



Public Service Commission
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TALLAHASSEE, FLORIDA 32399-0850

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

FROM: OFFICE OF THE GENERAL COUNSEL (MOORE, BRUBAKER) *KB*
DIVISION OF ECONOMIC REGULATION (WILLIS, HEWITT, DANIEL) *CTM PA C#*

RE: DOCKET NO. 001502-WS - PROPOSED RULE 25-30.0371, F.A.C.,
ACQUISITION ADJUSTMENT *JOS 109*

AGENDA: 05/21/02 - REGULAR AGENDA - RULE PROPOSAL - INTERESTED
PERSONS MAY PARTICIPATE

RULE STATUS: PROPOSAL MAY BE DEFERRED

SPECIAL INSTRUCTIONS: THIS RECOMMENDATION REVISES STAFF'S
NOVEMBER 19, 2001, RECOMMENDATION

FILE NAME AND LOCATION: S:\PSC\GCL\WP\001502D.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 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

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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.

The Commission explained why it believed its policy was appropriate and what benefits it believed were derived from the policy in Order No. 25729 at pages 3-4.:

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 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

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more professional and experienced management, and the elimination of a general disinterest in utility operations in the case of developer owned systems.

The Commission has approved an acquisition adjustment in very few cases. The Commission 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 (transfer from St. Johns North Utility Corporation to Jacksonville Suburban Utilities); Order No. PSC-92-0895-FOF-WS, issued August 27, 1992, in Docket No. 920177-WS (transfer from Atlantic Utilities to Jacksonville Suburban Utilities); and Order No. PSC-93-1819-FOF-WS, issued December 22, 1993, in Docket No. 930204-WS (limited proceeding to adjust rates by Jacksonville Suburban Utilities.)

The Commission has recognized five negative acquisition adjustments since 1988, two of which were based on settlement agreements with the Office of Public Counsel (OPC); one based on a finding that a transfer involved a non-arms length, non-taxable transaction between related parties; another involving an adjustment that was used to correct "lost CIAC"; and lastly, a case involving the condition of the assets purchased. See Order No. 22962, issued May 21, 1990, in Docket No. 881500-WS (transfer from Beacon 21 Development Corporation to Laniger Enterprises); Order No. PSC-93-0011-FOF-WS, issued January 5, 1993 in Docket No. 920397-WS (CGD Corporation staff-assisted rate case); Order No. PSC-93-1675-FOF-WS, issued November 18, 1993, in Docket No. 920148-WS (Jasmine Lakes Utilities rate case); Order No. PSC-97-0034-FOF-WS, issued January 7, 1997, in Docket No. 960040-WS (transfer from Water Oak Utilities to Sun Communities Finance); and Order No. PSC-01-2511-PAA-WS, issued December 24, 2001, in Docket No. 010396-WS (Burkim Enterprises staff-assisted rate case.)

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. A decision was deferred and 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 filed a recommendation on November 19, 2001, for the December 4, 2001, agenda conference. Staff's recommendation presented a primary and an alternative recommended rule. The primary recommendation was for the Commission to adopt a rule that modified existing Commission policy on acquisition adjustments for the water and wastewater industry. Staff's alternative recommendation was for the Commission to adopt a rule that codified existing Commission policy on acquisition adjustments in the water and wastewater industry.

At the December 4, 2001, agenda conference, the Commission deferred a decision on the proposed rule to allow staff to conduct an informal workshop in an attempt to resolve the differences between parties and come back to the Commission with a stipulated rule. Staff conducted informal workshops on January 31 and February 26, 2002. The parties' differences were partially resolved, but they were unwilling to stipulate to a revised rule.

With this recommendation, staff brings to the Commission the revised rule that it believes comes closest to resolving the differences of the parties. Attachment A to this recommendation is a draft of the staff's primary recommended rule which revises current Commission policy. Attachment B is the staff's alternative recommended rule which codifies current Commission policy. Attachment C is the Statement of Estimated Regulatory Cost.

Both the primary and the alternative rule implement 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.

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, MOORE, BRUBAKER, 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, MOORE, BRUBAKER, DANIEL)

STAFF PRIMARY ANALYSIS: Staff's primary rule is the rule draft that resulted from the two staff informal workshops held on January 31 and February 26, 2002. The primary recommendation is for the Commission to adopt a rule that modifies existing Commission policy on acquisition adjustments for the water and wastewater industry by providing an incentive for a purchasing utility to refrain from filing a rate case for a five-year period subsequent to the purchase. The recommended rule also provides an incentive for a utility to try to obtain the lowest price possible when negotiating a purchase price lower than book value. Staff's alternative recommendation is the same as in its last recommendation, which is for the Commission to adopt a rule that codifies existing Commission policy on acquisition adjustments in the water and wastewater industry.

The primary recommended rule is set out below in table format showing each subsection of the proposed rule with an analysis of each subsection:

25-30.0371 Acquisition Adjustments.	
RULE TEXT	EXPLANATION
<p>(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 purchase price is less than the net book value.</p>	<p>Subsection (1) 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.</p>

(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 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 improvements in compliance with regulatory mandates, anticipated rate reductions or rate stability over a long-term period, and anticipated cost efficiencies.

Subsection (2) provides that a positive acquisition adjustment shall not be included in rate base absent proof of extraordinary circumstances. This subsection also provides 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 In re Wedgefield Utilities, Order No. PSC-98-1092-FOF-WS, issued August 12, 1998, in Docket No. 960235-WS. In addition, the subsection 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), subsection (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.

(3) Negative Acquisition Adjustments. A negative acquisition adjustment shall not be included in rate base unless there is proof of extraordinary circumstances or where the purchase price is less than 80 percent of net book value. If the purchase price is less than 80 percent of net book value then the inclusion of a negative acquisition adjustment shall be calculated pursuant to paragraph (b) below.

Subsection (3) provides that a negative acquisition adjustment shall not be included in rate base unless there is proof of extraordinary circumstances or where the purchase price is less than 80 percent of net book value. If the purchase price is less than 80 percent of net book value, then it requires the inclusion of a negative acquisition adjustment calculated pursuant to paragraph (3)(b). Example 1 gives an example of how subsection (3) works when the purchase price is greater than 80 percent of net book value.

(a) Contested. Any entity that believes a full or partial negative acquisition adjustment should be made has the burden to prove the existence of extraordinary circumstances. Under no circumstance, however, shall the purchaser be required to record on its books more than 70 percent of a negative acquisition adjustment. In determining whether extraordinary circumstances have been demonstrated, the Commission shall consider evidence provided to the Commission such as the anticipated retirement of the acquired assets and the condition of the assets acquired.

Paragraph (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. This paragraph also provides an incentive to the purchasing utility company to try and negotiate the best price possible when purchasing below net book value. It provides that only 70 percent of the acquisition adjustment can be booked if an entity proves extraordinary circumstances. Example 2 illustrates the application of paragraph (3)(a). In addition, this paragraph 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.

(b) Uncontested. If the purchase price is less than 80 percent of net book value, then the amount of the difference in excess of 20 percent of net book value shall be recognized for ratemaking purposes as a negative acquisition adjustment. The negative acquisition adjustment shall not be recorded on the books for ratemaking purposes or 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., that will be effective during the amortization period. The negative acquisition adjustment shall be amortized over a 5-year period from the date of issuance of the order approving the transfer of assets.

Paragraph (3)(b) outlines the Commission treatment when the purchase price is less than 80 percent of net book value. This paragraph requires that the amount that exceeds 20 percent of net book value be recognized for ratemaking purposes as a negative acquisition adjustment as an incentive for the utility not to file for a rate increase. The paragraph establishes an amortization period for the acquisition adjustment of five years. If the utility does not file for a rate increase that will be effective during the amortization period, then the negative acquisition adjustment is not booked or recognized for any review of earnings. If the utility does file for a rate increase that will be effective during the amortization period, the unamortized negative acquisition adjustment is booked and used to test the earnings level and the need for a rate increase. The 20 percent that was not booked as a negative acquisition adjustment would not be recognized. Example 3 illustrates the application of paragraph (3)(b).

(4) Amortization Period. In setting the amortization period for a Commission approved acquisition adjustment pursuant to (2) or (3)(a) above, the Commission shall consider evidence provided to the Commission such as the composite remaining life of the assets purchased and the condition of the assets purchased. Amortization of the acquisition adjustment shall begin on the date of issuance of the order approving the transfer of assets.

Subsection (4) requires the Commission to establish an amortization period for any approved positive or negative acquisition adjustment except for one booked under (3)(b) above. It also lists some factors that the Commission will take into consideration when establishing the amortization period.

(5) Subsequent Modification. Any full or partial acquisition adjustment, once made by the Commission pursuant to (2) or (3)(a) above, may be subsequently modified if the extraordinary circumstances do not materialize or subsequently are eliminated or changed within five years of the date of issuance of the order approving the transfer of assets.

Subsection (5) of the rule authorizes the Commission to subsequently modify a positive or negative acquisition adjustment, except for one made pursuant to paragraph (3)(b), 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 in 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.

Example 1

**Treatment of Negative Acquisition Adjustment in the Instance of a
Rate Case Filing Under the Proposed Acquisition Adjustment Rule
[Subsection (3)] - Purchase Price more than 80 percent of NBV**

- | | | |
|----|---|------------|
| 1. | Net Book Value: | \$ 100,000 |
| 2. | Purchase Price: | \$ 80,100 |
| 3. | Negative Acquisition Adj. (Line 1 - Line 2): | \$ 19,900 |
| 4. | Amount of Negative Acq. Adj. That is (Partially or In Total) Recognized for Ratemaking Purposes | \$ 0 |
5. Rate Base Example:

	Net Book Value	Beginning of Year 1	Beginning of Year 2	Beginning of Year 3	Beginning of Year 4
Utility Plant in Service	\$190,000	\$190,000	\$190,000	\$190,000	\$190,000
Accumulated Depreciation	(50,000)	(50,000)	(55,100)	(60,200)	(65,300)
Contributions In Aid of Construction	(55,000)	(55,000)	(55,000)	(55,000)	(55,000)
Accumulated Amortization of CIAC	15,000	15,000	16,650	18,300	19,950
Negative Acquisition Adjustment		0	0	0	0
Accum. Amortization of Acq. Adj.		0	0	0	0
Rate Base	\$100,000	\$100,000	\$96,550	\$93,100	\$89,650

Example 2

**Treatment of a Contested Negative Acquisition Adjustment Under
the Proposed Acquisition Adjustment Rule
[Paragraph (3) (a)]**

- 1. Net Book Value: \$ 100,000
- 2. Purchase Price: \$ 30,000
- 3. Negative Acquisition Adj. (Line 1 - Line 2): \$ 70,000
- 4. Amount of Negative Acq. Adj. NOT Recognized in Rate Base Pursuant to Proposed Rule (Line 3 x 30%): \$ 21,000
- 5. Maximum Negative Acq. Adj. That Can Be Approved By The Commission (Line 3 x 70%) \$ 49,000
- 6. Amortization Period Pursuant to Subsection (4) (Remaining life): 25 years
- 7. Rate Base Example:

Paragraph (3) (a)	Net Book Value	Beginning of Year 1	Beginning of Year 2	Beginning of Year 3	Beginning of Year 4
Utility Plant in Service	\$190,000	\$190,000	\$190,000	\$190,000	\$190,000
Accumulated. Depreciation	(50,000)	(50,000)	(55,100)	(60,200)	(65,300)
Contributions In Aid of Construction	(55,000)	(55,000)	(55,000)	(55,000)	(55,000)
Accumulated Amortization of CIAC	15,000	15,000	16,650	18,300	19,950
Negative Acquisition Adjustment	(49,000)	(49,000)	(49,000)	(49,000)	(49,000)
Accum. Amortization of Acq. Adj.		1,960	3,920	5,880	7,840
Rate Base	\$51,000	\$52,960	\$51,470	\$49,980	\$48,490

Example 3

**Treatment of Negative Acquisition Adjustment in the Instance of a
 Rate Case Filing Under the Proposed Acquisition Adjustment Rule
 [Paragraph (3) (b)]**

1. Net Book Value: \$ 100,000
2. Purchase Price: \$ 30,000
3. Negative Acquisition Adj. (Line 1 - Line 2): \$ 70,000
4. Amount of Negative Acq. Adj. NOT Recognized for
 Ratemaking Purposes (Line 1 x 20%): \$ 20,000
5. Amount of Negative Acq. Adj. That is (Partially or In
 Total) Recognized for Ratemaking Purposes (Line 3 - Line 4) \$ 50,000
6. Rate Base Example:

	Net Book Value	End of Year 1	End of Year 2	End of Year 3	End of Year 4	End of Year 5
Utility Plant in Service	\$190,000	\$190,000	\$190,000	\$190,000	\$190,000	\$190,000
Accumulated. Depreciation	(50,000)	(55,100)	(60,200)	(65,300)	(70,400)	(75,500)
Contributions In Aid of Construction	(55,000)	(55,000)	(55,000)	(55,000)	(55,000)	(55,000)
Accum. Amortization of CIAC	15,000	16,650	18,300	19,950	21,600	23,250
Negative Acquisition Adjustment		(50,000)	(50,000)	(50,000)	(50,000)	(50,000)
Accum. Amortization of Acq. Adj.		10,000	20,000	30,000	\$40,000	\$50,000
Rate Base	\$100,000	\$56,550	\$63,100	\$69,650	\$76,200	\$82,750

Parties' Comments on Proposed Rule

At the end of the February 26, 2002, informal workshop, staff requested that all parties submit their comments on the proposed rule. Staff asked that the comments not exceed one page in length so that they could be inserted verbatim into this recommendation. The parties represented at the two staff informal workshop were Florida Water Service Corporation (FWSC), Utilities, Inc. (UI), Burkim Enterprises, Inc. (BEI) and the Office of Public Counsel (OPC). Staff has inserted each parties' comments below.

Florida Water Service Corp.

FCWC did not file comments on the proposed rule.

Utilities, Inc.

Staff has requested that participants in this docket provide written responses, not more than one page in length, regarding the most recent draft of the rule. We appreciate the opportunity to go through the workshop process, which has been very helpful. Utilities, Inc. has been willing to work toward a mutually agreeable formulation of the rule, even though to do so will substantially change some of the prior expectations regarding acquisitions in Florida. That process has worked well, but there is need for some further consideration and assistance on some of the numbers in the draft. The following changes are recommended.

Page 1, line 25 - change 80 percent to 60 percent.

Page 2, line 2 - change 80 percent to 60 percent.

Page 2, line 9 - after the word "books", insert "for ratemaking purposes".

Page 2, line 9 - change 70 percent to 50 percent.

Page 2, line 15 - change 80 percent to 60 percent.

Page 2, line 17 - change 20 percent to 40 percent.

Page 2, line 20 - after the word "books", insert "for ratemaking purposes".

Page 2, line 24 - change 5-year period to 4-year period.

We would appreciate consideration of the fact that, if a "sharing of the benefits" is to result, and "80/20" sharing with the customers getting the 80% percent benefit isn't much "sharing".

Burkim Enterprises, Inc.

Although the various percentages are not science and thus are open to legitimate debate, Burkim Enterprises, Inc.'s primary concern is the carry over from existing policy defining "extraordinary circumstances" which would result in a negative acquisition adjustment. It is our belief that the Public Service Commission should encourage the acquisition of troubled systems by larger utilities with financial and technical expertise. This will increase the quality of service and ultimately stabilize rates through economies of scale. By determining that a utility acquiring another utility which has assets in poor condition and thus anticipated for retirement to be penalized by imposing a negative acquisition adjustment is contrary to the goal of having those systems purchased by other utilities with better technical and financial resources. Although we recognize that anticipated retirement of acquired assets and the conditions of the assets acquired are not the only elements considered in determining whether extraordinary circumstances have been demonstrated, from my review of the cases, those are the two elements most heavily relied upon. That was certainly true in Burkim Enterprises, Inc.'s recent acquisition in Brevard County. My recommendation is to make it clear in the proposed Rule that merely because the conditions of the assets acquired are poor and thus will be retired, in and of itself does not support a conclusion that extraordinary circumstances exist.

Office of the Public Counsel

In our view there are both good and bad aspects to the proposed rule. On the positive side, in ordinary circumstances a portion of a negative acquisition adjustment would be amortized over a five year period where the purchase price is less than 80% of the company's book value. This gives an incentive to the purchasing company to provide rate stability to the customers of the purchased utility. On the negative side, the rule would change current policy about recognition of an acquisition adjustment where extraordinary circumstances exist by limiting the amount of the adjustment.

In ordinary circumstances the proposed rule phases out the acquisition adjustment over a relatively short time frame. We continue to believe that our proposed rule to split the negative

acquisition adjustment is fairer. 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. This proposal would provide longer lasting benefits to customers while also providing a significant benefit to the purchasing company.

Staff Analysis of the Party's Comments

Staff has already agreed to and included the words "for ratemaking purposes" in paragraph (3) (b) of our proposed rule which was part of the comments by Utilities, Inc. Staff believes that the rule as proposed is as close to an agreement as the parties could get. Staff would not recommend any further changes as proposed in the parties' comments.

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 with a few exceptions. If an acquisition price is less than 80 percent of the book value, the amount that exceeds 20 percent would be recognized for ratemaking purposes as a negative acquisition adjustment according to a formula. The negative acquisition adjustment would not be recorded on the books for ratemaking purposes or used for earnings review unless the purchaser files for a rate increase. This would lower the amount of rate base on which to earn a return. If there is no request for a rate increase, the acquisition adjustment would be amortized over five years with no effect on revenues.

If the Commission approves a negative acquisition adjustment, the purchaser would not have to book more than 70 percent of the adjustment. This benefit would be an incentive to acquire systems that may not be in good condition. There should be no cost to ratepayers because the new book value would still be lower than the pre-purchase book value and rates should not increase.

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 ALTERNATIVE ANALYSIS:

Staff's alternative rule draft differs from staff's primary rule draft only in the treatment of negative acquisition adjustments. Staff believes that the current Commission policy concerning negative acquisition adjustments has been a reasonable method for promoting the consolidation of the industry. The alternative rule codifies this Commission policy and is set out below in table format showing each subsection of the proposed rule with an analysis of each subsection:

25-30.0371 Acquisition Adjustments. (Alternative Rule)	
RULE TEXT	EXPLANATION
(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.	Subsection (1) 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.

<p>(2) An acquisition adjustment shall not be included in rate base absent proof of extraordinary circumstances.</p>	<p>Provides that an adjustment shall not be included in rate base absent proof of extraordinary circumstances.</p>
<p>(3) Any entity that believes a full or partial positive acquisition adjustment should be made has the burden to prove the existence of 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 or rate stability over a long-term period, and anticipated cost efficiencies.</p>	<p>Subsection (3) provides that a positive acquisition adjustment shall not be included in rate base absent proof of extraordinary circumstances and 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 <u>In re Wedgefield Utilities</u>, Order No. PSC-98-1092-FOF-WS, issued August 12, 1998, in Docket No. 960235-WS. The subsection also lists, by way of example, certain factors the Commission will consider to determine whether there are extraordinary circumstances justifying a positive adjustment. These factors include anticipated improvements in quality of service, anticipated compliance with regulatory mandates, anticipated rate reductions, and anticipated cost efficiencies.</p>

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

Subsection (4) 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 subsection 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. The factors are listed by way of an example, and other evidence may be offered.

(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 issuance of the order approving the transfer of assets.

Subsection (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.

<p>(6) Any full or partial acquisition adjustment, once made by the Commission, may be subsequently modified if the extraordinary circumstances do not materialize or subsequently are eliminated or changed within five years of the date of issuance of the order approving the transfer of assets.</p>	<p>Subsection (6) of the rule authorizes the Commission to subsequently modify a positive or negative 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 in 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.</p>
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The alternative 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 adjusted 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: MAY 9, 2002

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

RECOMMENDATION: Yes. (MOORE, WILLIS, HEWITT, BRUBAKER, 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 Adjustments.

(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 purchase price is less than the net book value.

(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 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 improvements in 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 unless there is proof of extraordinary circumstances or where the purchase price is less

than 80 percent of net book value. If the purchase price is less than 80 percent of net book value then the inclusion of a negative acquisition adjustment shall be calculated pursuant to paragraph (b) below.

(a) Contested. Any entity that believes a full or partial negative acquisition adjustment should be made has the burden to prove the existence of extraordinary circumstances. Under no circumstance, however, shall the purchaser be required to record on its books more than 70 percent of a negative acquisition adjustment. In determining whether extraordinary circumstances have been demonstrated, the Commission shall consider evidence provided to the Commission such as the anticipated retirement of the acquired assets and the condition of the assets acquired.

(b) Uncontested. If the purchase price is less than 80 percent of net book value, then the amount of the difference in excess of 20 percent of net book value shall be recognized for ratemaking purposes as a negative acquisition adjustment. The negative acquisition adjustment shall not be recorded on the books for ratemaking purposes or 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., that will be effective during the amortization period. The negative acquisition adjustment shall

be amortized over a 5-year period from the date of issuance of the order approving the transfer of assets.

(4) Amortization Period. In setting the amortization period for a Commission approved acquisition adjustment pursuant to (2) or (3) (a) above, the Commission shall consider evidence provided to the Commission such as the composite remaining life of the assets purchased and the condition of the assets purchased. Amortization of the acquisition adjustment shall begin on the date of issuance of the order approving the transfer of assets.

(5) Subsequent Modification. Any full or partial acquisition adjustment, once made by the Commission pursuant to (2) or (3) (a) above, may be subsequently modified if the extraordinary circumstances do not materialize or subsequently are eliminated or changed within five years of the date of issuance 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 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 or rate stability over a long-term period, 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

ATTACHMENT B

existence of 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.

(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 issuance of the order approving the transfer of assets.

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

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FLORIDA PUBLIC SERVICE COMMISSION
DIVISION OF APPEALS

TO: DIVISION OF APPEALS (MOORE)

FROM: DIVISION OF ECONOMIC REGULATION (HEWITT) *CH* *AS* *RA* *TS*

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.

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