

FLORIDA PUBLIC SERVICE COMMISSION

REFOCUSING ON THE COMMISSION'S
ACQUISITION POLICY REGARDING WATER AND
WASTEWATER UTILITIES

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Introduction

The Commission's policy on acquisition adjustments, in short, is that absent extraordinary circumstances, there won't be one. Often in water and wastewater cases, this policy is questioned for, we believe, two main reasons. First, if a change in the composition of the industry is something the Commission would like to pursue, it may want to encourage certain acquisitions by granting positive acquisition adjustments or not granting negative acquisition adjustments. Second, sometimes there are glaring "deals" where a utility is purchased for a negligible sum while rate base is large; not necessarily where the purchase price is below but close to rate base, but where there is an extreme difference between the two, and allowing a return on rate base rather than purchase price does not seem "fair". The Commission's acquisition policy, as determined through past decisions as well as a discussion of opposing views questioning this policy, is explained in greater detail within this paper.

The composition of the water and wastewater industry in Florida is an amalgam of differing sized municipal, county, investor and cooperatively owned systems. A majority of these systems are small "Mom and Pop" utilities. Since enactment of the Safe Drinking Water Act, utilities have had to meet increasingly stringent environmental and water quality standards in an already high capital arena.

As a direct result of these rising costs, a large segment of the industry comprised of utilities serving less than 500 connections are in jeopardy of being unable to continue operations without environmental or water quality problems. This also raises concerns over the affordability of water service. The Commission has long recognized the technical, managerial and financial problems inherent in most small utility operations which work against their ability to be viable and to sustain safe, efficient and cost effective long term operation.

Because Florida is now plagued by the past proliferation of small utilities, concerns exist about their long term viability. Consolidation of these smaller systems is one way in which the Commission could address the issues of environmental and water quality compliance as well as financial viability. Further, from a regulatory standpoint, issues such as conservation, reuse, overall service quality and affordability are generally easier to address with larger utilities.

The controversy regarding acquisition adjustments is spotlighted in cases where there is a wide discrepancy between rate base and purchase price. Due to the concerns these "deals" raise, the Commission may want to consider competing regulatory goals in evaluating this issue. This will be discussed in the section regarding arguments against current Commission policy.

Types of Acquisitions

The following scenarios show the various ways in which FPSC regulated utility assets change ownership.

- Transfers to governmental authorities.
- Transfers to non-jurisdiction entities such as a homeowners association, non-profit entity, etc.
- Transfer of a larger system to another large system.
- Transfers of small systems to large systems.
- Interconnection to regional facilities with the acquired utility remaining jurisdictional
- Interconnection to regional facilities with the acquired utility becoming non-jurisdictional

Current Acquisition Policy

Current Commission policy with regard to acquisition adjustments was formalized in a generic proceeding by two orders, PAA Order No. 23376, issued 8/21/90 and Final Order No. 25729, issued 2/17/92. The Commission stated the following:

Our policy on acquisition adjustments since approximately 1983 has been that absent extraordinary circumstances, the purchase of a utility system at a premium

or discount shall not affect rate base. The purpose of this policy, as stated in PAA Order No. 23376, has been to create an incentive for larger utilities to acquire small, troubled utilities. We believe that this policy has done exactly what it was designed to do. Since its implementation, many small utilities have in fact been acquired by larger utilities, and we have changed rate base in only a few cases.

Also in Order No. 25729, the Commission goes on to elaborate why it believes its practice is appropriate and what incentives it believes are included within this practice:

We still believe that our current policy provides a much needed incentive for acquisitions. The buyer earns a return on not just the purchase price but the entire rate base of the acquired utility. The buyer also receives the benefit of depreciation on the full rate base. Without these benefits, large utilities would have no incentive to look for and acquire small, troubled systems. The customers of the acquired utility are not harmed by this policy because, generally, upon acquisition, rate base has not changed, so rates have not changed. Indeed, we think the customers receive benefits which amount to better quality of service at a reasonable rate.

The following table details transfer/acquisition activity since 1997 and shows activity to be fairly constant.

SUMMARY OF TRANSFERS SINCE 1997				
Year	Transfers	Transfers of small utilities resulting in certificate cancellations	Sale to Governmental Entities resulting in certificate cancellations	Total
1997	13	1	5	19
1998	4	2	11	17
1999	5	0	10	15
2000	8	5	7	20

Commission policy is well established and acquisitions continually occur. However, controversy still exists on a case by case basis surrounding the issue of acquisition adjustments.

Acquisition Adjustments

An acquisition adjustment is a regulatory convention by which the books of the utility are

adjusted to reflect changes in the historical rate base valuation resulting from purchase prices that differ from original cost rate base valuations. The need to develop this separate accounting treatment is largely a consequence of certain abuses in the utility industry during the acquisition and merger period of the 1920's and 30's. The decision to include an acquisition adjustment in rate base must be made by the Commission and must be consistent with current policy based upon the existence of extraordinary circumstances.

Since 1988, the Commission has found extraordinary circumstances resulting in three negative and three positive acquisition adjustments. The Commission policy of not recognizing acquisition adjustments, either positive or negative, in the absence of a showing of extraordinary circumstances does constitute an incentive for acquisition of small systems when they can be purchased at a discount to established rate base value.

Positive acquisition adjustments

A positive acquisition adjustment results when the purchase price exceeds the net book value of the acquired property. For example, if the original cost rate base valuation is \$100, but an acquiring utility paid \$120 for the assets, a positive acquisition adjustment, if approved, would inflate the original cost rate base valuation to \$120. The acquiring utility would then be permitted to earn a rate of return on the

investment of \$120. It has been argued that in certain situations such an adjustment provides incentive for the acquisition of troubled or run down utilities by larger and more able utilities.

The criteria for evaluating a positive acquisition adjustment are enumerated in Commission Orders Nos. 8206 and 9455:

- Did the purchaser pay more than the original cost?
- Was the transaction at arms length?
- Did the purchased assets remain in use?
- Does the purchased system provide a needed expansion of the old system?
- Was the purchase price below replacement cost?
- Was the sale approved by the proper authority?
- Did the purchase benefit the customers?

A determination of whether the purchase benefits the customers is typically the most analyzed of the above criteria. Additionally, if the inclusion of a positive acquisition adjustment can be related to cost reductions, a double recovery of the utility's investment will not occur.

Opponents of a positive acquisition adjustment believe there are no circumstances where a positive acquisition adjustment would be appropriate. The basis of the argument is that any positive acquisition adjustment leads to increased rate base, based solely on a change in

ownership.

Negative Acquisition Adjustment

A negative acquisition adjustment is recorded when the purchase price of the transaction 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 previous example, assume a purchase price of \$80. An approved negative acquisition adjustment would reduce rate base to the \$80 purchase price. The rationale in this instance is to not permit an acquiring utility to earn a return on a value greater than its actual investment. However, if the purchasing utility were to negotiate a price much lower than rate base and be required to earn a return only on the purchase price, this could act as a disincentive to negotiate a lower price or conclude the purchase.

In evaluating negative adjustments, the Commission considers the physical condition of the acquired facilities and whether the purchase was prudent.

Arguments Against Current Commission Policy

Opponents of the current policy argue that no incentive should be necessary for larger utilities to purchase smaller systems. They argue that if the regulatory process is properly functioning, the opportunity to earn a reasonable return on its capital investment and recover all prudently incurred operating expenses should be

sufficient incentive for any utility.

While rate of return regulation may be appropriate for larger utilities, it is apparent that this method of regulation contributes to the cash flow problems for Class C utilities. We have reviewed all Class C utilities which filed 1999 Annual Reports and have developed the following table detailing achieved rates of return. It should be noted that the calculated rates of return are based upon data as filed by the utilities subjected to only a desk audit.

CLASS C WATER AND WASTEWATER UTILITIES' 1999 ACHIEVED RATES OF RETURN				
UTILITY	TOTAL	UNDER 10%	NEGATIV E	PERCENT UNDER 10% OR NEGATIV E
WATER	113	26	57	73%
WASTEWAT ER	81	16	51	83%

This analysis shows that a majority of these regulated utilities have failed to achieve adequate rates of return and cash flow under rate base regulation. While reducing rate base to purchase price may appear fair and reasonable by allowing a return solely on the owner's investment, this practice could reduce a utility's ability to fund its operations and thereby jeopardize its long term viability.

Consequently, ratepayers may end up paying higher rates in later years to overcome neglect or the inability to fund improvements resulting from lower rates in the short term. A utility's future cash needs must be met if it is to remain viable.

The present acquisition policy is especially questioned in the case of deals where a utility is purchased at a price well below the rate base level and no acquisition adjustment is made. This scenario was recently highlighted in Docket No. 970409-SU, regarding the purchase of the Tropical Isles system by Florida Water Service Corporation. In this case, the utility was purchased for \$5.00 with rate base being in excess of \$270,000. This docket provided a vivid example of the reaction to future rates being based upon rate base and not the actual \$5.00 investment of the new owners.

One view is that purchasing utilities should not be allowed to earn a return on so-called "phantom" investment when purchase price is below rate base of the acquired utility. A negative acquisition adjustment is appropriate in such cases, absent a showing by the acquiring utility that it should not be made.

Beyond the need for an acquisition incentive, there is an additional important reason for not including a negative acquisition adjustment in rate base. If regulatory policy is to have long term rather than short term objectives, regulators should therefore treat utilities as

going concerns and evaluate rates on a cash need's basis. Utilities are often sold at a discount because the owner is unable to continue operating it at existing rate levels. This is an example where regulators should also consider the ability of the new owner to provide long term service in compliance with regulatory standards. Where large differences exist between rate base and purchase price, the Commission should explore the reasons for the differences on a case by case basis and consider the possibility of approving a partial acquisition adjustment if warranted by extraordinary circumstances.

Another concern regarding excluding negative acquisition adjustments involves cases in which the system is in disrepair and the acquiring utility must incur major capital outlays for improvements. The concern is that if the rate base remains at full original cost and the purchaser makes significant improvements, the customers may in effect be paying for the same plants twice -- once for the original rate base amount and again for the improvements to restore the facilities.

It is countered that the former utility owner was unable to maintain the system due to low rates paid by customers causing a deterioration of the system. Therefore, any improvements should be considered deferred maintenance expense never included in previous rates. The basis of the argument is that customers have paid too little for too long, benefiting from low rates which were in part responsible for the neglect and

condition of the utility system. The new owner has assumed the existing problems of the utility and an inevitable increase in rates will be needed to correct problems to the ultimate benefit of the customers. Viewing the improvements as deferred maintenance, not included in the previous rates, presents the double payment issue as a problem of timing as opposed to rate level. In any event, it may be that the Commission, in order to fulfill its obligation to fairness, should in some way recognize the reasons for such disparities and address them in a manner that is fair to both customers and utility owners.

B. Acquisition Practices of Other States

New York, Pennsylvania and California have all implemented acquisition policies with the stated goals of consolidating the industry, thereby achieving the additional goals of safe, adequate, reasonably priced service for the long term. A review of the other states' policies and programs will highlight additional incentives for acquisitions.

New York

In 1994 the New York Department of Public Service (NYDPS) adopted a policy statement to encourage acquisitions of smaller troubled systems by larger systems. It included in its policy a number of options to provide incentives for such acquisitions. Acquisition adjustments were among a list of possible incentive

mechanisms. The NYDPS stated its intention to foster acquisitions and mergers if such transactions would address the following goals:

1. Improve the ability of small water companies to provide service;
2. Improve customer service;
3. Make it easier to comply with current and future regulations;
4. Avoid drastic rate increases;
5. Bring the rates of merged systems into parity;
6. Improve and consolidate management and operation; and
7. Promote conservation (NYDPS, 1994).¹

The NYDPS also provides for acquisition incentives if there is clear customer benefit. A water company must demonstrate long run viability and be able to provide safe and adequate service. Acquisition incentives will be considered based on the following factors:

1. Whether the acquiring company has the ability to adequately manage, serve customers, comply with regulations and

¹ New York Department of Public Service Statement on Policy of Acquisition Incentive Mechanisms for Small Water Companies, August 8, 1994.

finance capital improvements.

2. Whether the impact on customers resulting from the acquisition is as beneficial or more beneficial than realistic alternatives.
3. Whether the terms of the acquisition will permit future beneficial solutions, such as municipalization.
4. Whether customer benefits are expected to be commensurate with the incentives for the acquisition or merger.
5. Whether meaningful customer participation has been obtained through effective public involvement.²

The NYDPS also expressed its willingness to consider additional incentives where proposals are made to consolidate several water systems at once.

The actual incentives to be considered were identified by category and are:

1. Rate Base

- a. Where purchase price is less than the rate base of the utility being acquired, we will consider allowing rates to reflect the full

² Ibid.

rate base of the acquired company.

- b. Where the purchase price is greater than the rate base, [the NYDPS] will consider allowing the rates to the purchase price premium. Such an adjustment could be justified by improved service, realized cost efficiencies and economies of scale.
- c. Where capital expenditures are required for service improvement or compliance reasons, we will consider allowing projected improvement costs to be reflected in rates immediately, subject to later review.
- d. When the acquired company has little or no rate base, we will consider allowing a proxy rate base equivalent to the rate base per customer of the acquiring company.

2. Depreciation

Where circumstances warrant, accelerated depreciation or depreciation on projected improvement costs subject to later reconciliation may be permitted.

3. Amortization

Amortization may be considered as a means of recovering the reasonable costs of acquisition and/or the recovery of a purchase premium. The term of the amortization should consider adverse customer impact.

In addition, the following incentives may be considered in special cases for good cause shown:

4. Operating Ratio

This mechanism may be used [for rate setting] in cases where rate base mechanisms may be less effective.

5. Rate of Return

When accompanied by appropriate justification, it may be beneficial to allow a premium on the overall rate of return as an acquisition incentive.

6. Delayed Recovery

Where acquisition costs or improvement costs, or the effects of rate equalization may cause adverse customer rate impact, a phase-in recovery or delayed recovery may be appropriate rather than lose the opportunity for consolidation.

7. Lease/Buy-out

When the overall benefit of an acquisition is uncertain and a trial takeover of management, operation, and ownership appear to be beneficial, we may consider leased company operation with an option to buy as a way to provide incentive.³

A recent contact with the New York Commission revealed that since the acquisition incentive program was implemented in 1994, it has not resulted in an increase in acquisitions. While acquisitions have occurred, they have not involved small or troubled utilities. However, utilities are encouraged to discuss with the Commission what they would need to buy certain utilities. Aquasource, which also operates within Florida, has purchased several utilities and it is believed a key incentive for the purchases was the provision of automatic rate increases after an initial rate freeze. Upon purchasing a utility, rates are frozen for four years after which rates may be increased by a factor based upon the cost of the GDP for each of the next seven years. This initially protects customers from rate increases and provides the utility with known increases without litigation or additional regulatory expense.

Pennsylvania

³ Ibid.

Pennsylvania has also adopted a policy of encouraging industry consolidation and acquisitions if the proposed transaction meets the following thresholds:

1. The acquisition is in the public interest;
2. The acquisition will not effect the viability of the acquirer;
3. The acquired system has less than 3,300 connections, is not currently viable, is in violation of statutory and regulatory standards, and has failed to timely comply with any order of the DEP or PUC;
4. The acquired system's customers will receive improved service in a reasonable time frame;
5. The purchase price is fair and reasonable and conducted through arms' length negotiations;
6. Single tariff pricing should be implemented to the extent reasonable. Phased in implementation of rates may be appropriate if necessary to address affordability.⁴

⁴ National Association of Water Companies Source Book of Regulatory Techniques for Water Utilities, June, 1997, p 1.1-11.

The specific incentive mechanisms to be considered include:

1. Rate of Return Premiums

Additional rate of return basis points may be awarded for certain acquisitions or improvement costs based on sufficient support filed by the utility in a rate proceeding;

2. Acquisition Adjustment

When acquisition costs exceed depreciated original cost, a reasonable excess may be included in rate base and amortized over 10 years;

3. Deferral of Acquisition Improvement Costs

In cases where improvement costs are too great to be absorbed by rate payers at one time, rate recovery may be in phases.

4. Plant Improvement Surcharge

Extraordinary improvement costs may be temporarily offset by surcharging the customers of the acquired system. If those improvements benefit only the customers of the acquired system, the improvement costs may be allocated to those customers on a greater than

average (but less than 100%) basis to the new customers for a reasonable period of time.⁵

The Pennsylvania program is directed at the reduction of small troubled utilities. A recent contact with the Pennsylvania Commission shows that acquisitions are a common occurrence. However, in most cases the transactions do not meet the criteria to utilize acquisition incentives. However, the state is willing to work with utilities to accomplish its goal of industry consolidation and it is believed this environment is conducive to acquisitions. Additionally, a major factor helping small utilities and acquisition activity is the Pennsylvania Infrastructure Investment Authority (PENNVEST) which provides low cost loans and grants for water and wastewater improvements.

California

The California Public Utilities Commission (CPUC) began workshops in 1997 to investigate the dynamics of acquisitions and mergers of water utilities in its state. One of the issues before the Commission was the use of original cost to establish rate base versus replacement cost new less depreciation (RCNLD) in acquisition cases. Before the CPUC could conclude its investigation, the California legislature enacted HB 1268 permitting "fair market value" (as determined by actual purchase price) rate base valuation if less than RCNLD.

⁵ Ibid, p12.

California Public Utilities Code Section 2718-2720 is the Public Water System Investment and Consolidation Act of 1997. The legislature found:

1. Public water systems face replacement and upgrade costs due to the Safe Drinking Water Act and state regulations and requirements;
2. Increasing amounts of capital necessary to fund public water system investment;
3. Scale economies are achievable;
4. Providing incentives to achieve economies will provide benefits to rate payers.⁶

In order to encourage investment and consolidation in public water systems, Section 2720 provides:

1. The Commission (CPUC) shall use "fair market value" when establishing rate base for distribution systems of public water systems acquired by a water corporation;
2. If "fair market value" is greater than RCNLD, the Commission may include the difference in the rate base for rate

⁶ Ibid, 1999 Update 1, pp 1.2-9, 1.2-10.

purposes if additional amounts are fair and reasonable. Fairness and reasonableness determinations may consider whether the acquisition will improve reliability, compliance, efficiencies, and economies of scale that would not otherwise be available and the impact to consumers will be fair and reasonable.

A recent contact with the California Commission reveals there has been activity regarding acquisitions and mergers of larger utilities with minimal activity regarding small utilities. It was indicated that the large utilities have business plans to expand to become more efficient and avoid being acquired by larger utilities. Also, California based utilities have acquired out of state utilities. The impact of allowing fair market value has had more of an impact on purchase price rather than the number of acquisitions. While this policy may act as a stimulus, it does make or break acquisitions. Aquasoure had initially shown interest in acquiring several utilities, but has since decided to not enter the California market. The California staff states they had opposition to their offering up to 7 times book value for utilities and seeking utilities throughout the state with no clear plan for central or regional operation.

The level and number of incentives offered for acquisitions is dependent upon defining the Commission's goals regarding industry

consolidation and determining how aggressively it wishes to pursue that goal. A review of other state's programs provides a shopping list of available incentives to facilitate consolidation of the industry.

C. Florida's Acquisition Policy for Other Industries

While this paper deals exclusively with the water and wastewater industry, a brief discussion of acquisition treatment by the other industries is provided for informational purposes.

In the gas industry, the Commission looks at acquisition adjustments on a case by case basis. In each case, the acquisition is thoroughly and individually reviewed on its merits as to whether or not it will provide benefit to the body of rate payers. In Docket No. 870118-GU, Central Florida Gas Company was purchased by Chesapeake Utilities, Inc., and requested that it be allowed to amortize a positive acquisition adjustment. The acquisition resulted in a revenue requirement reduction. Central Florida indicated there would be additional savings associated with the use of Chesapeake's gas purchasing agent, engineering department, and rate and accounting staff for the preparation of rate cases. In Order No. 18716, the Commission approved the amortization based on projected savings due to Central Florida's acquisition by Chesapeake. However, Central Florida was put on notice that the projected savings would be analyzed in future rate cases to determine if the projected savings actually

occurred or had eroded. In Docket No. 891179-GU, Central Florida failed to demonstrate that the projected savings related to the acquisition had occurred. It was noted that Central Florida had actually experienced a total increase in its revenue requirements since its acquisition by Chesapeake. Therefore, in Order No. 23166, the Commission disallowed the acquisition adjustment.

City Gas Company was purchased by NUI Corporation and had requested that it be allowed to amortize a positive acquisition adjustment. In evaluating the request, the Commission referred to the policy established in Order No. 23376 (Docket No. 891309-WS). In Order No. 24013, the Commission found that there was insufficient evidence in the record to support the finding that City Gas customers had benefitted as a result of the acquisition by NUI. Therefore, the Commission found that City Gas had not demonstrated any extraordinary circumstances to justify the inclusion of the acquisition adjustment.

In the telecommunications industry, Section 364.33, Florida Statutes, provides that Commission approval is required for the acquisition, transfer, or assignment of majority stock ownership of a telecommunications company operating a telecommunication facility in Florida. The acquisition, transfer, or assignment of majority stock ownership of the company is approved by the Commission based upon an analysis of the public's interest in efficient, reliable telecommunications.

Generally speaking, most telecommunications companies are acquired at a premium and companies tend not to request an acquisition adjustment.

Until recently in the electric industry, it was rare that you would find acquisitions or mergers of power companies. However, the commission currently has two open dockets pertaining to acquisitions in this industry. Docket No. 00-0824 is a review of Florida Power Corporation's earnings including the effects of its acquisition by Carolina Power & Light. Also, Docket No. 00-1148 is a review of Florida Power & Light Company's (FPL's) proposed merger with Entergy Corporation, the formation of a Florida regional transmission Company, GridFlorida, and the effect of these activities on FPL's retail rates. In instances of acquisitions involving larger utilities, synergy is generated through economies of scale, especially in administrative functions where some duplication can be eliminated.

Certain transactions give rise to intangible assets that are not separately identifiable such as patents, copyrights, and trademarks. Intangible assets that cannot be separately identified relate to the company as a whole. Intangible assets are factors in the production or distribution of goods or services that generate revenue. They are similar to property, plant, and equipment. However, they lack physical characteristics. They frequently exist because of the unique combination of separate assets and personnel of the company, and their

synergism explains why the value of an company as a whole-- measured in terms of its anticipated earning capacity--may be greater than the sum of the values of the individual parts of the company. This is commonly called goodwill. Goodwill is the capability of an company to produce earnings in excess of normal.

This unique earning capability results from intangible advantages working for the company in conjunction with the separately identifiable tangible and intangible assets. The value of the enterprise as a whole may exceed the value of the sum of the individual assets, less the liabilities, of the company. Such situations result from the existence of intangible qualities, such as an outstanding reputation, superior managerial capability, and/or the ability to operate at an above-normal level of efficiency.

Where Do We Go From Here

In Order No. 25729, issued on February 17, 1992, the PSC concluded an investigation regarding acquisition adjustments and confirmed its existing policy. In that Order, the Commission enumerated the benefits to customers of new ownership as follows:

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, a reduction in the high cost of debt due to lower risk, the elimination of substandard operating 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 more professional and experienced management, and the elimination of general disinterest in utility operations in the case of developer owned systems.

The Commission may want to consider an overall goal of helping ensure the sustained provision of safe, environmentally sound and reasonably priced water and wastewater service to Floridians. While infusion of funds through rate

increases, grants or low interest loans may provide a short term fix for many utilities, many utilities will continue to have long term problems based predominately upon their small scale of operation. Therefore, consolidation of the industry by larger utilities acquiring smaller utilities, resulting in the above stated benefits, may be a reasonable option to eliminating problems faced by small utilities and assuring the long term provision of better quality water and wastewater service. However, the Commission should assure that each acquisition is in the public interest and evaluate each case based upon resulting customer benefits. Additionally, the Commission must closely investigate all cases where a wide difference exists between purchase price and rate base. It is important to understand the reasons for these differences and evaluate customer benefits in determining if and at what level an acquisition adjustment might be granted.

If the Commission were to pursue a goal of consolidating the industry thereby eliminating small non-viable utilities, a key factor is if the acquiring entity is regulated by this Commission. The Commission is not involved in negotiating or establishing the purchase price of a utility. If the Commission chooses to provide incentives for small system acquisitions, such incentives could only be based upon its continued regulatory authority. The acquiring utility is concerned how continued regulatory treatment of the acquired assets and customers will impact its profit. Conversely, a non-

regulated entity such as a city, county, cooperative or exempt homeowners association is concerned mainly with purchase price and its ability to expand its customer base and provide ongoing service to its citizens or members. While it is desirable for governmental entities to acquire utilities based upon their ability to fund operations and their vested interest in providing service to their citizens, the Commission cannot offer incentives for these purchases. However, since these type acquisitions are fairly common, it appears motivation and incentive already exist.

From the standpoint of the Commission, an acquisition policy which provides incentives for consolidation is most beneficial with the scenario of a larger utility acquiring a smaller utility. However, at issue is the economic rationale for acquisition of a small, poorly maintained utility with limited customer growth potential and whether additional incentives may be needed to promote these transfers.

The key to any policy which would lead to consolidation of the industry and reduction in the number of small utilities is an understanding that the problems faced by small utilities and their customers may be a statewide problem that extends beyond this Commission's jurisdiction. Any action, including acquisition incentives, designed to promote an environment conducive to acquisitions by this Commission would impact only a portion of the state's utilities. Therefore, we can help to provide a solution to only part of

the problem. Based upon our experience in certifying new utilities when a county gives jurisdiction to the Commission, we are well aware that non-jurisdictional counties are likewise inundated with small utilities.

We believe if consolidation of the industry is pursued it may be best addressed if considered as a state goal expressed by the legislature. This state policy would then serve as a backdrop to implement measures to stimulate acquisitions. Mergers or acquisitions cannot be mandated. Acquisitions are business decisions which for investor-owned utilities are generally prudent only with the expectation of future profit.

Utilities rely on this Commission's policy to bargain for and purchase utilities. It is important that this policy be clearly stated so all players know the rules of the game and are able to anticipate the Commission's reaction. The policy should also be flexible to entertain ways to finalize transactions and avoid same issue hearings. Litigation costs associated with transfers would be better spent in making improvements to the acquired systems.

Within its jurisdiction, the Commission could do several things to stimulate acquisitions. Regarding acquisition of large systems by other large systems and the acquisition of small utilities by larger utilities, we believe the present policy of not acknowledging either positive or negative acquisition adjustments absent extraordinary circumstances is still

appropriate. However, if a goal of reducing the number of small utilities is pursued, additional incentive options could be considered.

For the acquisition of small utilities, we believe the umbrella policy could be to facilitate a reduction in the number of small utilities for the long term benefit of the ratepayers. While higher rates are inevitable, the goal of providing safe, reliable long term service in compliance with regulatory standards benefits ratepayers. To accomplish this goal, the key question is why would an entity want to acquire a small utility in need of substantial upgrades? Further, we must recognize that these upgrades must be done by either the present or new owner with the cost borne by the ratepayers. Therefore, a two prong attack is needed to help upgrade existing small utilities making them more attractive for acquisition and/or providing incentives for larger utilities to acquire either well run or troubled small utilities.

Since small utilities may be a statewide problem, a state program such as PENNVEST in Pennsylvania, which provides low interest loans and grants for infrastructure improvements would help. This funding would be in addition to the state revolving fund. For example, we have seen many instances of small utilities seeking to retire their water or wastewater plants and tie their systems into regional systems. In several cases, these transactions have not happened due to the unwillingness of the regional system to assume dilapidated collection or distribution

systems. Access to these funds can help make utilities willing to make improvements more attractive for acquisition. Additionally, a rate increase may be needed to cover the costs of improvements and position the utility to service its acquired debt. An acquiring utility would rather not alienate its new customers with an immediate rate increase. Obviously, they would rather assume recently increased rates by the prior owner.

For small utilities with little rate base, traditional rate of return rate setting fails to provide adequate cash flow to service debt or put profit back into the utility. The operating ratio alternative currently available for Florida's small utilities can provide needed additional revenues for these utilities. To date, the Commission has approved rates based upon the operating ratio for three utilities. One of these utilities is no longer jurisdictional due to the loss of Citrus county and another was just approved in 2000. While these cases cannot reveal the impact of the operating ratio, the third case, Lake Osborne may show the positive impact of using the operating ratio. In 1996, Lake Osborne received a rate increase based upon the operating ratio. In 1997, the utility was acquired by Crystal River Utilities. Even though Lake Osborne was a small utility with rate base of only \$1,842, the ability of the new owner to continue charging the rates based upon the operating ratio may have provided the incentive to close the transfer. This is another way a small utility can make itself more attractive for

acquisition.

Small utilities where the present owners lack the desire and ability to make improvements present a different scenario. In these cases, improvements can only be made by the new owner with the cost ultimately borne by the ratepayers. In many instances, the present owners are looking to cut their losses and sell at bargain prices. Absent extraordinary circumstances, a negative acquisition adjustment would go against the goal of consolidation. Additionally, contentious recovery of costs to upgrade the acquired system is also an acquisition disincentive. Depending upon the size of the acquiring utility and the magnitude of improvements to the acquired system, implementation of a surcharge to customers of the acquired system could be made available. A surcharge would earmark only the customers of specific systems.

Additionally, when a utility acquires a system which has little or no rate base, the Commission could consider allowing a proxy rate base equivalent to the rate base per customer of the acquiring company. This would increase cash flow over otherwise break even rates providing an incentive to acquire the system.

In summary a package of the following measures would serve to provide needed incentives if the Commission were to pursue a goal of industry consolidation.

- Work with other agencies and the legislature

for funding to establish additional funding for infrastructure replacement and improvement.

- Educate our utilities to make them aware of funding options.
- Codify, through rule, the Commission's current policy of acknowledging neither a positive nor negative acquisition adjustment, absent extraordinary circumstances.
- Recognize that additional incentives are needed for the acquisition of small utilities and that immediate rate increases may be needed to achieve the long term goal of providing safe, reliable service in compliance with regulatory standards.
- Educate customers of the costs to provide quality service and the price tag of needed improvements to their specific systems. Educate them that in order to receive quality service they will bear the cost of regulatory compliance which is to their long term benefit.
- Expand applicability and promote setting rates on the operating ratio method. Utilities with sufficient cash flow are more viable entities and are better targets for acquisition.
- When the acquired company has little or no

rate base, consider allowing a proxy rate base equivalent to the rate base per customer of the acquiring company.

- Allow surcharges for specific improvements needed to be in compliance with regulatory standards.
- When a small troubled system is discovered, allow Commission staff to act as a facilitator in promoting an acquisition. This would involve a proactive approach whereby staff would find out if the owner is willing to sell, locate a potential purchaser and determine what regulatory incentives are needed to close the deal.
- Consider non-economic incentives such as allowing acquiring utilities temporary authority to manage and operate systems they want to acquire prior to finalizing the acquisition and streamlining the Commission's present transfer process.