

COMMONWEALTH OF KENTUCKY
BEFORE THE PUBLIC SERVICE COMMISSION

In the Matter of:

APPLICATION OF AQUASOURCE UTILITY,)
INC. FOR TRANSFER OF OWNERSHIP) CASE NO. 99-303
RIGHTS OF GOSHEN UTILITIES, INC.)

O R D E R

On July 9, 1999, AquaSource Utility, Inc. (AquaSource Utility) applied to the Commission for authority to transfer all outstanding stock in, and ownership rights of, Goshen Utilities, Inc. (Goshen). The application also contains requests for Commission approval to treat the difference between the purchase price of the stock of Goshen and the book value of the acquired assets as an acquisition adjustment for accounting and rate-making purposes and to amortize the acquisition premium over a fifteen-year period. In conformity with Commission regulations, AquaSource Utility filed an Adoption Notice stating that the rates and services of Goshen would be adopted.

REQUEST FOR APPROVAL OF TRANSFER OF THE STOCK OF GOSHEN

The requirements for determining if a transfer should be approved are contained in KRS 278.020(4) and (5). KRS 278.020(4) provides that the Commission must approve the transfer if the person acquiring the utility has the financial, technical, and managerial abilities to provide reasonable service. KRS 278.020(5) provides that the Commission shall approve the transfer if it finds the transfer is to be made in accordance with the law, for a proper purpose, and is consistent with the public interest.

The Commission finds that KRS 278.020(4) and (5) are applicable to the transaction proposed by AquaSource Utility and that Commission approval is necessary.

Goshen is a public utility organized under the laws of the State of Kentucky serving approximately 1,700 water and 1,200 wastewater customers in Oldham County, Kentucky. Goshen's principal mailing address is 1001 Riverside Drive, Goshen, Kentucky 40026.

AquaSource Utility is a corporation incorporated under the laws of the State of Texas. It is a wholly owned subsidiary of AquaSource, Inc., an investor-owned water utility company formed on April 1, 1997 as a subsidiary of DQE, Inc. (DQE). DQE has assets of more than \$5.2 billion and annual revenues in excess of \$1.2 billion. AquaSource, Inc. is acquiring and operating water utility systems throughout the United States and presently provides water and wastewater services to more than 370,000 customers in 12 states.

The Commission, having determined that KRS 278.020(4) and (5) are applicable to the proposed transaction, finds that the transaction will be made in accordance with law, for a proper purpose, and consistently with the public interest. The Commission further finds that the information submitted by AquaSource Utility in the application establishes that AquaSource Utility has the financial, technical, and managerial ability to provide reasonable service in Kentucky. Therefore, the request for approval to transfer the issued and outstanding stock of Goshen is consistent with the requirements of KRS 278.020(4) and (5) and should be approved.

PLANT ACQUISITION ADJUSTMENT

When the sale of a utility results in a purchase price greater than the original cost less accumulated depreciation (net book value), the difference between the purchase price and the net book value is accounted for as a plant acquisition adjustment.

AquaSource Utility and Goshen have entered into an agreement wherein AquaSource Utility will purchase all the outstanding shares of stock of Goshen for the purchase price of \$3,500,000. Goshen reported in its 1998 Annual Reports a net book value of \$2,292,824.¹ However, a deduction must be made from this amount to reflect Goshen's Contributions in Aid of Construction (CIAC). The Commission finds that in the past Goshen did not amortize its CIAC. Therefore, Goshen's CIAC balance should be reduced by the unrecorded amortization. Goshen's reported CIAC balance is \$2,453,283. When the unrecorded amortization of \$1,231,826 is deducted, Goshen's CIAC balance is \$1,231,457. Deducting the correct CIAC balance from Goshen's reported net book value leaves a correct net book value of \$1,061,367. Therefore, the plant acquisition adjustment is approximately \$2,488,633. AquaSource Utility requests Commission approval of this acquisition adjustment for accounting and rate-making purposes.

¹ Utility Plant	\$3,988,827
Accumulated Depreciation	<u>-1,696,003</u>
Net Utility Plant	\$2,292,824

One primary source of information regarding the Commission's past position on acquisition adjustments is Case No. 9059.² In the Order on rehearing in that case, the Commission stated that plant acquisition adjustments should be considered on a case-by-case basis and that, if the record demonstrates that the consumers are benefited by the acquisition, the recovery should be allowed. The Commission, however, maintained its position that the net original cost of plant devoted to utility use is the fair value for rate-making purposes unless there is conclusive evidence that the overall operations and financial condition of the utility have benefited from the acquisition at a price in excess of the net book value. The Commission set forth in that case five criteria that should be taken into consideration when granting recovery of an acquisition adjustment.³ A discussion of each of those criteria as it pertains to this case follows:

1. The purchase price was established upon arms-length negotiations.

AquaSource Utility stated that it had no prior affiliation with Goshen or any of its principal employees or shareholders. It stated that AquaSource Utility mailed a letter of intent to Goshen and negotiated the potential transaction that the shareholders of Goshen approved.

The Commission agrees that the negotiations were at arms-length, but finds the evidence produced by AquaSource Utility to support the reasonableness of the purchase price to be based on incorrect assumptions. On October 8, 1999, in response to a request for information made by Commission Staff at the informal conference held

² Case No. 9059, An Adjustment of Rates of Delta Natural Gas Company, Inc.

³ Case No. 9059, Order dated September 11, 1985, at 3.

on September 30, 1999, AquaSource Utility filed information on its due diligence.⁴ The information provided indicates that AquaSource incorrectly assumed that in Goshen's last rate case the allowed margin or revenue requirement was based on a return on rate base; however, the Commission used the operating ratio method. If Goshen's revenue requirement had been based on a return on rate base, its revenue requirement would have been significantly lower.

Given that the acquisition adjustment is approximately 70 percent of the purchase price, AquaSource Utility should have been prepared to provide evidence beyond its due diligence analysis to support the requested rate-making treatment. To support the reasonableness of the acquisition adjustment, AquaSource Utility should have provided either an analysis showing the appraised value of Goshen's system or a comparison of the price paid for Goshen in relation to comparable system sales.

2. The initial investment plus the cost of restoring the facilities to required standards will not adversely impact the overall costs and rates of the existing and new customers.

According to AquaSource Utility, there will be no adverse impact in the overall costs as a result of the acquisition. In support of its position, AquaSource Utility pointed to its commitment to a rate freeze through the year 2000. If the anticipated savings in

⁴ Item No. 6, Response to Request for Additional Information, dated October 8, 1999.

operations and maintenance expense occur, AquaSource Utility will extend the rate freeze, absent any unforeseen capital expenditures.⁵

AquaSource Utility's position regarding the impact of the acquisition on Goshen's ratepayers is based on projections that might or might not come true. Therefore, the Commission is unable at this time to find that the rates paid by Goshen's ratepayers will not be adversely impacted.

3. Operational economies can be achieved through the acquisition.

AquaSource Utility anticipates cost savings through operational efficiencies in areas such as professional fees, insurance and office operations and, over time, through regionalized operations. Upon review of AquaSource Utility's projections, the Commission has determined that they are based upon reasonable assumptions. However, there is no guarantee that they will be realized.

4. The purchase price of the utility and non-utility property can be clearly identified.

Goshen has maintained its financial records in accordance with the Uniform System of Accounts (USoA) prescribed by the Commission. According to AquaSource Utility, the only non-utility property on Goshen's books is a dam. In negotiating its purchase price of Goshen, AquaSource Utility attributed a zero value to Goshen's dam. However, AquaSource Utility did not provide evidence to support its assumption that the dam should have a zero value and not be allocated a portion of the purchase price.

⁵ Amended Petition for Transfer of Ownership Rights of Goshen Utilities, Inc., dated August 30, 1999, p. 6.

5. The purchase will result in overall benefits in the financial and service aspects of the utility s operations.

AquaSource Utility states that it will have the financial backing of its parents, AquaSource and DQE, and access to financial markets to attract lower cost capital than that which is otherwise available to Goshen. In addition, AquaSource Utility states that these resources, combined with DQE s experience in utility operations, demonstrate AquaSource Utility s commitment to ensure high levels of customer satisfaction, to comply more efficiently and more expeditiously with federal and state requirements, and to support future growth in the region. DQE has granted corporate approval to AquaSource to invest over \$350 million in its water and wastewater subsidiaries. Since these resources are available to all subsidiaries of AquaSource, it is difficult for the Commission to determine the actual impact these resources will have on either Goshen s utility operations or the region.

The Commission finds that the acquisition adjustment should be approved for accounting purposes only and a decision on rate-making treatment deferred until the next rate proceeding. This finding is based upon Aquasource Utility s inability to prove in this proceeding the reasonableness of its purchase price. Furthermore, many of the benefits, operational efficiencies, and financial resources of AquaSource Utility s acquisition of Goshen are speculative.

AMORTIZATION OF THE ACQUISITION PREMIUM

AquaSource Utility requested approval to amortize its acquisition premium over a 15-year period for both accounting and rate-making purposes. The Commission s finding regarding the acquisition premium dictates the manner in which the amortization

will be treated. For this reason the Commission finds that the amortization of the acquisition premium should be approved in this proceeding for accounting purposes only, with the decision on rate-making treatment deferred to the next rate proceeding.

Since the acquisition adjustment relates to the utility plant investment, it should be amortized over the remaining life of the assets. The Commission has determined that a 20-year amortization period is a closer estimation of the remaining life of Goshen's water and wastewater assets. For this reason the Commission finds that AquaSource Utility should amortize its acquisition adjustment premium over 20 years for accounting purposes.

IT IS THEREFORE ORDERED that:

1. The proposed transfer of all the outstanding stock of Goshen as well as the responsibility for its management, operation, and maintenance is approved.
2. AquaSource Utility shall notify the Commission of the transfer within 10 days of the completion thereof.
3. AquaSource Utility is granted approval to treat the difference between the purchase price of the Goshen stock and the net book value of the acquired assets as an acquisition adjustment for accounting purposes only.
4. AquaSource Utility is granted approval to amortize the acquisition premium over a 20-year period for accounting purposes only.
5. AquaSource Utility shall record the acquisition adjustment on its books in accordance with the requirements of the UsaA.

6. AquaSource Utility shall maintain the financial records of its water and wastewater divisions separately. All allocations used by AquaSource Utility to separate the shared costs and plant investment between its two divisions shall be presented in the next rate case.

7. Within 30 days of the completion of the transaction, AquaSource Utility shall file the journal entries used to record the purchase and identify the detailed plant accounts to which the assets are recorded. AquaSource Utility shall also file the proposed amortization of the acquisition adjustment as a journal entry.

8. In its next rate case, AquaSource Utility shall have the burden of demonstrating why the acquisition adjustment and amortization premium should be approved for rate-making purposes.

9. In its next rate case, AquaSource Utility shall have the burden of demonstrating that its projected operational efficiencies have been achieved and in what manner they will be used to benefit the ratepayers.

10. AquaSource Utility, having filed an adoption notice pursuant to 807 KAR 5:011, shall, within 10 days of the date of this Order, issue and file in its own name those tariffs of Goshen that it has adopted.

Done at Frankfort, Kentucky, this 5th day of November, 1999.

By the Commission

ATTEST:

Executive Director