

STATEMENTS OF POLICY

PENNSYLVANIA PUBLIC UTILITY COMMISSION

[52 PA. CODE CH. 69]

[M-00051926]

Acquisitions of Water and Wastewater Systems

The Pennsylvania Public Utility Commission, on December 1, 2005, adopted a proposed policy statement order which seeks to increase the number of mergers and acquisitions of small, nonviable water companies to foster regionalization and enhance the viability of jurisdictional water and wastewater systems in this Commonwealth.

Public Meeting held
December 1, 2005

Commissioners Present: Wendell F. Holland, Chairperson; James H. Cawley, Vice Chairperson; Bill Shane; Terrance J. Fitzpatrick; Kim Pizzingrilli

*Proposed Policy Statement on Acquisitions of
Water and Wastewater Systems;
Doc. Nos. M-00051926; P-00052155*

Proposed Policy Statement

By the Commission:

Introduction

On March 11, 2005, Aqua Pennsylvania, Inc. (Aqua) filed a petition with the Commission in which it requested the Commission issue a statement of policy on water and wastewater system acquisitions that Aqua had drafted. In support of its petition, Aqua asserted that the adoption of its proposed policy statement would enhance the Commission's and the Department of Environmental Protection's (DEP) continued goals of promoting water system viability and regionalization and would provide a workable system under which acquiring companies could continue acquisitions and, concomitantly, ensure fair treatment of customers. The Commission determined that comments on Aqua's petition would be helpful and assist it in reaching a final determination on the necessity of issuing a final policy statement regarding acquisitions of water and wastewater systems in Pennsylvania. The notice requesting comments from interested parties regarding Aqua's petition was published April 16, 2005, at 35 Pa.B. 2366.

The National Association of Water Companies—Pennsylvania Chapter (NAWC), the Pennsylvania Office of Consumer Advocate (OCA), the Pennsylvania Municipal Authority Association (PMAA), and a private individual, Lawrence G. Spielvogel, all filed comments to Aqua's petition. This order addresses those comments and sets forth a proposed policy statement on the acquisition of water and wastewater systems in Pennsylvania.

Background

Prior to the enactment of section 1327 of the Public Utility Code, 66 Pa.C.S. § 1327, in 1990, the Commission, under the then-existing law, was prohibited from recognizing in a utility's rate base for ratemaking purposes anything other than the original cost of the assets of the acquired water company less any accrued depreciation. *Scranton v. Scranton Steam Heat*, 405 Pa. 397, 176 A.2d 86 (1961). Thus, if Company A purchased Company B,

Company A's rates could only reflect the original cost of Company B's physical plant less any depreciation. Therefore, even though Company A may have paid substantially more than the depreciated value of Company B's physical plant, Company A was prohibited from having the actual purchase price recognized in the ratemaking process.

The water industry advised the Commission that this ratemaking prohibition created an economic disincentive for larger, more capable and viable water utilities to acquire and merge with smaller, nonviable water systems. Moreover, the situation, as explained by the water industry, was further exacerbated if the rate base of the small water system was fully depreciated.

In 1987, the Commission, in conjunction with a consortium of water industry stakeholders, collaborated to address this ratemaking prohibition and the related proliferation of small, nonviable systems throughout the Commonwealth. The result of this 3-year process, which included input from large investor-owned utilities as well as the OCA, was Act 24 of 1990 adding section 1327 to the Public Utility Code. Section 1327 now allowed, under well-defined statutory parameters, an acquiring utility to request an adjustment to its rate base when the actual purchase price or acquisition costs are greater than the depreciated original cost of the assets of the acquired system. As a result of further stakeholder collaboration, including valuable input again from the water industry, section 1327 was subsequently amended in 1995, to expand further the opportunities for actual purchase price recognition to systems with 1,200 or fewer customer connections to systems with 3,300 or fewer customer connections.

In light of section 1327 of the Code, at its February 22, 1996, Public Meeting, the Commission adopted a policy statement regarding incentives for the acquisition and merger of small, nonviable water and wastewater systems. See 52 Pa. Code § 69.711. Through this policy statement, the Commission sought to enhance its objective of increasing the number of mergers and acquisitions of small, nonviable water companies to foster regionalization and enhance the viability of jurisdictional water and wastewater systems in Pennsylvania. Specifically, our policy statement identified the following acquisition incentives available to encourage the acquisition of nonviable water and wastewater systems: (1) rate of return premium; (2) acquisition adjustment; (3) deferral of acquisition improvement costs; or (4) plant improvement surcharge. See 52 Pa. Code § 69.711(b).

Aqua's Proposed Policy Statement

Aqua's proposal was filed on March 11, 2005. According to Aqua, the proposed Policy Statement is intended to provide "clear guidance" regarding the Commission's expectations on water and wastewater system acquisitions, especially as to the need for original cost studies and cost records. Aqua also states that the proposed Policy Statement represents Aqua's "best efforts to memorialize existing understandings with Commission staff and to resolve the remaining issues." Aqua Petition at 2.

Aqua's proposed Policy Statement sets forth several substantive duties and procedural obligations for acquiring utilities, most notably, a requirement that the acquiring utility prepare an original cost study within six months of acquisition closing. See 52 Pa. Code § 69.721(b)(1) and (b)(2). In connection with determining

original cost, the proposed Policy Statement further addresses failure of the seller to provide original cost documentation, procedures for booking customer contributions in aid of constructions (CIAC), the obligation to exclude plant not booked due to contributions, and the obligation to reconcile the acquiring utility's proposed original cost with the Commission's records. See 52 Pa. Code § 69.721 (b)(3)—(6).

In addition, the proposed Policy Statement outlines the procedures for booking a positive acquisition adjustment (purchase price above depreciated original cost), booking a negative acquisition adjustment (purchase price below depreciated original cost) and use of a "proxy" purchase price per customer. See 52 Pa. Code § 69.721 (c)—(e).

OCA Comments

In general, OCA states that section 1327 of the Code governs the acquisitions of water and wastewater utilities. OCA goes on to explain that section 1327 was enacted in 1990 and created an exception to the general rule in section 1311(b), which values utility property for ratemaking purposes as the depreciated original cost of such property when first devoted to public service. As to the alleged need for the proposed Policy Statement, the OCA submits that section 1327 of the Code "is very clear and does not require any unnecessary or cumbersome policies." OCA Comments at 2.

In response to the particulars of Aqua's proposed Policy Statement, OCA asserts that Aqua's proposed Policy Statement includes "several statements which are inconsistent with section 1327 and are inappropriate for ratemaking purposes." OCA Comments at 2. For example, section 69.721(c) of Aqua's proposed Policy Statement addresses acquisitions where the purchase price is less than net original cost—the negative acquisition adjustment. According to the OCA, to address this situation, Aqua's proposed Policy Statement at § 69.721(c) states that "the reasonable difference should be amortized over a ten year period." However, the OCA observes that this language is contrary to section 1327(e) of the Code, which states: "that difference shall, absent matters of a substantial public interest, be amortized as an addition to income over a reasonable period of time or be passed through to the ratepayers by such other methodology as the commission may direct."

In addition, Aqua's proposal limits the Commission's discretion in addressing negative acquisition adjustments because the Commission, under Aqua's proposed Policy Statement, would be required to amortize the difference over ten years. According to OCA, contrary to section 1327(e), this proposed provision would remove the Commission's discretion to use a different time period or any other methodology to amortize the excess of net original cost over the purchase price.

As another alleged example of section 1327 inconsistency, the OCA observes that Aqua's proposed Policy Statement at § 69.721(d) provides that a positive acquisition adjustment should be allowed in rate base if the acquisition meets the requirements of section 1327(a) or the utility can demonstrate that the acquisition produced operational or financial customer benefits. According to OCA, by adding an additional criteria to the statutory mandate of section 1327(a), this proposal "eviscerates the requirements of section 1327 (a) with respect to the inclusion of positive acquisition adjustments in rate base and should not be accepted." OCA Comments at 6-7. OCA states that there is no need to provide an alternative to

the criteria in section 1327(a) because the General Assembly has enumerated the criteria that will establish those benefits.

Aqua's proposed Policy Statement at 69.721(e) suggests that, if the original cost is in dispute, the Commission should consider the relationship between purchase price per customer and the acquiring utility's rate base per customer as a relevant test and "significant benchmark of the reasonableness of the purchase price for a water or wastewater system." The OCA submits that this proposed section would limit the ability of the parties to address the requirements of section 1327(a)(6). In this regard, the OCA states that the utility has the burden of proof under section 1327 to establish the reasonableness of the purchase price and that there needs to be some connection between the evidence produced by the utility and the criterion. Accordingly, the OCA concludes that "no nexus has been established in this Petition that the purchase price per customer is an appropriate way to establish that the purchase price is reasonable. OCA Comments at 9.

Finally, the OCA discusses at length the Aqua-proposed requirement of an original cost study for every acquisition or, as an alternative, the election to rely in whole or in part upon the original cost records of the seller or the Commission. Once again, the OCA notes that there is no requirement in section 1327 that an original cost study be performed for an acquisition. Because an original cost study is expensive and in many cases unnecessary because of the existence of adequate records, the OCA cautions the Commission against placing such a requirement on utilities. According to OCA, "it should not be assumed that an original cost study is always a better measurement of the net investment not yet recovered from customers. Undertaking a cost study because it is required under the proposed policy statement may result in a waste of utility, intervenor, and Commission resources." OCA Comments at 5.

NAWC-PA Chapter Comments

The National Association of Water Companies—Pennsylvania Chapter (NAWC), a trade association representing many of Pennsylvania's largest investor-owned water utilities, submitted comments to Aqua's proposed Policy Statement. According to NAWC, the proposed Policy Statement does not at all appear to be a declaration of a flexible, non-binding policy. Instead, according to NAWC, the proposed Policy Statement sets forth procedural duties or obligations of the acquiring utility, some of which may or may not be necessary for every acquisition. To this end, the NAWC cautions the Commission in characterizing a "binding norm" as a policy statement when it is really a regulation, subject to the formalities of the Commonwealth Documents Law and the Regulatory Review Act. NAWC Comments at 2.

Finally, the NAWC submits that the stated need for clarification and explanation in the petition and proposed Policy Statement is not developed in the Petition or in the proposed Policy Statement. Indeed, the NAWC suggests that sufficient clarification and explanation already exist on the main issues raised by the proposed Policy Statement. Specifically, according to NAWC, in the Reconsideration Order in *Application of Pa. Suburban Water Co. and Eagle Rock Utility Corp.*, Docket Nos. A-210104F0023 and A-210075F2000 (Order entered March 5, 2005) (*Eagle Rock*), the Commission, in response to Aqua's petition for reconsideration, held: (1) an application proceeding is not the appropriate forum to determine the ratemaking impact of an acquisition; (2) specific bookkeeping entries should not be ordered in an application proceeding; and

(3) an applicant should be given the opportunity to submit an original cost study prior to its next rate filing. NAWC Comments at 3.

PMAA Comments

The Pennsylvania Municipal Authority Association (PMAA), representing over 650 municipal authorities across the Commonwealth, submitted comments to Aqua's proposed Policy Statement. In its comments, PMAA asserts that the proposed Policy Statement is inconsistent with the Commission's Policy Statement at 52 Pa. Code § 69.711, which addresses acquisition incentives for small, non-viable water and wastewater systems. Specifically, PMAA contends that the Aqua's proposed Policy Statement repeatedly uses the word "or" when identifying the criterion for an acquisition adjustment whereas section 1327(a) of the Code and the Commission's Policy Statement at 52 Pa. Code § 69.711 both use the word "and" when identifying the criterion for an acquisition adjustment.

Lawrence G. Spielvogel Comments

Lawrence G. Spielvogel, an individual, also filed comments to Aqua's proposed Policy Statement. In sum, Mr. Spielvogel objected to the approval of Aqua's proposed Policy Statement because "it codifies practices that require regulatory latitude." According to Mr. Spielvogel, the Petition and proposed Policy Statement "fails to show that existing procedures at the Commission are inadequate."

Aqua Reply Comments

Aqua filed reply comments to the comments filed by the OCA, NAWC, PMAA and Lawrence G. Spielvogel. In its reply, Aqua notes that the proposed Policy Statement was filed "in order to seek guidance regarding recent Commission staff actions and informal policies that have made the acquisition of water and wastewater systems increasingly burdensome." Aqua Reply at 1. Aqua continues:

The Petition memorializes concessions made by Aqua in order to satisfy concerns raised by Commission staff. As to issues on which Aqua and Commission staff have irreconcilable differences, Aqua has openly and forthrightly presented its proposals for resolution. While other water and wastewater companies may have not yet experienced the same obstacles in the acquisition process, they likely will as they increasingly acquire other systems. The time to address the problem is now. An acquiring utility should not be subjected to the initial financial and operational risk of buying a small troubled water system and then be subjected to ongoing risk with no finality as to whether it will be permitted to earn on its investment.

Aqua Reply at 1-2. Aqua concludes its reply comments by stating that the Commission should not continue along the "same beaten path" and that the Commission should not be satisfied with the status quo—particularly when the acquisition process has become "riddled with misunderstandings and unnecessary obstacles." Aqua Reply at 2.

a. Reply to the OCA Comments

In response to the comments of the OCA, namely, that the proposed Policy Statement conflicts with section 1327 of the Code, Aqua acknowledges that if there is a conflict, the statute controls. Aqua Reply at 8. On this point, Aqua agrees that certain provisions of the proposed Policy Statement could have led to confusion, thus, Aqua has proposed alternative language in an attempt to satisfy OCA's concerns.

As to OCA's comments concerning the prohibitive cost of an original cost study in every case, Aqua in its reply agrees that the preparation of an original cost study can be a costly endeavor; however, according to Aqua, it should nevertheless be a requirement because: (1) Commission staff already expects the preparation of an original cost study; (2) the proposed Policy Statement already recognizes that there may be situations in which a "full-blown" original cost study is not necessary; (3) the proposed Policy Statement is just that—a statement of policy merely providing Commission guidance; and (4) OCA's criticism relating to proper calculations in an original cost study is beyond the scope of Aqua's instant Petition. Aqua Reply at 9-10.

In its reply comments, Aqua has revised the language in its proposed Policy Statement at § 69.721(c) and (d) to address the comments of OCA concerning inconsistency with the provisions of section 1327(a). As to OCA comments concerning the relevance of "the relationship between the purchase price per customer and the acquiring utility's average rate base per customer," Aqua has modified/clarified its position by stating in its reply that the purchase price per customer is "one test of many" as opposed to "a significant benchmark" of the reasonableness of the purchase price.

b. Reply to NAWC Comments

In response to the specific comments of NAWC, namely, that the proposed Policy Statement establishes a "binding norm" and, therefore, constitutes a regulation that must comply with the Commonwealth Documents Law and the Regulatory Review Act and that the issues raised in the proposed Policy Statement were sufficiently addressed by the Commission's reconsideration order in *Eagle Rock*, Aqua contends that "both arguments represent half-hearted efforts to encourage the Commission to do nothing." Aqua Reply at 2. Accordingly, Aqua argues that the comments should be summarily dismissed essentially because the proposed Policy Statement is discretionary in nature and that *Eagle Rock* was not the impetus for the proposed Policy Statement. Aqua Reply at 7.

c. Reply to PMAA and Spielvogel Comments

In response to the comments of PMAA, Aqua states that PMAA comments essentially raise the same concern of OCA, namely, that the proposed Policy Statement uses disjunctive language with regard to the requirements of section 1327(a). To this end, Aqua states that it has proposed new "compromising language" that simply refers to section 1327. As to the comments of Mr. Spielvogel, Aqua asserts that his comments constitute "unfounded speculation regarding Aqua's motives in the filing of the Petition."

Discussion

After reviewing the comments to the proposed Policy Statement and Aqua's reply, the Commission believes that there are several problems with Aqua's policy statement as presently drafted. First, the proposed language appears to amend and/or expand, by way of a proposed policy statement, the parameters of section 1327. Section 1327 created an exception to the general rule in section 1311(b) of the Code, 66 Pa.C.S. § 1311(b), which values utility property at the original cost of such property when first devoted to public service, less applicable accrued depreciation. As stated above, section 1327 now permits for ratemaking purposes the recognition of the actual purchase paid by the acquiring utility for the acquired system. However, section 1327-treatment is expressly applicable only to the acquisitions of non-viable water and

wastewater systems. Aqua's policy statement appears to expand the applicability of section 1327 treatment to all acquisitions of water and wastewater systems. Such an amendment, even if warranted, is not permissible via a policy statement.

Aqua acknowledges in its reply comments that section 1327 governs only the acquisition of troubled water and wastewater systems in Pennsylvania. Accordingly, Aqua has revised the proposed language in its policy statement to address this concern. Nevertheless, Aqua's revisions still remain somewhat inconsistent with section 1327 and include requirements that would be costly to the water industry and their ratepayers (i.e., a general requirement to provide an original cost study for every acquisition). Moreover, the Commission notes that there is already an existing policy statement at 52 Pa. Code § 69.711 that is consistent with the parameters of section 1327 and specifically enumerates the requirements for granting an acquisition adjustment to the rate base of the acquiring utility. Thus, the need for a further interpretative policy statement concerning 1327-type acquisitions is less than compelling.

However, the Commission acknowledges that one of Aqua's primary concerns regarding the acquisition process was attempting to provide guidance as to when and whether an acquiring utility should prepare an original cost study that determines the appropriate value of the assets of an acquired non-viable system. We note that Aqua's proposed policy statement attempts to address this concern by identifying the records an acquiring utility should use in preparing the original cost study, outlining the duty for the acquiring utility to obtain information from the seller, and clarifying the treatment of CIAC. These provisions, in an acceptable form, can provide guidance to the water industry, and bring predictability to the process of acquiring non-viable water and wastewater systems.

Accordingly, the Commission will revise Aqua's proposed policy statement so that it is consistent with section 1327 of the Code and incorporate the above-mentioned provisions, which we believe will provide guidance to acquiring companies. We herein propose to incorporate the revised proposed policy statement into the existing policy statement at 52 Pa. Code § 69.711, which deals exclusively with small, non-viable water and wastewater systems. While this policy statement will not establish binding norms, as would a comprehensive regulation, the policy statement will provide acquiring utilities with guidance and predictability regarding the Commission's treatment of acquisitions and original cost studies.

As previously noted, the existing policy statement at 52 Pa. Code § 69.711 deals exclusively with the consolidation of non-viable water and wastewater systems through acquisitions. The Commission issued this existing policy to highlight its objective of promoting regionalization and smaller water system viability by encouraging larger water systems to consolidate and acquire smaller, non-viable water companies. Nonetheless, we also believe that further consolidation of water and wastewater systems within the Commonwealth may, with appropriate management, result in greater environmental and economic benefits. The Commission notes that it is extremely difficult and very costly for water companies to bring on-line new sources of water supply to meet the ever-increasing demand for potable water in those areas experiencing urban sprawl and an exponential growth in population. Regionalization of water and wastewater systems through mergers and acquisitions will allow the

water industry to institute better management practices and achieve greater economies of scale that will permit greater public access to safe and reliable water. Consequently, we think that it is appropriate to provide guidance to the water industry regarding the acquisition of viable water and wastewater systems. Accordingly, in addition, we are herein setting forth proposed language that provides guidance for an acquiring company that is seeking to include the original cost of the used and useful assets (less depreciation) of an acquired water/wastewater system in its rate base during a subsequent rate proceeding.

At the same time, however, we note that these categories of acquisitions fall outside of the parameters of section 1327 and, therefore, no acquisition adjustment would be permitted by the Commission. Nonetheless, we believe that these types of acquisitions generally serve public policy goals and that some sort of acquisition premium for this category of acquisitions might be appropriate. While the smaller systems may not be chronically troubled today or have long records of poor compliance, as defined in section 1327, these smaller utilities might likely have viability challenges in the future. Smaller water and wastewater systems throughout the Commonwealth currently have varying degrees of financial, technical and managerial viability, and currently experience or are likely to experience the concomitant operational challenges in the future of meeting the costs of escalating Safe Drinking Water Act requirements and making upgrades to their aging infrastructure.

Acquisitions of smaller systems by larger more viable systems will likely improve the overall, long-term viability of the water and wastewater industry and quality of ratepayers' daily lives, the community's economic development and environmental enhancements. See 52 Pa. Code § 69.701. Moreover, we note that the quality of service provided by a public utility is not a neutral factor in determining the just and reasonable level of rates that may be charged. *National Utilities Inc. v. Pa. PUC*, 709 A.2d 972 (Pa. Cmwlth. 1998); 66 Pa.C.S. § 523(a); *Pa. P.U.C. v. Aqua Pennsylvania, Inc.*, 2004 Pa. PUC LEXIS 39; 236 P.U.R.4th 218 (Order entered August 5, 2004). Accordingly, for those utilities that have a demonstrated track record of acquiring and improving the service provided to the customers of these smaller and less viable water systems, we seek comment on whether the Commission should, in its discretion, consider this factor in a subsequent rate case filed by the acquiring utility when determining an appropriate return on equity commensurate with the quality of service provided. See, e.g., *Pa. PUC v. United Water*, Docket No. R-00973947 (January 30, 1998).

To provide guidance to the water industry regarding acquisitions, we propose to amend Chapter 69 of our regulations by amending § 69.711 and adding § 69.721, to read as set forth in Annex A. Under section 501 of the Public Utility Code, 66 Pa.C.S. § 501, and the Commonwealth Document Law, 45 P.S. §§ 1201 et seq., and regulations promulgated thereunder at 1 Pa. Code §§ 7.1—7.4, we amend the regulations at 52 Pa. Code § 69 and as set forth in Annex A; *Therefore*,

It Is Ordered That:

1. The proposed amendments to 52 Pa. Code Chapter 69 (§§ 69.711 and 69.721), as set forth in Annex A, are issued for comment.
2. The Secretary shall submit this order and Annex A to the Governor's Budget Office for review of fiscal impact.

3. The Secretary shall certify this order and Annex A and deposit them with the Legislative Reference Bureau for publication in the *Pennsylvania Bulletin*.

4. A copy of this order and Annex A shall be served upon the Office of Consumer Advocate, the Office of Small Business Advocate, the Office of Trial Staff, all jurisdictional water and wastewater utilities, the DEP, the National Association of Water Companies-Pennsylvania Chapter and the Pennsylvania Rural Water Association. This order and Annex A shall also be served upon all persons who submitted comments to Aqua's policy statement.

5. Interested persons may submit an original and 15 copies of written comments to the Office of the Secretary, Pennsylvania Public Utility Commission, P. O. Box 3265, Harrisburg, PA 17105-3265, within 30 days from the date this order is published in the *Pennsylvania Bulletin*. A copy of written comments shall also be served upon the Commission's Law Bureau.

6. The contact Person for this matter is David Screven, Law Bureau, (717) 787-2126.

JAMES J. MCNULTY,
Secretary

Fiscal Note: 57-246. No fiscal impact; (8) recommends adoption.

Annex A

TITLE 52. PUBLIC UTILITIES

PART I. PUBLIC UTILITY COMMISSION

Subpart C. FIXED SERVICE UTILITIES

CHAPTER 69. GENERAL ORDERS, POLICY STATEMENTS AND GUIDELINES ON FIXED UTILITIES

ACQUISITIONS OF SMALL NONVIABLE WATER AND WASTEWATER SYSTEMS—STATEMENT OF POLICY

§ 69.711. Acquisition incentives

(a) *General.* To accomplish the goal of increasing the number of mergers and acquisitions to foster regionalization, the Commission will consider the acquisition incentives in subsection (b). The following parameters shall first be met in order for Commission consideration of a utility's proposed acquisition incentive. It should be demonstrated that:

* * * * *

(2) The acquiring utility meets the criteria of viability [**which**] **that** will not be impaired by the acquisition; that it maintains the managerial, technical and financial capabilities to safely and adequately operate the acquired system, in compliance with 66 Pa.C.S. (relating to the Public Utility Code), the Pennsylvania Safe Drinking Water Act (35 P. S. §§ 721.1—721.17) and other requisite regulatory requirements on a short and long-term basis.

* * * * *

(b) *Acquisition incentives.* In its efforts to foster acquisition of suitable water and wastewater systems by viable utilities when the acquisitions are in the public interest, the Commission seeks to assist these acquisitions by permitting the use of a number of regulatory incentives. Accordingly, the Commission will consider the following acquisitions incentives:

(1) *Rate of return premiums.* [**Additional**] **Under 66 Pa.C.S. § 523 (relating to performance factor con-**

struction), additional rate of return basis points may be awarded for certain acquisitions and for certain associated improvement costs, based on sufficient supporting data submitted by the **acquiring** utility within its rate case filing. **The rate of return premium as an acquisition incentive may be the most straightforward and its use is encouraged.**

(2) *Acquisition adjustment.* [**In cases when the acquisitions are greater than the depreciated original cost, the reasonable excess may be included in the rate base of the acquiring utility and amortized as an expense over a 10-year period.**] When the **acquiring utility's acquisition cost differs from the depreciated original cost of the water or wastewater facilities first devoted to public use, the difference may be treated as follows for ratemaking purposes:**

(i) *Credit acquisition adjustment.* Under 66 Pa.C.S. § 1327(e) (relating to acquisition of water and sewer facilities), when a utility pays less than the depreciated original cost of the acquired system, the acquiring utility may book and include in rate base the depreciated original cost of the acquired system, provided that the difference between the acquisition cost and original cost should be amortized as an addition to income over a period of time that is determined by the Commission. The acquiring utility may argue that no amortization is appropriate when the acquisition involves a matter of substantial public interest.

(ii) *Debit acquisition adjustment.* Under 66 Pa.C.S. § 1327(a), when a utility pays more than the depreciated original cost of the acquired system, the acquiring utility may book and include in rate base the excess of acquisition cost over depreciated original cost of the acquired system, provided that the utility can meet the requirements of 66 Pa.C.S. § 1327(a). When the acquisition does not qualify under 66 Pa.C.S. § 1327(a), the debit acquisition adjustment should be treated in accordance with generally accepted accounting principles and not be amortized for ratemaking purposes.

* * * * *

(5) *Additional acquisition incentives.* Other appropriate incentives may be considered by the Commission, when they meet the parameters in subsection (a).

(c) *Procedural implementation.*

(1) The appropriate implementation procedure for the acquisition incentives [**listed**] in subsection (b) would be to file the request during the next filed rate case. In the case of the first incentive, for example, the rate of return premium, appropriate supporting data should be filed within the rate of return section for Commission evaluation of its applicability. [**The rate of return premium as an acquisition incentive may be the most straightforward and its use is encouraged.**]

(2) [**Other appropriate incentives may be considered by the Commission, if they meet the parameters listed at subsection (a).**] Acquisition incentive requests will be considered on a case-by-case basis. In acquisition incentive filings, the burden of proof rests with the acquiring utility.

(d) *Documentation to support inclusion of acquisition adjustment.* An acquiring utility may use a

variety of documentation to support an acquisition adjustment to its rate base as a result of the acquisition of a small, nonviable water and wastewater system.

(1) *Statement of reliance on existing records.* An acquiring utility may elect to rely in whole or in part upon the original cost records of the seller or Commission in determining the original cost of the used and useful assets of the acquired system.

(2) *Preparation of data to support acquisition adjustment.* An acquiring utility, upon its own election, may file an original cost plant-in-service study with the Commission to support its requested acquisition adjustment to its rate base. An original cost study is one method of determining the valuation costs of the property of a public utility. It requires the acquiring utility to develop realistic plant balances and accumulates the records and accounting details that support those balances. Disputes regarding the acquiring utility's original cost valuation of the assets of the acquired system will be resolved in the context of a rate proceeding in which all interested parties will have an opportunity to be heard.

(i) *Contents of an original cost plant-in-service study.* The acquiring utility is obligated to exercise due diligence and make reasonable attempts to obtain, from the seller, documents related to original cost. In particular, as part of its exercise of due diligence, the acquiring utility should request from the seller, for purposes of determining the original cost plant-in-service valuation, the original cost of the assets being acquired and records relating to contributions in aid of construction (CIAC), such as the following:

(A) Accounting records and other relevant documentation and agreements of donations or contributions, services, or property from states, municipalities or other government agencies, individuals, and others for construction purposes.

(B) Records of unrefunded balances in customer advances for construction (CAC).

(C) Records of customer tap-in fees and hook-up fees. When booked by the seller as revenue, the plant value should be included in plant-in-service and the related contribution account and not treated as revenue for ratemaking purposes.

(D) Prior original cost studies.

(E) Records of local, State and Federal grants used for construction of utility plant.

(F) Relevant PennVEST or Department of Environmental Protection records.

(G) Any Commission records.

(H) Summary of the depreciation schedules from all filed Federal tax returns.

(I) Other accounting records supporting plant-in-service.

(ii) *Failure of seller to provide cost-related documents.* The failure of a seller to provide cost-related documents, after reasonable attempts to obtain the data, will not be a basis for the Commission's denial of the inclusion of the value of the acquired system's assets in its proposed rate base. Because the documents obtained from the seller may be incomplete and may result in an inaccurate valuation, the

acquiring utility will not be bound by the incomplete documents from the seller in the preparation of its original cost plant-in-service valuation.

(iii) *Procedure for booking CIAC.* The acquiring utility, at a minimum, should book as CIAC contributions that were properly recorded on the books of the system being acquired. If evidence supports other direct or indirect CIAC that was not booked by the acquired utility, the acquiring utility should make a documented effort to determine the actual CIAC and record the contributions for ratemaking purposes, such as lot sale agreements or capitalization vs. expense of plant-in-service on tax returns.

(iv) *Plant retired/not booked/not used and useful.* The acquiring utility should identify all plant retirements and plant no longer used and useful, and complete the appropriate accounting entries.

(v) *Reconciliation with commission records.* The acquiring utility should reconcile and explain any discrepancies between the acquiring utility's original cost plant-in-service valuation and the Commission's record at the same time the supporting documentation for the study is filed.

(e) *Time to submit original cost valuation.* When the acquiring utility wants to request an acquisition adjustment for ratemaking purposes, it should submit a copy of its newly prepared original cost plant-in-service valuation of the acquired system or a statement of reliance of the existing records of the Commission or the seller to the Commission's Secretary's Bureau, the Bureau of Audits, the Bureau of Fixed Utility Services, the Office of Trial Staff, the Office of Consumer Advocate, and the Office of Small Business Advocate 6 months prior to the date that the acquiring utility plans to make its next rate case filing with the Commission.

(1) The Commission staff may conduct an audit of the original cost valuation, but if no staff audit is completed and released at public meeting before the date of the rate case filing, the Commission's determination of the original cost valuation in the rate case will be deemed final action on the original cost valuation and any associated acquisition adjustment, absent subsequently discovered fraud or misrepresentation.

(2) When the acquiring utility makes a rate case filing sooner than the 6-month window, the acquiring utility should not include the acquisition adjustment in its proposed rate base unless it includes the original cost valuation with the rate filing and one of the following circumstances applies:

(i) A compelling reason exists for requesting the acquisition adjustment in the current rate filing.

(ii) The acquisition was requested or otherwise directed by the Commission.

(iii) No statutory party objects to the inclusion of the acquisition adjustment to the proposed rate base of the acquiring utility.

(f) *Purchase price per customer.* The Commission considers the relationship between purchase price per customer and the acquiring utility's average rate base per customer prior to acquisition to be one of many relevant tests to determine the reasonableness of the purchase price for a water or wastewater system. The Commission recognizes

that the use of purchase price per customer may not be appropriate in every situation, but that it is in most situations a practical way to indicate whether an acquisition is in the best interest of the acquiring utility's existing customers and its overall long-term viability (as defined in § 69.701(a)(2) (relating to viability of small water systems)). Other relevant considerations indicating the reasonableness of the purchase price include:

- (1) Promotion of long-term viability.
- (2) Promotion of regionalization.
- (3) Usage per customer.
- (4) Growth rates.
- (5) Cost of improvements.
- (6) Age of the infrastructure.
- (7) Return on equity.
- (8) Existing rates.

(Editor's Note: The following text is new and is printed in regular type to enhance readability.)

ACQUISITIONS OF VIABLE WATER AND WASTEWATER SYSTEM—STATEMENT OF POLICY
§ 69.721. Water and wastewater system acquisitions.

(a) *General.* The Commission believes that further consolidation of water and wastewater systems within this Commonwealth may, with appropriate management, result in greater environmental and economic benefits to customers. The regionalization of water and wastewater systems through mergers and acquisitions will allow the water industry to institute better management practices and achieve greater economies of scale. To further this goal, the Commission sets forth the following guidance regarding the acquisition of water and wastewater systems. Guidance specifically applicable to the acquisition of nonviable systems is set forth in § 69.711 (relating to acquisition incentives).

(b) *Inclusion of acquisition assets in rate base.* After the approval of an acquisition, as evidenced by the receipt of a certificate of public convenience, an acquiring utility may request the inclusion of the value of the used and useful assets of the acquired system in its rate base. A request will be considered during the acquiring utility's next filed rate base proceeding. See 66 Pa.C.S. § 1311(a) (relating to valuation of and return on the property of a public utility).

(c) *Method of valuation of acquisition assets.* The assets of the acquired system should be booked at the original cost of the acquired system when first devoted to the public service less the applicable accrued depreciation and related contributions. See 66 Pa.C.S. § 1311(b).

(d) *Determining original cost of acquisition assets.* An acquiring utility may use various methods to support its valuation of the original cost of the used and useful assets of the acquired water or wastewater system. For example, an acquiring utility may elect to rely in whole or in part upon the original cost records of the seller or the Commission in determining the original cost of the used and useful assets of the acquired system that are to be included in its rate base.

(e) *Preparation of an original cost of plant-in-service valuation.* The Commission will not require an acquiring utility to submit a full original cost plant-in-service study in order to determine the value of the assets of the acquired system. An acquiring utility, upon its own

election, may file an original cost study with the Commission to support its valuation of the assets of the acquired water and wastewater system proposed to be included in its rate base. A full original cost plant-in-service study is one method of determining the valuation costs of the property of a public utility. It requires the acquiring utility to develop realistic plant balances and accumulates the records and accounting details that support those balances. Disputes regarding the acquiring utility's original cost valuation of the acquired assets will be resolved in the context of a rate proceeding in which all interested parties will have an opportunity to be heard.

(1) *Contents of an original cost plant-in-service study.* The acquiring utility is obligated to exercise due diligence and make reasonable attempts to obtain, from the seller, documents related to original cost. In particular, as part of its due diligence, the acquiring utility should request from the seller, for purposes of determining the original cost plant-in-service valuation, the original cost of the assets being acquired and records relating to contributions in aid of construction (CIAC), such as the following:

(i) Accounting records and other related documentation and agreements of donations or contributions, services, or property from states, municipalities or other government agencies, individuals, and others for construction purposes.

(ii) Records of unrefunded balances in customer advances for construction (CAC).

(iii) Records of customer tap-in fees and hook-up fees. If booked by the seller as revenue, the plant value should be included in plant-in-service and the related contribution account and not treated as revenue for ratemaking purposes.

(iv) Prior original cost studies.

(v) Records of local, State and Federal grants used for construction of utility plant.

(vi) Relevant PennVEST or Department of Environmental Protection records.

(vii) Any Commission records.

(viii) Summary of the depreciation schedules from all filed Federal tax returns.

(ix) Other accounting records supporting plant-in-service.

(2) *Failure of seller to provide cost-related documents.* The failure of a seller to provide cost-related documents, after reasonable attempts to obtain the data, will not be a basis for the Commission's denial of the inclusion of the value of the acquired system's assets in its proposed rate base. Because the documents obtained from the seller may be incomplete and may result in an inaccurate valuation, the acquiring utility will not be bound by the incomplete documents from the seller in the preparation of its original cost plant-in-service valuation.

(3) *Procedure for booking CIAC.* The acquiring utility, at a minimum, should book as CIAC contributions that were properly recorded on the books of the system being acquired. If evidence supports other direct or indirect CIAC that was not booked by the acquired utility, the acquiring utility should make a documented effort to determine the actual CIAC and record the contributions for ratemaking purposes, such as lot sale agreements or capitalization vs. expenses of plant-in-service on tax returns.

(4) *Plant retired/not booked/not used and useful.* The acquiring utility should identify all plant retirements and plant no longer used and useful and complete the appropriate accounting entries.

(5) *Reconciliation with commission records.* The acquiring utility should reconcile and explain any discrepancies between the acquiring utility's original cost plant-in-service valuation and the Commission's records at the same time the supporting documentation for the study is filed.

(f) *Time to submit original cost valuation.* When the acquiring utility wants to request inclusion of its acquisition in rate base, it should submit a copy of its newly prepared original cost plant-in-service valuation of the acquired system or a statement of reliance of the existing records of the Commission or the seller to the Commission's Secretary's Bureau, the Bureau of Audits, the Bureau of Fixed Utility Services, the Office of Trial Staff, the Office of Consumer Advocate and the Office of Small Business Advocate 6 months prior to the date that the acquiring utility plans to make its next rate case filing with the Commission.

(1) The Commission staff may conduct an audit of the original cost valuation, but if no staff audit is completed and released at public meeting before the date of the rate case filing, the Commission's determination of the original cost valuation in the rate case will be deemed final action on the original cost valuation, absent subsequently discovered fraud or misrepresentation.

(2) When the acquiring utility makes a rate case filing sooner than the 6-month window, the acquiring utility should not include the acquisition in its proposed rate

base unless it includes the original cost valuation with the rate filing and one of the following circumstances applies:

(i) A compelling reason exists for requesting the acquisition in the current rate filing.

(ii) The acquisition was requested or otherwise directed by the Commission.

(iii) No statutory party objects to the inclusion of the acquisition to the proposed rate base of the acquiring utility.

(g) *Acquisition incentives.* In its efforts to foster the acquisitions of smaller, less viable water and wastewater systems by larger more viable systems, the Commission, under 66 Pa.C.S. § 523 (relating to performance factor consideration), has broad latitude to allow the acquiring utility to request a rate of return premium in a subsequent rate case. The allowance of a rate of return premium, as an acquisition incentive for an acquisition that falls outside of the parameters of 66 Pa.C.S. § 1327 (relating to acquisition of water and sewer utilities), is encouraged for those utilities that have a demonstrated track record of acquiring and improving the service provided to the customers of smaller and less viable water systems. The allowance of additional rate of return basis points may be awarded based on sufficient supporting data submitted by the utility within its rate case filing.

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