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Southern States Utilities • 1000 Color Place • Apopka, FL 32703 • 407/880-0058

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April 18, 1996

Via UPS

Ms. Blanca S. Bayo
Florida Public Service Commission
Director of Records & Reporting
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

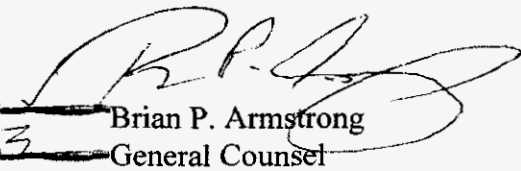
Re: Docket No. 950495-WS: Rate Increase
Application of Southern States Utilities, Inc.

Dear Ms. Bayo:

Enclosed please find an original and fifteen copies of Exhibit ____ (SWV-4). It has come to SSU's attention that the copy of the exhibit originally filed with Mr. Vierima's testimony included only odd numbered pages. By copy of this letter, we are forwarding the complete exhibit to all parties (by UPS today) in this matter. If there are any questions or complications resulting from this correction, please do not hesitate to call me at (407) 880-0058, ext. 152.

As always, your assistance and cooperation is appreciated.

Very truly yours,


ACK _____ Brian P. Armstrong
AFA 3 _____ General Counsel

APP _____
CAF _____ dlh/96L31

CMU _____ cc: All Parties

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WATER FOR FLORIDA'S **FUTURE**

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STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

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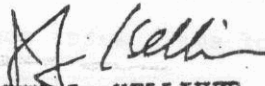
CASE 93-W-0962 - Proceeding on Motion of the Commission to establish a Policy to Provide Incentives for the Acquisition and Merger of Small Water Utilities.

NOTICE

(Issued November 10, 1993)

The Commission's Order Instituting Proceeding invites interested persons to submit comments and/or consider proposals regarding a possible Commission policy concerning acquisition incentive mechanisms (AIMs).

NOTICE is hereby given that any interested person may submit comments in response to the issues set forth in the Order by filing 15 copies of such comments or proposals with John J. Kelliher, Secretary, State of New York Public Service Commission, Three Empire State Plaza, Albany, New York 12223, by February 21, 1994. Persons with substantially similar interests are invited to submit jointly-filed comments.


JOHN J. KELLIHER
Secretary

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

At a Session of the Public Service
Commission held in the City of
New York on October 20, 1993

COMMISSIONERS PRESENT:

- Peter Bradford, Chairman
- Lisa Rosenblum
- Harold A. Jerry, Jr.
- William D. Cotter
- Raymond J. O'Connor

CASE 93-W-0962 - Proceeding on Motion of the Commission to
establish a Policy to Provide Incentives for the
Acquisition and Merger of Small Water Utilities.

ORDER INSTITUTING PROCEEDING
AND SOLICITING COMMENTS

(Issued and Effective November 10, 1993)

BY THE COMMISSION:

This Order institutes a proceeding to solicit comments
and consider proposals regarding a possible Commission policy
concerning acquisition incentive mechanisms (AIMs) intended to
foster acquisition of small water companies. The concept of an
AIM was developed as part of an initiative to design
regulatory/rate making procedures and state-wide initiatives to
deal with small water company problems.¹

¹ Other initiatives arising out of that collaborative
process are being developed separately.

CASE 93-W-0962

Typical problems of small water companies are an inability to finance system improvements, poor capitalization, inexperienced operation, part-time management, untimely rate applications, poor records and recordkeeping, inadequate service, poor maintenance and replacement, and unfamiliarity with regulation.¹ While often-troubled small companies continue to operate, they are unable to cope with emergencies, and may not be viable on a long-term basis. The problems that occur in finance, service and management (including poor records) stem from the fundamental fact that the companies often are too small to function efficiently as a public utility.² The new financial and operating demands created by the Safe Drinking Water Act (SDWA) are expected to be beyond small company capabilities in many cases.

Moreover, the amount of staff and Commission time historically spent on the service and rates of small water companies has been disproportionate to the revenues and number of people involved. Looking to the future, this disproportionate effort could become worse in light of the new SDWA mandates. In New York State, there are approximately 350 investor-owned waterworks subject to Commission regulation. Of these, about 300

¹ NRRI Report "Commission Regulation of Small Water Utilities: Some Issues and Solutions," 1983, pp. 3-5. A description of nationwide problems.

² Supra, p. 26.

CASE 93-W-0962

have less than 100 customers. Approximately 200 companies have 50 customers or less.

Any policy concerning AIMs must satisfy broad economic goals while maintaining a proper balance between ratepayers and investors. As a starting point for a dialogue with interested parties, staff has identified several broad goals and factors for consideration in establishing an AIM policy.¹ Also, parties are invited to comment on the following proposed guidelines for development of any AIM policy that have been proposed by staff:

1. The proposal must be in the general public interest.
2. The acquiring company should demonstrate that it will have the capacity to serve and manage the acquired company efficiently and adequately, and has the ability to achieve compliance with the SDWA and other regulatory requirements, including the ability to finance improvements.
3. The level of any incentives provided should be reasonable and commensurate with the magnitude of overall benefits to customers in terms of improved service quality, rate stability and long term ability to repair and replace equipment and meet SDWA mandates as economically as possible.
4. The terms of an acquisition should not preclude the occurrence of beneficial future alternatives for system ownership and management, such as municipal or water authority take over.
5. The impacts on the acquired company customers should be measured against the

¹ The specific goals and factors are set forth in the attached memorandum.

CASE 93-W-0962

likely impact of the alternatives, such as continued independent operation, public ownership, bankruptcy, or contracted operation/management.

6. Should there be a purchase premium, there should be a clear demonstration that the acquisition is arm's length and that the acquisition premium is fair and reasonable.
7. To the extent possible, rates of the merging companies should be equalized, and plans to do so should equitably balance competing concerns and minimize rate shock.

Finally, AIM guidelines should be intended to provide general parameters for consideration of proposed acquisitions and are not intended to be fixed and immutable rules.

As part of this proceeding, the attached staff memorandum will be used to initiate comment and is intended to become the subject for focus group meetings between staff and the water industry, consumers, and other interested parties. These meetings are intended to stimulate a collaborative and constructive dialogue among all interested parties.

The Commission orders:

1. A proceeding is hereby instituted to address the matters described in this order relating to the establishment of AIM policy guidelines.

¹ Appendix D to the memorandum contains a further discussion on the evaluation of the purchase price.

CASE 93-W-0962

2. Initial comments and reply comments of interested persons shall be submitted in accordance with a schedule to be issued by the Secretary of the Public Service Commission.

3. This proceeding is continued.

By the Commission,

(SIGNED)

JOHN J. KELLIHER
Secretary

FILED-SESSION OF OCT 20 1993

STATE OF NEW YORK
DEPARTMENT OF PUBLIC SERVICE

October 12, 1993

TO: THE COMMISSION

FROM: ENERGY AND WATER DIVISION
CONSUMER SERVICES DIVISION
OFFICE OF ACCOUNTING AND UTILITY FINANCE

SUBJECT: CASE 93-W-0862
Proceeding on Motion of the Commission to establish a
Policy to Provide Incentives for the Acquisition and
Merger of Small Water Utilities.

SUMMARY OF PROPOSED ACTION: It is proposed that -
A proceeding be instituted to establish a policy for
Acquisition Incentive Mechanisms (AIM), and that this
memorandum and its concepts be issued for comment and
become the subject for discussions with industry,
consumers, other state agencies, municipalities, and
other interested parties. Comments and the results of
discussions should be submitted by February 21, 1994,
and then used in formulating a Commission policy.

** *** **

Summary

The Department has recently identified three initiatives to
improve regulation in the water industry:

- (1) development of long-term planning processes for the
seven largest water companies;
- (2) design of regulatory/ratemaking procedures and
statewide initiatives to deal with small water
company problems; and
- (3) increase our activity at national levels and
improve our presence with the federal government on
water industry matters, and communicate positions
on the Safe Drinking Water Act (SDWA).

This memorandum recommends that a proceeding be instituted
to establish a Commission policy for acquisition incentive
mechanisms (AIM) to foster acquisition of small water companies.

STATE OF NEW YORK
DEPARTMENT OF PUBLIC SERVICE

October 12, 1993

TO: THE COMMISSION

FROM: ENERGY AND WATER DIVISION
CONSUMER SERVICES DIVISION
OFFICE OF ACCOUNTING AND UTILITY FINANCE

SUBJECT: CASE 93-W-0025
Proposed as an action of the Commission to establish a policy to provide incentives for the acquisition and merger of small water utilities.

SUMMARY OF PROPOSED ACTION: It is proposed that a proceeding be instituted to establish a policy for acquisition incentive mechanisms (AIM) and that the Commission and the Public Service Commission (PSC) be requested to conduct discussions with industry, consumer, other state agencies, environmental, and other interested parties. Comments and the results of discussions should be submitted to the Commission by February 15, 1994, and then used to formulate a Commission policy.

cc see 44

Summary

The Department has recently identified three initiatives to improve regulation in the water industry:

- (1) Development of industry planning processes for the seven largest water companies
- (2) Design of regulatory/incentive programs and statewide initiatives to deal with small water company problems and
- (3) Increase our activity at national levels and improve our presence with the federal government on water industry matters, and communicate positions on the Safe Drinking Water Act (SDWA).

This memorandum recommends that a proceeding be instituted to establish a Commission policy for acquisition incentive mechanisms (AIM) to foster regulation of small water companies.

This will be the first proposal to come out of the regulatory/ratemaking process and statewide initiative area. Other interdivisional collaborative work is proceeding in this area and additional proposals will be forthcoming. The remaining two initiatives are being developed separately, and will be implemented or subsequently reported to the Commission, if appropriate.

It is further recommended that this memorandum be issued for comment, and that the broad goals, factors for consideration, incentive mechanisms, and guidelines described herein, become the subject for focused group meetings with industry, consumers, and other interested parties. The purpose of these meetings is to stimulate a collaborative and constructive dialogue among all interested parties to obtain comprehensive formal comments to the Commission by February 21, 1994. These comments would then be used by the Commission to establish an AIM policy statement.

Typical problems and issues of the small water company are inability to finance, poor capitalization, inexperienced operation, part-time management, untimely rate applications, poor records and recordkeeping, inadequate service, poor maintenance and replacement, and unfamiliarity with regulation.¹ While the small often-troubled companies continue to operate, they are unable to cope with emergencies, and are generally not viable on

1/ NRRI Report "Commission Regulation of Small Water Utilities: Some Issues and Solutions", 1983, pp. 3-5. A description of nationwide problems.

a long-term basis. The problems that occur in finance, service, and management (including poor records) stem from a fundamental cause: the company is simply too small to function efficiently as a public utility.¹ The new financial and operating demands created by the SDWA are expected to be beyond small company capabilities in many cases.

Historically, the amount of staff and Commission time spent on the service and rates of small water companies has been disproportionate to the revenues and number of people involved. Looking to the future, this disproportionate effort could become worse in light of the new SDWA mandates. In New York State there are approximately 350 investor owned waterworks subject to Commission regulation. Of these, about 300 have less than 100 customers. Approximately 200 companies have 50 customers or less.

Because of the many public benefits to be derived from acquisition/mergers, especially the absorption of small water utilities into larger entities, staff believes the Commission should actively engage the private water industry and other interested parties in achieving this goal. To this end we believe that a clearly articulated policy on mergers and acquisitions should be developed. By developing such a policy statement it is hoped that more applications will be brought to the Commission for consideration and approval. Safe and

1/ supra p. 26

reasonably priced service by small water utilities could be improved significantly by efficient acquisition/mergers. Regulatory efficiencies would result as well since less time would be required to deal with small company issues.

Current Commission Authority and Policy

The Commission's power relative to mergers or acquisitions of utility systems is inherent in its authority to approve or disapprove applications that are made to it. This authority is derived from the Public Service Law Section 89-h, Article 4-B, which governs the transfer or lease of a "waterworks franchise, works or system", or the acquisition of stocks or bonds. Within 16 NYCRR, the rules relating to applications of this sort are addressed in Subchapter C, Articles 1 - 6. Particularly, Part 31 sets forth the requirements concerning the transfer of certificates, permits and/or property. This part details the contents required in such petitions and requires that they "show in detail the reasons for what is proposed, all of the facts warranting the same and that the transfer or lease is in the public interest". Other articles within this subchapter detail filing requirements relating to securities and to applications under uniform systems of accounts that will also be applicable in many instances to acquisitions.

In addition to the general standard that the application be shown to be in the public interest, a note to Section 31.2 of 16 NYCRR states that the Commission may refuse to approve an application where the purchase price exceeds the legitimate

original cost less depreciation unless the applicant will amortize immediately said excess through charges to surplus. That is, the purchase price that exceeds book value (or the "purchase premium") may not be recouped or be added to the acquiring company's rate base. In addition, the Commission in past decisions has often allowed a rate base no more than the purchase price, where the book value has been greater than the purchase price.

Staff believes these past decisions, while not stated policy, were designed to protect the ratepayers from excessive charges, but may have had the effect of acting as a significant disincentive to small water company acquisitions. Over the four year period 1989-1992, there were 23 transfers of utility water systems or property approved by the Commission. Over half of these were system transfers to municipalities, and only three could be termed consolidations/mergers. Given New York's large number of water companies, it would appear there is significant room for improvement in this activity and that an effective Commission incentives policy would provide that improvement.

Elements of an Acquisition Incentive Mechanisms Policy (AIM)

To be effective, an AIM policy should satisfy broad economic goals while maintaining a proper balance between ratepayers and investors, and use a few well understood implementation guidelines to foster mergers and acquisitions that provide maximum customer benefit. In regulating utilities, the Commission is constantly balancing consumer and investor

interests. Use of an incentive policy is expected to create additional competing interests. While an effective AIM policy is expected to provide definite benefit to the public at large, the incentives themselves can conceivably affect the negotiations resulting in a purchase price greater, or on terms different, than would otherwise be negotiated, to the detriment of the ratepayers. The ultimate guidelines should be capable of balancing these important factors.

What now needs to be explored is how acquisitions/mergers of small companies can help provide good service at fair and reasonable rates. A recommendation of this memorandum is to open a dialog with the private water utility industry, interested municipalities, other state agencies, and the affected ratepayers, to explore creative solutions to the problems faced by small water companies. For the purposes of initiating this dialog, staff has prepared the following lists of goals, factors for consideration, incentive mechanisms, and guidelines for evaluating AIM petitions. These constitute the current thinking about the parameters of the policy that should result from the proceeding. The questions posed for comment in Appendix A raise issues relating to the final development of these policy elements.

Broad Goals of AIM Policy

Staff has identified the major broad goals of the AIM policy as follows:

- * Moderate the rate impacts of the costs¹ facing the water industry, specifically those imposed by the SDWA.
- * Promote small water company acquisitions/mergers.
- * Improve the economic efficiency of small water companies.
- * Provide regulatory flexibility and openness to a wide range of alternatives, thereby stimulating creative and economic solutions.
- * Fairly balance acquisition incentives with service and rate impacts to promote acquisitions/mergers that are in the public interest.
- * Provide meaningful and clear guidelines which encourage exploration of acquisition opportunities and facilitate the development and approval of acceptable proposals.
- * Ensure public participation.

Factors for Consideration

Staff has identified a number of factors that should be considered in the evaluation of any AIM proposal. They include the following:

- * Purchase price
- * Realized economies
- * Rate impact on customers of both systems
- * Service history
- * Rate equalization considerations
- * Customer service
- * Long term benefits² to customers
- * Customer satisfaction with the proposal
- * Access to capital
- * Operational and capital improvement
- * Economic viability
- * Management

1/ Aging infrastructure replacement, and the monitoring, treatment and plant addition requirements of the SDWA.

2/ Lower rates and better service resulting from economies of scale, better operation and management, and access to financing for improvements.

Evaluation of the above factors will require the submission of detailed information as a part of the petition. As already noted, Part 31 details the contents of transfer petitions. However, in the context of the AIM policy, where incentives may be applicable and the special concerns and problems of the small water companies are involved, staff believes that some of the requirements of Part 31 may be appropriately waived and other information should be provided. See Appendix B for a list of contents that staff believes should be required for transfer petitions, cross referenced to the existing rules, and annotated to show the elements that might be appropriately waived in the policy statement or in the context of individual petitions.

Incentive Mechanisms

The following mechanisms are identified for consideration as incentives for acquisition/mergers, to be included in a Commission policy. Staff contemplates that a petition could propose to use one or more of the following in a variety of combinations and degrees (although some of them are mutually exclusive), and that alternative incentive packages could be presented as well. For a more detailed description of some of these mechanisms and their use, see Appendix C.

* Rate base inclusions

- Where rate base exceeds purchase price, reflect all or a portion of the difference in rates.
- Where little rate base exists for the acquired company, allow up to the equivalent of the acquiring company's rate base per customer.
- Where there is a purchase premium, reflect all or part of the premium in rates through rate base.

- * Operating ratios in lieu of rate base treatment
Where rate base of the acquired company is very low relative to construction cost, relate net income and revenue requirement to a ratio of operating costs.
- * Incentive returns
Allow a higher than normal rate of return for certain acquisition and improvement costs.
- * Depreciation allowances
Reflecting increased annual depreciation in rates provides additional cash flow and incentive. This can be accomplished by allowing depreciation on contributed plant where little or no rate base exists, or by allowing accelerated depreciation where rate base does exist.
- * Amortization of acquisition costs
Where there is a purchase premium, reflect all or part of the premium in rates.
- * Delayed recovery of costs
In some cases, the use of certain economic incentives may be initially unacceptable for various reasons, such as rate shock; however, their use may be necessary to attain the acquisition. A possible mechanism in this situation would be to delay the recovery of any of the above mechanism costs to mitigate customer impact.
- * Lease buyout plans
Where companies, the Commission, or customers are uncertain about the benefits of an acquisition, the acquiring company may lease a system before acquisition, allowing time to evaluate the acquisition benefits.

As discussed in the Staff Guidelines section that follows, staff believes that, in general, rates should be equalized between the two merging companies. Rate equalization can also be an incentive for acquisition, and the speed at which rates are equalized relevant to how great this incentive is.

Staff Guidelines

Staff's views on some important issues are as follows:

- * The proposal must be in the general public interest.

- * The acquiring company should demonstrate that it will have the capacity to efficiently and adequately serve and manage the acquired company, and the ability to achieve compliance with the SDWA and other regulatory requirements, including the ability to finance improvements.
- * The level of incentives should be reasonable and commensurate with the magnitude of overall benefits to customers in terms of improved service quality, rate stability, and long term ability to repair and replace equipment and meet SDWA mandates as economically as possible.
- * The terms of an acquisition should not preclude the occurrence of beneficial future alternatives for system ownership and management, such as municipal or water authority takeover.
- * The impacts on the acquired company customers should be measured against the likely impact of the alternatives, such as continued independent operation, public ownership, bankruptcy, or contracted operation/management.
- * Should there be a purchase premium, there should be a clear demonstration that the acquisition is arms-length, and that the acquisition premium is fair and reasonable. For a further discussion of staff's thoughts on evaluation of the purchase price, see Appendix D.
- * To the extent possible, rates of the merging companies should be equalized, and plans to do so should equitably balance competing concerns and minimize rate shock. For a discussion of this issue, see Appendix E.

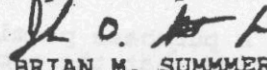
It is expected there are other factors, mechanisms, and guidelines that should be included for consideration, and that public comment and discussion will bring them to the proceeding for evaluation. Any guidelines that are ultimately adopted should not be considered fixed and immutable. As the Agency examines individual cases, it is expected that the guidelines may be modified. In addition, circumstances of a particular proposed acquisition may warrant deviation from the guidelines.

Recommendation

It is recommended a proceeding be instituted to establish a policy to provide incentives for the acquisition and merger of small water companies, and that this memorandum and its contents

be issued for comment, with special focus on the questions set forth in Appendix A. Notice of the proceeding should be served on a broad range of potentially interested parties, and the Commission should direct that all comments be submitted by February 21, 1994. It is further recommended that staff, industry, concerned consumers, and other interested parties be encouraged to immediately establish dialog and convene focused groups, as well as use other means of communication to explore the concepts contained in this memorandum. The results of these discussions and comments would then be used in formulating the policy.

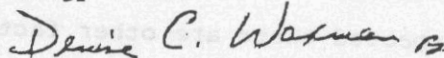
Respectfully submitted,



BRIAN M. SUMMERS
Associate Utility Financial Analyst
Office of Accounting and Finance

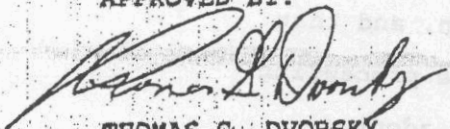


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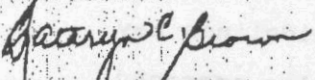


DENISE C. WAXMAN
Supervisor of Utility Hearings
Consumer Services Division

APPROVED BY:



THOMAS G. DVORSKY
Deputy Director, Cost Performance
Energy and Water Division



KATHRYN C. BROWN
Director, Consumer Services Division



FRANCIS M. HERBERT
Director, Office of Accounting & Finance

APPENDIX A

QUESTIONS FOR PUBLIC COMMENT

1. Are the policy goals articulated correct? Are there others? If so, identify and elaborate.
2. Are the factors identified for consideration all relevant? Are there other factors that should be considered? What relative weight should be given to the different factors?
3. Are the incentive mechanisms identified complete, or are there others that should be considered for inclusion? Should any of the identified incentives be rejected? Are any of the incentives to be preferred over others? Generally? In particular situations? Elaborate on any guidelines that might be appropriate for weighing or prioritizing the use of different incentives, informing the use of multiple incentives, etc.
4. Are the guidelines set forth reasonable? If not, explain how they should be modified or why they should be rejected. Are there other guidelines that should be applied?
 - a. Purchase price
Comment on the guidelines set forth in Appendix D. Are there alternative ways of determining a fair purchase price? Other information that should be considered? How should the need for objective evidence of a fair price be balanced against the desire for a streamlined process? To what extent, if at all should the standards of valuation in eminent domain law be used? To what extent should the estimated costs of immediately needed capital improvements be a factor in evaluating the fair purchase price?
 - b. Application of incentives
Is it possible to articulate more concrete guidelines for the application of incentives in a particular case, that is, to evaluating the magnitude of the benefits that will result from the transfer and in determining the commensurate incentive? If so, explain and provide details.
 - c. Rate equalization
Are the guidelines described in appendix E proper? If not, explain how they should be modified or why they should be rejected. Are there other guidelines or factors that should be considered in the context of setting forth a rate equalization plan? If so, identify them and describe their applicability. Are there any circumstances where rates should not be equalized? If so, explain.

5. Are further or different factors, incentives or guidelines appropriate to incent the Gas, Electric and Telephone utilities to acquire small water companies? If so, explain what these would be, and whether it is a good idea to encourage such acquisitions.
6. What other matters should be addressed in the context of an AIM policy?
7. What suggestions do you have to streamline, yet facilitate input into, the Commission's consideration of a specific AIM petition? For example, to whom should the initial petition be sent? Should settlement rules apply to efforts by staff to obtain modification of the proposed terms, incentives, etc.?
8. Are there any particular measures that should be included to ensure customer protection; i.e. minimization of rate rate shock, and availability, adequacy, and quality of customer service?

APPENDIX B

ESSENTIAL ELEMENTS OF AN AIM PETITION

Existing Requirements of 16 NYCRR, Part 31

- o Copy of Certificate of Incorporation and any modifications. (17.2)
- o Copy of the proposed contract [31.1 (d)]
- o Description of the property to be transferred. [31.1(b)]
- o Copy of franchises, consents, and rights to be transferred, with details (31.1 (c)) (including DEC Certificate of Convenience and Necessity and any modifications).
- o Municipal approvals, if required [31.1 (d)]
- o Inventory of Water Plant being transferred [31.3 (f)], in accordance with applicable system of accounts [31.1 (g)].
- o Accrued depreciation in property to be transferred with methodology [31.1 (h)]
- o Cost of property to be transferred, per books [31.1(i)].
- o Depreciation and amortization reserves applicable to the property to be transferred. [31.1 (j)]
- o Statement of contribution toward construction of property, showing those subject to refund. [31.1 (k)]
- o Statement of operating revenue, expenses, and taxes for each of the 3 preceeding years. [31.1 (l)]
- o Most recent balance sheet for both transferee and transferor. [31.1 (l)]
- o The company's proposal for financing the acquisition, and if this involves the issuance of stocks, bonds, notes or other evidences of indebtedness, details as required in Part 37.

Proposed Requirements

- o Summary of current rate structure and charges for both companies, including the average annual cost of water for 90,000 gallons under residential rates.
- o Copy of the most recent DOH inspection report and of any outstanding orders of DEC, DOH, PSC, or other agencies or governmental authorities.
- o Customer Service Standards reports, if applicable, and customer complaint records of both companies.
- o Engineering report on structural condition of the system to be transferred, any necessary and/or discretionary capital improvements with estimated costs, timing of each element of the work and the company's proposal for financing the improvements with details as required in Part 37.
- o Other information relevant to evaluation of the purchase price of the property being transferred, such as appraisals of unimproved real property or capitalization of earnings.
- o Details and alternatives of the proposed AIM's for which approval is sought.
- o Analysis of the rate impact through the time of full rate equalization, accounting for projected capital expense.
- o Report on the Public Involvement Policy (PIP) effort concerning this petition and input received from the customers of both companies.
- o Statement explaining how this acquisition fits into the long range plans of the acquiring company.
- o Evaluation of benefits to the customers of both companies, the public at large, and other long or short range benefits, including projected economies of scale.
- o Evaluate alternatives - Estimate the likely future of service and rates for acquired company customers if the acquisition is not approved. Identify all public and private water systems, and their distance to the system, within 10 miles of system to be acquired.

APPENDIX C

ACQUISITION INCENTIVE MECHANISMS

The following mechanisms are largely taken from the National Regulatory Research Institute publication, Commission Regulations of Small Water Utilities: Mergers and Acquisitions, NRRRI-86-10 (October 1986).

Commission policy on acquisitions should be flexible and include a wide range of alternatives, including public acquisition. In general, the extent of incentives for acquisition should be related to the amount of benefit to the customer, and the desirability and/or liability associated with the company to be acquired, largely determined by its viability.

Alternatives to acquisition by a regulated utility are: acquisition by municipal authority; or contractual central management and operation by experts, such as in a regional arrangement. There is another course of action, not discussed here, that can be taken concurrently with incentives to the acquiring company; that is disincentives to the troubled company to stay in business.

Where a private regulated utility will be the acquirer, a wide range of incentives can be offered:

1. Equalization of the rates of the two companies. Where the acquired company's (AQD) rates are lower than the acquiring company (AQG), making the AQD rates equal can be an incentive to the AQG company. The faster the pace of equalization, the more the incentive that may be provided. However, this pace of equalization should be balanced against possible customer rate shock. Where the AQD rates are higher than the AQG rates, the policy could be more flexible, and equalization may not be as critical a factor to acceptability of the proposal.
2. Rate base treatments. When the acquisition cost is less than the net book value (NBV), allowance of all or part of the difference in rate base provides an earnings incentive. Where NBV of the AQD company is very low, allow a rate base (RB) addition equivalent to the AQG company's rate base per customer, applied to the AQD number of customers.

3. Operating ratios in lieu of rate base.
Where little or no RB exists, use an operating ratio, where allowed net income for return can be a portion, or ratio, of operating expense which may or may not include FIT.
4. Incentive returns.
Allow a higher than normal rate of return on the acquisition cost, and/or new capital needed for improvements.
5. Depreciation allowances.
Where little NBV exists, provide a depreciation allowance on contributed plant to improve cash flow and earnings.
6. Where a purchase price premium is proposed, allow part or all of the premium to be reflected in rates. However, there should be a clear demonstration that the acquisition is arms length and that the customers of the acquired company will benefit sufficiently to outweigh the acquisition premiums. Allowance of the purchase premium can be accomplished in a number of ways:
 - a. Full amortization of the premium and inclusion of the unamortized balance (UB) in RB.
 - b. Amortization of the premium, but inclusion of only a portion of the UB in RB.
 - c. Full amortization of the premium, but exclusion of the UB from RB.
 - d. Partial amortization of the premium and exclusion of the UB from RB.
 - e. Treat the premium as a current expense.
 - f. Provide no recovery of the premium, but allow a higher ROR on RB.
 - g. Allow the premium in RB, or to be reflected in rates, but phase in or delay the recovery.
 - h. Completely disallow the purchase premium.

- 7. **Delayed recovery of cost.**
While not strictly an incentive, delayed recovery is a tool that could be used in creating an acceptable acquisition proposal. For any of the above mechanisms, where a cost is to be allowed as an incentive, its effect on ratepayers may be mitigated by delaying its inclusion in rates.

- 8. **Lease buyout plans.**
These plans generally provide that the acquiring company will lease the system for some specified period, with an option to buy at the end of that time. This mechanism can allow the companies, customers, and Commission to observe the advantages and disadvantages of the acquisition before it becomes irreversible.

As previously indicated, the amount of incentives to induce an acquisition is likely to be related to the viability and liabilities associated with the acquired company. Other possible factors are the proximity of the acquirer, system age, quality of system installation and design, number of customers, RB/customer, construction cost/customer, cost of needed improvements, viability of acquirer, volatility of O & M and earnings, and ability of customers to pay.

APPENDIX D

PURCHASE PRICE EVALUATION

As stated in the Staff Guidelines section of this memo, the AIM policy, by its very nature could affect the negotiated purchase price. If sellers and buyers can reasonably expect that the price paid will be recouped, that fact may encourage a price higher than might be attained otherwise. That said, we should recognize that most of the small water companies that might be acquisition targets have no rate base or one that represents a very small amount of the utility assets. Since the market may value some of these properties differently, any acquisition policy that desires to encourage economic transfers conflicts with the present policy, which has been that when one utility purchases another for a price higher than book value, only the book value of the purchased entity may be recouped.

It is also clear that any acquisition policy should not discourage purchases below book value, where appropriate. From a public benefit standpoint, encouraging a purchase price below net book value through an AIM policy would be desirable. The incentive in this instance could be to allow all or a portion of the difference between the lower price and book value to be reflected in rates. This would be in contrast to current policy which has replaced the existing rate base with the lower purchase price for ratemaking.

The AIM policy should endeavor to allow economic forces and each unique situation set the price. The Commission can best do this by retaining its discretion and its position as an economic arbiter, subjecting each transaction to serious economic review. That review would evaluate the transaction with respect to the Commission's broad goals, its guidelines, and to the peculiar economic circumstances presented.

Staff would offer the following proposed broad guidelines relating to the purchase price:

- * The purchase price should be determined to represent an exchange value that, in the totality of the circumstances, is fair and reasonable.
- * The burden of demonstrating that the proposed purchase price is fair and reasonable is on the petitioners.

* The evidence that may be relevant to establishing a fair price in these cases includes the following:

- Net book value
- Actual structural condition of the property
- Capitalization of earnings
- Estimated necessary capital improvements
- Value of lands

It is important to emphasize that these purchase price guidelines relate only to the evaluation of the purchase price proposed in the application. The extent to which any of the possible incentives would apply to any part, or all, of the purchase price, (whether the purchase price is below or above book value), is a function of the key guideline set forth on page 11, which provides that the incentive package that the Commission will approve is a function of the magnitude of the expected benefits to the customers from the acquisition.

APPENDIX E

RATE EQUALIZATION

Staff believes that in a merger or acquisition, except where there are very unusual circumstances, the rates of the merged companies should be equalized. While it is impossible to lay down specific rules for how rate equalization should be handled in each case, staff believes that it is important to have some principled basis for judging the rate equalization proposals that are presented to assure that, on a statewide basis, customers are being treated fairly. Accordingly, we have endeavored to articulate several general guidelines or principles that we believe should guide the rate equalization proposal that is put forth in a petition.

An AIM petition should contain a proposal for the equalization of rates, including a schedule for a planned phase-in, if applicable, and an estimate of the rate impacts for typical customers. Where the engineer's report indicates that the acquired company will require a major infusion of capital expenditures in the near term, and/or other causes make it likely that a rate increase will result from the acquisition, the petition should include projections of the increase, and any phase-in of equalization. The petition should justify the plan proposed in the light of these guidelines.

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

CASE 93-W-0962 - Proceeding on Motion of the Commission to
Establish a Policy to Provide Incentives for the
Acquisition and Merger of Small Water Utilities.

STATEMENT OF POLICY ON
ACQUISITION INCENTIVE MECHANISMS
FOR SMALL WATER COMPANIES

Issued and Effective: August 8, 1994

Case 93-W-0962

STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

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STATE OF NEW YORK
PUBLIC SERVICE COMMISSION

COMMISSIONERS:

Peter Bradford, Chairman
Lisa Rosenblum
Harold A. Jerry, Jr.
William D. Cotter

CASE 93-W-0962 - Proceeding on Motion of the Commission to
Establish a Policy to Provide Incentives for the
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STATEMENT OF POLICY ON ACQUISITION INCENTIVE
MECHANISMS FOR SMALL WATER COMPANIES

(Issued and Effective August 8, 1994)

BY THE COMMISSION:

GUIDELINES FOR WATER COMPANY ACQUISITIONSPREAMBLE

On October 20, 1993, we instituted Case 93-W-0962 to consider the provision of incentives for the acquisition of small water companies by, and therein merger into, larger entities. Public comment was invited, and on the basis of that comment and the recommendations of Department staff, we are establishing goals and guidelines that will apply to proposals to consolidate small water companies through acquisitions and mergers.

Small water companies typically cannot attract capital and often have small cash reserves, or none at all. Frequently, these companies are run by part-time managers possessing little technical training. In addition, their small customer base

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limits their ability to incur significant expenditures for regulatory compliance and other purposes. As a result, these small companies frequently fail to comply with new, or even existing, health and safety regulations. In particular, the requirements of the Safe Drinking Water Act are expected to impose requirements that many systems will be unable to meet. Consolidation of water companies through acquisition or merger may serve as a solution in these situations.

GOALS

This policy is intended to foster acquisitions and mergers that will: (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.

GUIDELINES

The guiding principal in granting acquisition incentives will be to increase customer benefit. An acquirer must be able to show that it can continue to exist in the long term and will be able to provide its customers with safe and adequate service at just and reasonable rates. To foster a

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transformation of small non-viable water companies into entities better able to serve, acquisition incentives may be provided in certain cases, where the following factors so suggest:

1. Whether the acquiring company has the ability to adequately manage the business, serve customers, comply with regulations, and finance capital improvements.
2. Whether the impact on customers resulting from the acquisition is at least as beneficial as the impact of realistic alternatives.
3. Whether the terms of the acquisition will permit future beneficial solutions, such as municipalization.
4. Whether benefits to customers are expected to be commensurate with the cost of the incentives for the acquisition or merger.
5. Whether meaningful customer participation has been obtained through effective public involvement.

We will also consider additional incentives where proposals are made to consolidate several water systems at once.

INCENTIVES

Because each small water company will present unique circumstances, incentive plans will have to be tailored case-by-case. The following incentive mechanisms are provided as examples of those that may be considered. They will not be appropriate in each instance, nor do they constitute an

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exhaustive list of measures that can be entertained. As a general matter, however, any significant rate increases that may be needed should be phased in, in order to avoid unduly harsh effects on customers.

1. Rate Base

- a. Where the purchase price is less than the rate base of the company being acquired, rates may nevertheless reflect the full rate base of the acquired company.
- b. Where the purchase price is greater than rate base, rates may reflect the purchase price premium if warranted. For example, a premium might be justified by improved service, realized cost efficiencies, or economies of scale.
- c. Where capital expenditures are required for service improvements or to comply with health and safety regulations, projected improvement costs may be reflected in rates immediately, subject to verification that the expenditures are made.
- d. Where the company being acquired has little or no rate base, a proxy rate base may be allowed, equivalent to the rate base per customer of the acquiring company.

2. Depreciation

Where circumstances warrant, depreciation may be allowed at accelerated rates, or depreciation on projected improvement costs may be allowed subject to subsequent adjustment.

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3. Amortization

The reasonable costs of acquisition may be recovered by amortization. Under certain conditions, amortization may also be considered for recovery of a purchase price premium. The term of an amortization should be chosen to minimize adverse effects on customers.

The four incentives described below will be considered only in special cases for good cause shown. They represent a departure from traditional rate-making practice and are meant to facilitate consolidation that may otherwise not be possible.

4. Operating Ratio

Where rate base incentive mechanisms are less practicable, a ratio of revenues to operation and maintenance costs may be used to determine revenue requirement.

5. Rate of Return

Where it can be shown to benefit customers, a premium on the overall rate of return may be allowed.

6. Delayed Recovery

Where the costs of acquisition or improvements, or the effects of rate equalization, would cause unduly harsh effects on customers, proposals to delay or phase in

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recovery of costs, rather than lose the opportunity for consolidation, may be considered.

7. Lease/Buyout

Where there is uncertainty regarding the overall benefit of an acquisition, and it would appear beneficial for ownership, management, and operation to occur for a trial period, operation of the company under a lease with an option to buy may be considered as a mechanism for providing incentives.

REQUIRED INFORMATION

The following information should be submitted with any request for our approval of an acquisition or merger.

- o With respect to both companies involved in the merger or acquisition:
 - The current extent of compliance with regulatory agency requirements and directives (Departments of Health, Environmental Conservation, and Public Service, and local authorities).
 - The prospects for future compliance with regulatory requirements.
 - The number of customers.
 - Comparative income statements for the three most recent years.
 - A current balance sheet.
 - Estimate of rates needed to comply with SDWA or other service requirements.

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- Evaluation of customer benefits and economies of scale.
 - Information and data on the rate impact on all customers (acquiring and acquired companies), and the rate plan to achieve parity.
 - A report on the public involvement effort and customer input.^{1/}
- o With respect to the acquired company:
- Identification of ownership of all transferred water plant.
 - Inventory of plant being transferred.
 - The location of the acquired company relative to the acquiring company and to nearby systems, both municipal and private.
- o With respect to the acquiring company:
- A copy of the proposed purchase contract.
 - Identification of municipal approvals, if required.
 - The proposal for financing the acquisition, if appropriate, including applicable information in compliance with 16 NYCRR Part 37.

By the Commission,

(Signed)

JOHN J. KELLIHER
Secretary

^{1/}In reviewing any acquisitions, we will focus on the results of the company's public involvement and information efforts.