals support the existing Commission policy, UI supports them. It is unclear to UI, however, what the full rate-making impact might be from these two initial proposals. It therefore reserves further comment on these concepts until all the details are presented and considered.

Aquasource Utility, Inc.:

AUI believes that the Commission's policy should be modified to treat 100 percent stock and asset purchases similarly to avoid creating unintended disincentives for worthwhile acquisitions. Additionally, the Commission should allow the utility to recognize its full cost of acquisition and associated amortization expense for financial reporting purposes in the annual report. Failure to do so will result in an overstatement of earned returns because efficiencies/synergies will automatically be reflected in reported operation and maintenance expenses. Utilities will be reluctant to pursue acquisitions at net book value, even where synergies are immediate and substantial, because of the threat from a show cause order to lower rates. Allowing these practices will save time and expenses for staff, the utility and the ratepayers. In other words, AUI believes that the acquisition adjustment should be allowed accounting treatment only and a decision on ratemaking treatment should be deferred until the next formal rate case.

AUI did not file post workshop comments.

United Water Florida:

UWF believes the future acquisition policy of the Commission should be a flexible approach to encourage and facilitate the acquisition of inefficient utilities by stronger more efficient ones that can provide some benefit to consumers. They suggest that the Commission look at incentive mechanisms employed by the New York Public Service Commission and the Pennsylvania Public Utilities Commission.

UWF believes that positive acquisition adjustments should be allowed if the utility can show some benefit to the consumer. Each case should stand on its own to determine the need for and the amount of an acquisition adjustment. Factors such as the need for additional capital improvements, increased operation and maintenance expense, current rate differentials and the expected timing of a rate case should all be considered in developing an equitable mechanism which would allow a beneficial acquisition.

UWF does not believe that a negative acquisition adjustment should be applied unless there are good reasons. If the acquiring

utility will benefit customers, it should not be burdened with the application of a negative acquisition adjustment.

The company did not file post workshop comments.

Legislative Direction and Authority

No party addressed the issue of whether the Commission has or should have legislative direction to promote acquisition of small utilities. Staff, however, believes that the Legislature already directed the Commission to encourage consolidation and the acquisition of small utilities when it enacted certain policy changes following its 1989 Sunset review of Chapter 367, Florida Statutes. In "A Review of Chapter 367, Florida Statutes, Relating to Water and Sewer Systems", dated March, 1989, Staff of the Senate Economic, Professional and Utility Regulation Committee reported that the large number of small sewer systems created serious regulatory problems for the Commission that are not encountered with larger systems. The problems identified included those such as the increased possibility of abandonment, greater costs of regulation, more company financial difficulties, and problems of environmental compliance. Legislative staff recommended policy changes to reduce the demand for and number of small sewer systems.

The specific recommendations to the Legislature were to enact a policy to reduce the number of small sewer systems by discouraging their proliferation and encouraging "regionalization", whereby only one Class A sewer system is certificated to serve an entire region. As the region's population grows, the system is expanded to meet the service demand. To implement the policy, legislative staff recommended amending Chapter 367 to authorize the Commission to deny a certificate for any new Class C wastewater system, if the public can be adequately served by modifying or extending a current wastewater system. The Legislature subsequently enacted Chapter 89-353, including this provision which is now section 367.045(5)(a), Florida Statutes. Ch. 89-353, § 5, Laws of Fla. This law took effect October 1, 1989.

The Commission also has broad authority to protect the public health, safety, and welfare, to set rates, and to regulate in the public interest, as well as the specific authority to grant, amend, or deny certificates if it is in the public interest. § 367.011(3), § 367.045(5)(a), and § 367.081, Fla. Stat. (2000). The statutes also prohibit a utility from selling, assigning, or transferring

facilities without approval of the Commission. § 367.071(1), Fla. Stat. (2000). The Commission must determine whether the proposed transaction is in the public interest, and that the transferee will fulfill the commitments, obligations, and representations of the utility. Id.

Staff believes that the above provisions furnish adequate direction and support for its acquisition adjustment policy.

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. (2000). Staff recommends that the Commission propose staff's attached primary 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), Florida Statutes, 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.

STAFF PRIMARY ANALYSIS:

Staff's primary rule draft differs from staff's alternative rule draft only in the treatment of negative acquisition adjustments. Staff believes that past Commission policy concerning negative acquisition adjustments was necessary to promote the consolidation of the industry. The primary rule "fine tunes" the current policy by addressing the concern over potentially high rates of return that a company might achieve by not recognizing a negative acquisition adjustment.

Staff believes that the difference between the net book value and a lower purchase price can, if material, cause real concerns over the earnings of a company if that company files for a rate increase soon after the purchase. This is the concern addressed by OPC at the Commission workshop and through its filed comments. Staff is concerned about the ability of a company which is

receiving a significant rate of return based on the purchase price of the utility that then files for a rate increase shortly after the purchase of the company. This has created concern from consumers and OPC in past cases such as in Order No. PSC-98-1092-FOF-WS, issued August 12, 1998, in Docket No. 960235-WS (Wedgefield Utilities, Inc.).

The primary proposed rule changes how negative acquisition adjustments would be treated in the future. It takes into account the concerns of consumers, OPC and the need to still provide an incentive for consolidation. Staff's primary proposed rule creates the same results as staff's alternative rule except when an acquired utility files for a rate increase within a set period of time after the purchase takes place. Under staff's primary rule, if the difference between the book value and the lower purchase price is 20 percent or less, then the treatment based on both proposed rules is the same. If, however, the difference is greater than 20 percent, then the primary rule provides for a different treatment. The primary rule requires that the amount that exceeds 20 percent be booked as a negative acquisition adjustment. The rule also establishes an amortization period for the acquisition adjustment of five years unless another period is justified. If the utility does not file for a rate increase during the amortization period, then the negative acquisition adjustment is not recognized for any review of earnings. If the utility does file for a rate increase during the amortization period, the amortized negative acquisition adjustment is recognized and used to test the earnings level and the need for a rate increase. The 20 percent that was not booked as an acquisition adjustment is treated the same as it would be under the proposed alternative rule. It would not be recognized unless there are extraordinary circumstances.

Staff believes that the proposed primary rule provides the necessary incentives for the purchase of troubled utilities. The proposed rule also addresses the concerns over a potential "windfall" that a company might receive if it were to file a rate case shortly after the transfer was completed. Below is a summary of the provisions of the primary rule.

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 a positive acquisition adjustment shall not be included in rate base absent proof of extraordinary circumstances. This section also provides that the entity which 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 re Wedgefield Utilities, Order No. PSC-98-1092-FOF-WS, issued August 12, 1998, in Docket No. 960235-WS. In addition, the section lists certain factors the Commission will consider to determine whether there are extraordinary circumstances justifying a positive adjustment.

For a positive acquisition adjustment (where the purchase price is greater than the net book value of the utility's assets), section (2) 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. These factors are listed by way of example, and other evidence may be offered.

Section (3) provides that a negative acquisition adjustment shall not be included in rate base absent proof of extraordinary circumstances or when the difference between the net book value and the purchase price exceeds 20 percent. If the difference does exceed 20 percent, it requires the inclusion of an acquisition adjustment calculated pursuant to section (3)(b).

Section (3)(a) provides that the entity that believes that a negative acquisition adjustment should be made has the burden to prove the existence of extraordinary circumstances. This is consistent with the Commission's decision in Order No. PSC-98-1092-FOF-WS. In addition, this section lists certain factors the Commission will consider to determine whether there are extraordinary circumstances justifying a negative adjustment. These factors include the anticipated retirement of the acquired assets and the condition of the assets acquired. These factors are listed by way of an example, and other evidence may be offered.

Section (3)(b) outlines the treatment when the difference between the net book value and the purchase price exceeds 20 percent. The section requires that the amount that exceeds 20 percent be booked as a negative acquisition adjustment. The

section also establishes an amortization period for the acquisition adjustment of five years unless another period is justified. If the utility does not file for a rate increase during the amortization period, then the negative acquisition adjustment is not recognized for any review of earnings. If the utility does file for a rate increase during the amortization period, the amortized negative acquisition adjustment is recognized and used to test the earnings level and the need for a rate increase. The 20 percent that was not booked as an acquisition adjustment is treated the same as it would be under section (3)(a). It would not be recognized unless there are extraordinary circumstances.

Section (4) requires the Commission to establish an amortization period for any included acquisition adjustment. It also lists some factors that the Commission will take into consideration when establishing the amortization period.

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, issued January 26, 1988, in Docket No. 870118-GU. In a subsequent rate review, the Commission 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.

In previous cases, 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. Second, 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 proposed primary rule, which modifies current Commission's policy, 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 (Primary Rule)

The primary proposed rule should not impose additional transaction costs on water and wastewater utility acquisitions. The primary rule codifies existing Commission policy except in a couple of instances. If an acquisition price is less than 20 percent of the book value, and an acquired utility files for a rate increase, the amount that exceeds 20 percent would be booked as a negative acquisition adjustment. This would lower the amount of rate base on which to earn a return. If there is no request for a rate increase, however, the acquisition adjustment would be amortized over five years with no effect on revenues. In addition, when a full or partial acquisition adjustment is approved by the Commission and the extraordinary circumstances change or do not materialize, then the adjustment could be modified. The modification would just return rate base to what it would have been before an assertion of extraordinary circumstances.

STAFF ALTERNATE ANALYSIS:

Staff's alternate rule draft differs from staff's primary rule draft only in the treatment of negative acquisition adjustments. Staff believes that past Commission policy concerning negative acquisition adjustments was necessary to promote the consolidation of the industry. The alternate rule codifies current Commission policy. Below is a summary of the provisions of the alternate rule.

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 re Wedgefield Utilities, Order No. PSC-98-1092-FOF-WS, issued August 12, 1998, in Docket No. 960235-WS. 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) requires the Commission to establish an amortization period for any included acquisition adjustment. It also lists some factors that the Commission will take into consideration when establishing the amortization period.

Section (6) 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, issued January 26, 1988, in 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.

This alternate rule codifies current Commission policy 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. Second, 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 current policy by rule will reduce costs in future proceedings by diminishing some of the controversy over acquisition adjustments and expediting transfer or rate case proceedings.

Statement of Estimated Regulatory Costs (Alternative Rule)

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.

DOCKET NO. 001502-WS
DATE: August 23, 2001

ISSUE 2: Should the rule amendments as proposed by the Commission be filed for adoption with the Secretary of State and the docket be closed?

RECOMMENDATION: Yes. (WILLIS, HEWITT, BRUBAKER, MOORE, SHAFER, DANIEL)

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

25-30.0371 Acquisition Adjustment.

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

(2) Positive Acquisition Adjustments. A positive acquisition adjustment shall not be included in rate base absent proof of extraordinary circumstances. Any entity that believes a full or partial positive acquisition adjustment should be made has the burden to prove the existence of those extraordinary circumstances. In determining whether extraordinary circumstances have been demonstrated, the Commission shall consider evidence provided to the Commission such as anticipated improvements in quality of service, anticipated compliance with regulatory mandates, anticipated rate reductions or rate stability over a long-term period, and anticipated cost efficiencies.

(3) Negative Acquisition Adjustments. A negative acquisition adjustment shall not be included in rate base absent proof of extraordinary circumstances unless the difference between the net

book value and the purchase price exceeds 20 percent of net book value. If the difference does exceed 20 percent of net book value then the inclusion of a negative acquisition adjustment shall be calculated pursuant to section (b) below.

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

(b) If the difference between purchase price and net book value exceeds 20 percent of net book value, then the amount in excess of 20 percent shall be recognized for ratemaking purposes as a negative acquisition adjustment, but not used for any earnings review unless the purchaser files for a rate increase pursuant to section 367.081(2), 367.0814, 367.0817 or 367.0822, F.S. The negative acquisition adjustment shall be amortized over a 5-year period unless a shorter or longer period can be justified.

(4) Amortization Period. The Commission shall establish the amortization period for any included acquisition adjustment, excluding any acquisition adjustment booked under subsection (3) (b)

above, on a case-by-case basis. The Commission in setting the amortization period will take into account the composite remaining life of the assets purchased or the condition of the assets purchased. Amortization of the acquisition adjustment shall begin on the date of the order transferring the assets.

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

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

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

History: New .

ATTACHMENT B

25-30.0371 Acquisition Adjustment.

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

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

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

(4) Any entity that believes a full or partial negative acquisition adjustment should be made has the burden to prove the existence of those extraordinary circumstances. In determining

ATTACHMENT B

whether extraordinary circumstances have been demonstrated, the Commission will consider evidence provided to the Commission such as the anticipated retirement of the acquired assets and the condition of the assets acquired.

(5) The Commission shall establish the amortization period for any included acquisition adjustment. The Commission in setting the amortization period will take into account the composite remaining life of the assets purchased or the condition of the assets purchased. Amortization of the acquisition adjustment shall begin on the date of the order transferring the assets.

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

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

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

History: New.

MEMORANDUM

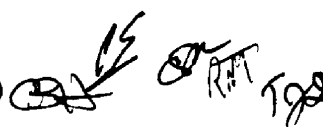
August 21, 2001

RECEIVED

01 AUG 21 PM 2:27

FLORIDA
DIVISION OF APPEALS

TO: DIVISION OF APPEALS (MOORE)

FROM: DIVISION OF ECONOMIC REGULATION (HEWITT) 

SUBJECT: STATEMENT OF ESTIMATED REGULATORY COSTS FOR DOCKET NO. 001502-WS, PROPOSED RULE 25-30.0371, F.A.C., ACQUISITION ADJUSTMENT

SUMMARY OF THE RULE

Proposed Rule 25-30.0371, F.A.C., Acquisition Adjustment, (primary recommendation) would modify existing Commission policy concerning the sale and purchase of jurisdictional water and wastewater utilities where the sale price is below book value. The primary rule would "fine tune" the current policy by recognizing a partial negative acquisition adjustment to preclude unjustified high rates of return on acquired utility assets. In the primary rule, if the difference between the book value and the lower purchase price is 20 percent or less, there would be no negative acquisition adjustment, just as in the alternative proposed rule. However, if the difference is greater than 20 percent then the amount which exceeds 20 percent would be booked as a negative acquisition adjustment. The rule would also establish an amortization period for the acquisition adjustment of five years unless another period is justified.

Staff's alternative recommendation would codify existing Commission policy which is to not allow a positive or negative adjustment to utility system asset values when purchased by a jurisdictional utility except with proof of extraordinary circumstances.

If, in either rule, 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.

ESTIMATED NUMBER OF ENTITIES REQUIRED TO COMPLY AND GENERAL DESCRIPTION OF INDIVIDUALS AFFECTED

The only entities that would be affected by the proposed rule are jurisdictional water and wastewater utilities that acquire other water and wastewater utilities. Although there are hundreds of jurisdictional water and wastewater utilities, normally the larger size utilities do the acquiring.

There are 11 Class A utilities under Commission jurisdiction, 54 Class B utilities, and 171 active Class C utilities. The ratepayers of an acquired utility should not be affected since rates would likely not change after an acquisition, absent a rate case and no acquisition adjustment.

Under the primary rule, if the difference between the purchase price and net book value exceeds 20 percent of net book value, then the amount in excess of 20 percent shall be recorded on the company's books but rates would not be adjusted unless the utility files a rate case. If there is a rate case requested by a purchaser within five years, a negative acquisition adjustment would be made and rates paid by utility customers accordingly could be reduced. Thus the purchaser has a choice and can avoid the negative acquisition adjustment and loss of potential revenues by not filing a rate case for five years following the acquisition. The largest negative acquisition adjustment not approved since 1986 was -\$1,700,391 with a potential revenue impact of -\$255,059 for Wedgefield Utilities. One other acquisition was in excess of -\$100,000 of revenue impact, eight acquisitions between -\$100,000 and -\$10,000 and the most, 33, had less than -\$10,000 in potential revenue impact. The proposed primary rule should help avoid as much litigation as has been experienced in the past. The cost saving would depend on the lessened number and the complexity of avoided hearings.

RULE IMPLEMENTATION AND ENFORCEMENT COST AND IMPACT ON REVENUES FOR THE AGENCY AND OTHER STATE AND LOCAL GOVERNMENT ENTITIES

The Public Service Commission and other state entities are not expected to experience implementation costs other than the costs associated with promulgating a proposed rule. Existing Commission staff would continue to handle monitoring of utility acquisitions. Local government entities should not be impacted.

ESTIMATED TRANSACTIONAL COSTS TO INDIVIDUALS AND ENTITIES

Only utility acquiring entities would be directly affected by either of the proposed rules. The transaction costs could be less under the proposed primary rule because there would be less incentive to litigate the issue of a negative acquisition adjustment. Rates could stay the same although the purchase price was less than book value. If the purchase price was more than 20

percent less than book value, the amount exceeding 20 percent would be recognized for ratemaking purposes as a negative acquisition adjustment, but not used for any earnings review unless the purchaser files for a rate case. The alternative rule would codify current policy where there is no recognition of positive or negative acquisition adjustment without a showing of extraordinary circumstances.

IMPACT ON SMALL BUSINESSES, SMALL CITIES, OR SMALL COUNTIES

There should be no significant impact on small businesses, small cities, and small counties since the proposed rule should only affect purchasing utilities.

ALTERNATIVE METHODS

The alternative recommendation would codify existing Commission policy. The other proposals to split the negative acquisition adjustment would be unsymmetrical if a positive acquisition adjustment is not treated the same way. Another suggestion was to make the amortization period three years instead of five. However, five years is the most appropriate time period to write off acquired properties because the interests of the purchaser and customers are best balanced.

acqadjsr.cbh