

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

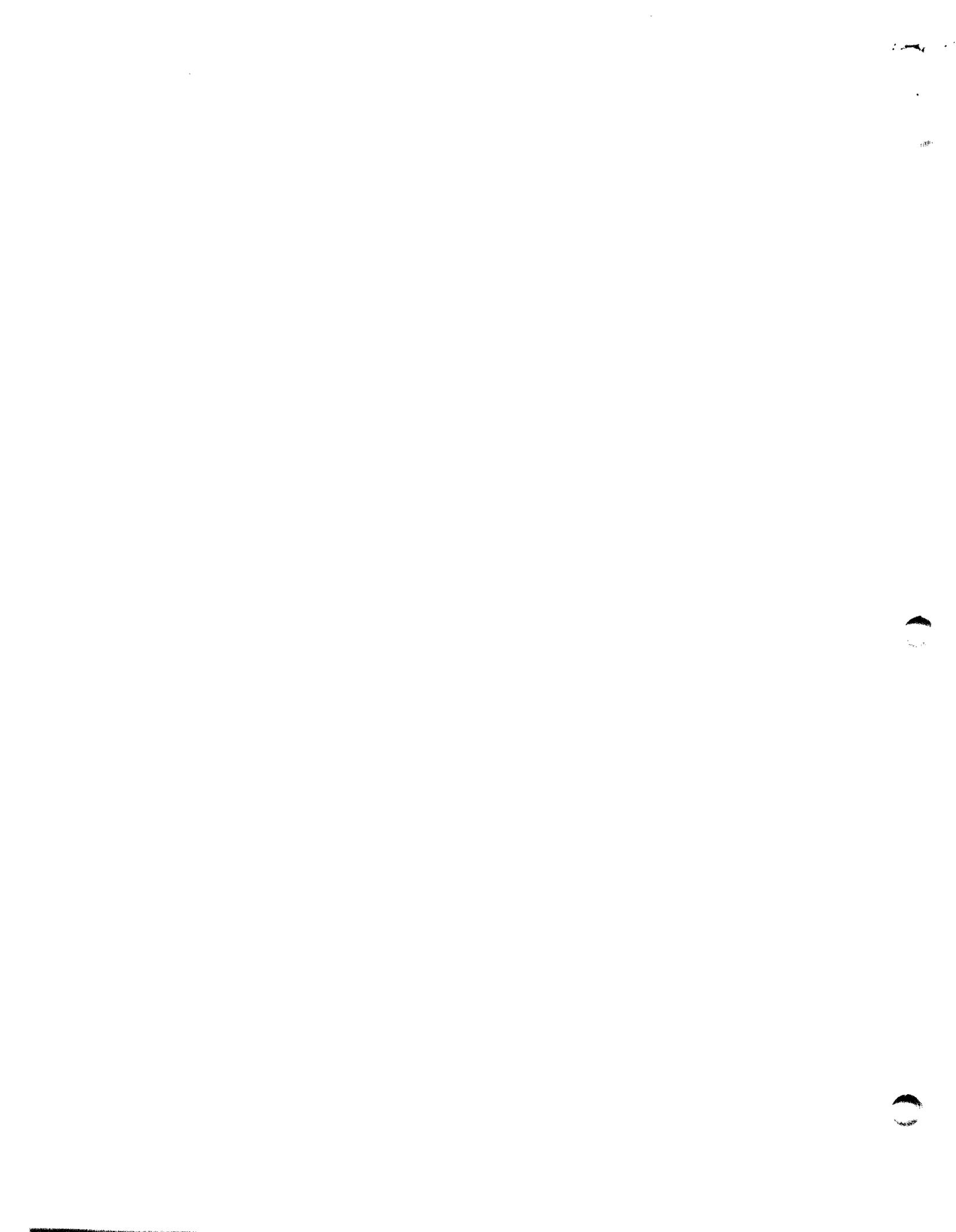
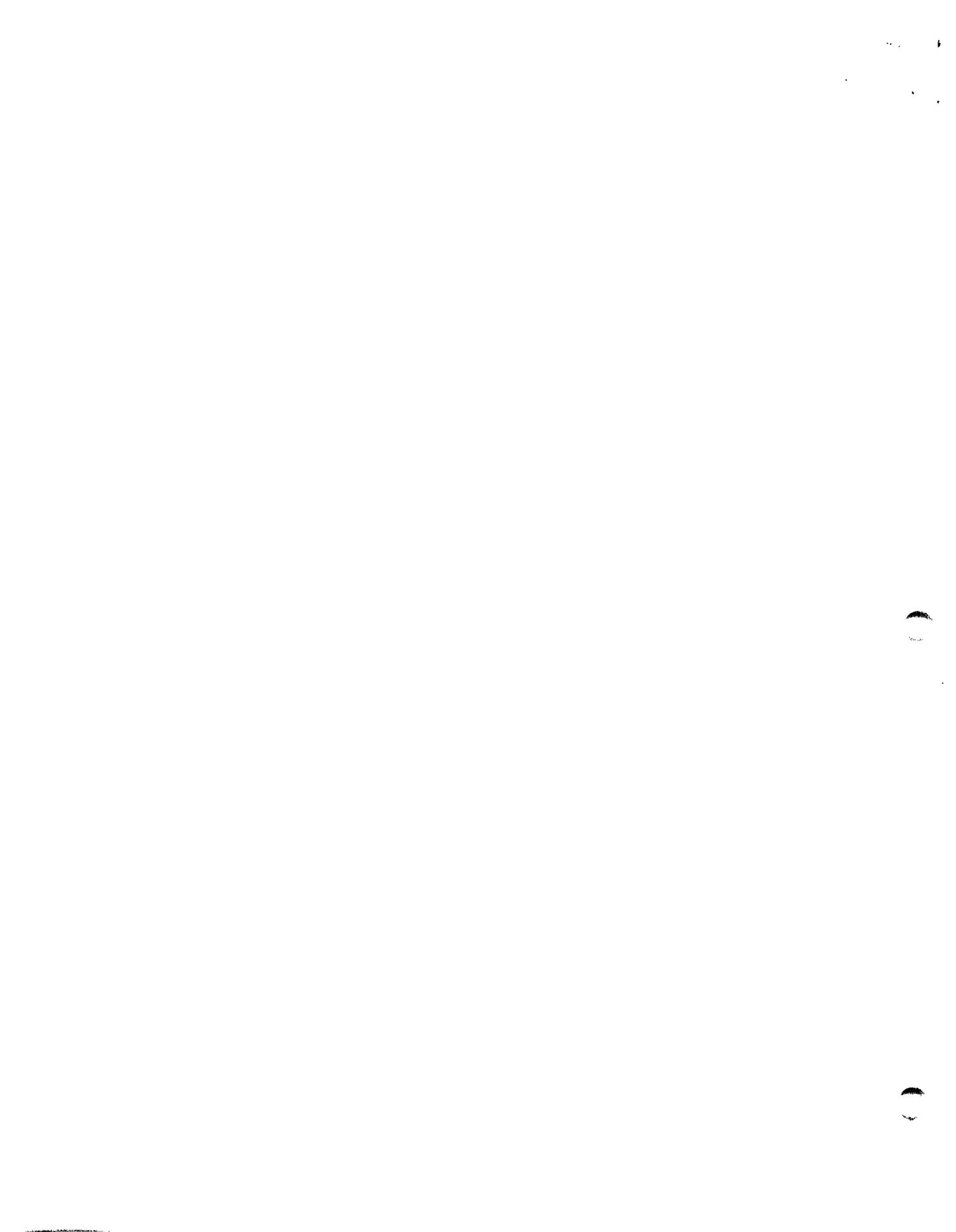


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COMMISSIONERS:

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William D. Cotter

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MECHANISMS FOR SMALL WATER COMPANIES

(Issued and Effective August 8, 1994)

BY THE COMMISSION:

GUIDELINES FOR WATER COMPANY ACQUISITIONS

PREAMBLE

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

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

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

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.

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

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.

- 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.

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