

BEFORE THE IDAHO PUBLIC UTILITIES COMMISSION

IN THE MATTER OF THE JOINT APPLICATION)
OF UNITED WATER IDAHO INC. AND SOUTH) **CASE NO. UWI-W-98-2**
COUNTY WATER COMPANY, INC. FOR AN)
ORDER APPROVING THE SALE AND)
TRANSFER OF THE COMMON STOCK OF)
SOUTH COUNTY WATER COMPANY, INC. TO) **ORDER NO. 27798**
UNITED WATER IDAHO INC.)
)

A joint Application in Case No. UWI-W-98-2 was filed with the Idaho Public Utilities Commission (Commission) on June 12, 1998 by United Water Idaho Inc. (United Water; UWI) and South County Water Company, Inc. (South County) for an order approving the sale and transfer of the common stock of South County to United Water. The negotiated and proposed purchase price is \$2,810,000. United Water also requests Commission approval of certain rate and ratemaking matters, including a schedule for a five-year phase-in of rates for South County customers and the right of United Water to include in its rate base in future rate proceedings the full purchase price which includes the depreciated original cost of South County's assets plus an acquisition adjustment.

By this Order, as more particularly described and qualified below, the Commission approves the sale and transfer of South County common stock to United Water, denies the request of South County to include \$312,867 of contributed plant in the sale price, approves a purchase price of \$2,497,133 adjusted to the closing date, authorizes the rate basing of said amount by United Water and approves a six year phase-in of rates for existing South County customers.

United Water provides water service to approximately 58,000 customers in and around the city of Boise and operates under Commission Certificate of Public Convenience and Necessity No. 143 (as amended). South County provides service to approximately 3,825 customers in Ada County and operates under Commission Certificate of Public Convenience and Necessity No. 274 (as amended). Tr. p. 116. As represented in the Application and repeated in South County's testimony, the owners of South County desire to sell the water system because they are reluctant to undertake the risks of continued operations arising from increasingly stringent water quality regulations, increasingly complex utility regulations, and increasingly complex operational and

technical requirements. Because of its small size, South County contends it has experienced, and in the absence of this sale, would continue to experience difficulties in maintaining its current quality of service and obtaining adequate financing for operations, maintenance and future necessary system improvements. South County is a closely held Subchapter S corporation. The shareholders decision to sell the South County Water Company was also influenced by the advanced age of the majority of shareholders and a financial institution requirement of personal shareholder guarantee of South County indebtedness.

A public hearing in this case was held in Boise, Idaho on September 17, 1998. The following parties appeared by and through their respective counsel:

United Water Idaho Inc.	Dean J. Miller, Esq.
South County Water Company	Barton L. Kline, Esq.
Commission Staff	Scott D. Woodbury, Esq.

Sale Consequences to UWI and South County Water Customers

Analysis of this transaction by the parties included the following enumeration of identified benefits and consequences accruing to both UWI and South County customers:

The purchase of South County by UWI and interconnection of the two water systems at an estimated interconnection cost of \$6,000, will result in operational efficiencies through shared water supply and storage (e.g., constant pressure during power outages, Tr. p. 78); will provide improved financial and technical ability to operate the South County system in the future, to make needed system improvements, plan for growth, to replace aging facilities and comply with regulatory requirements, and will provide a revenue benefit to existing UWI ratepayers as South County rates are phased into current UWI rates. Tr. pp. 15, 16, 154, 155, 161, 179, 181, 201.

The physical effects of interconnection will depend upon the hydraulic characteristics of the system after interconnection. Tr. p. 157. As a result of planned chlorination of all South County source wells by United Water to safeguard and improve water quality and to comply with an expected ground water disinfectant rule, South County customers may perceive a change in water taste and smell. Tr. pp. 14, 75, 157. Also available to South County customers, although perhaps noticeable only if needed or utilized, will be emergency electrical backup, faster response to system problems (SCADA) and UWI resource experts, full-time maintenance crews/material inventory,

personnel trained and certified in water system distribution, water treatment and cross connection control, and an in-house state certified laboratory. Tr. pp. 14, 157.

If the United Water requested phase-in rates are approved as opposed to an immediate flash cut to UWI rates, South County customers will realize an estimated phase-in benefit of approximately \$1.75 million (Year 1, \$700,000; Year 2, \$525,000; Year 3, \$350,000; and Year 4, \$175,000). Tr. pp. 184, 185.

Recognizing the value of establishing a dialogue with customers of acquired water systems, United Water commits to form a customer "liaison team" for South County during the transitional period. Tr. p. 19. To ensure that South County customers are schooled in conservation and the efficient use of water, the Company will provide and offer in the South County area its (1) residential water audit program, (2) water efficient landscaping classes, (3) school programs, and (4) other related water information. Tr. pp. 21-28.

Regarding water quality in the South County system, South County notes that it is presently experiencing problems with iron, manganese and hydrogen sulfide. Of 14 production wells, two wells are not used at all, one because of sand and low production, and the other because of high iron. Both however are reportedly tested and remain in standby readiness, Tr. p. 123. South County has five wells with iron problems and one well with a hydrogen sulfide problem which it treats by chlorination. Tr. pp. 117, 120. South County expressed concern over problems encountered with water quality, the ever increasing burden of regulation, and the Safe Drinking Water Act requirements (customer confidence reports, additional water testing, capacity development requirements). South County knows there are solutions but states it lacks the experience and money to bring them about. Tr. p. 96.

Growth in the South County customer base and a need to increase fire protection and address water quality concerns is estimated to require \$875,000 capital investment for distribution analysis & study, mapping, storage, source well, and telemetry within the next two years. Exhibit 2, Tr. p. 12. This investment would cause an increase in rates equivalent to the first year phase-in rate increase proposed in the sale. Tr. pp. 31, 35, 40, 201, 202, 214, 215, Exhibit 108. It was represented that the economic effect of interconnection of South County with United Water may avoid the need for \$306,000 of capital cost. Exhibit 2, Tr. p. 12.

The difficulty presented by this sale, Staff notes, is that South County is a low cost, well operated system. Although this transaction is not being proposed to resolve any immediate problem or deficiency, it was represented that its approval may assure that high quality service will continue. Tr. pp. 81, 160. Arguably South County, Staff contends, could continue to successfully operate the system, continue to borrow against personal assets, hire necessary technical expertise and raise rates. Tr. p. 161. But Staff queried, should the owners be required to do so?

The customers of South County appear generally to be quite satisfied with their present water service and water quality. The written comments and testimony of South County customers reflect frustration and opposition to the proposed sale based on a perceived lack of immediate benefit to customers and to a greater extent based on the expected increase in their rates should the sale be approved and how that increase will affect water's affordability. Despite the increase in rates that a sale will bring to its customers, South County believes the customers will be better served in the long run by United Water and that service, water quality and system dependability will improve if the sale to United Water is approved. Tr. p. 106.

Commission Findings

The Commission has reviewed and considered the filings of record, transcript and exhibits in Case No. UWI-W-98-2, including the letters and comments received from South County customers. We have reviewed our Orders in Case No. U-1117-1, the South County Certificate case. We have also reviewed and considered the relevant statutory authority (*Idaho Code* § 61-526) and Commission Rules (IDAPA 31.01.01.112) regarding amendments to Certificates of Public Convenience and Necessity for existing utilities.

We are faced in this case with the proposed purchase of a comparatively low-cost water company (South County) by a relatively higher cost water company (United Water). The fact that there is a significant difference in the respective costs of service and related rates and charges has caused many South County customers to oppose the sale which, if approved, will result in higher rates to them. The difference in cost of service and rates, however, provides insufficient reason to deny the sale. This Commission has approved the tariff rates for each utility in general rate proceedings based on individual review and assessment of the respective systems, investment and expense. Regarding rates alone, the evidence reflects that even should the Application be denied,

South County customers will experience significant increases in rates within the next two years for substantial required improvements.

The regulatory, operational and personal reasons expressed by South County as prompting the decision to sell by its stockholders cannot be casually dismissed. Although consistently a well-run company, clearly South County faces operational and regulatory challenges today and in the future that will be more technically and physically demanding. It is the assessment of Mr. Stokes, president of South County, that on a going-forward basis the customers of South County would be better served by United Water. South County customers have had the benefit for 24 years of continuous system management and ownership. The present ownership, many advanced in age, desire to sell and bring an end to their venture. The fact that their water system is a regulated entity should not preclude them from selling. Based on the record, and as reflected and described below, however, we find that for Commission approval the sale terms must be adjusted and changed.

Purchase Price

Pursuant to a Stock Purchase Agreement dated June 5, 1998, the stated purchase price for the South County Water system is \$2,810,000. The purchase price consists of the following elements:

Book Value South County Assets (6/30/97)	\$1,488,122 (Incl. \$10,000 legal fees)
Plant Held for Future Use	\$ 312,867
Acquisition Adjustment (Premium)	<u>\$1,009,011</u>
TOTAL	\$2,810,000

Tr. pp. 10, 192.

Book Value: \$1,488,122 (6/30/97)

The stated depreciated book value of South County assets of \$1,488,122 as of 6/30/97, is undisputed. Tr. p. 190. Staff found no discrepancies in South County Water records which it found accurately presented South County investment and water system plant in service. Tr. p. 190. Staff proposes that for rate base purposes, the plant valuation on the date of closing be used. Tr. p. 208.

We find: We find the stated depreciated book values for South County assets to be consistent and reasonable and we further find reasonable the rate basing of same by United Water on its books in an amount adjusted to the calculated plant valuation on the South County books on

the date of closing the sale with related depreciation/amortization based on remaining scheduled life of assets appropriate for the respective classes of property and investment.

Plant Held for Future Use: \$312,867

South County seeks as part of the negotiated sales price to include or add to South County plant value \$312,867 in “unclassified plant,” an amount that dates back to South County’s original certificate application in 1974 (Case No. U-1117-1) and which South County contends was wrongfully excluded. The Commission-approved valuation in the South County certificate case was \$325,125, the net amount reflected in the underlying purchase and sale agreements with Idaho Land Developers (\$278,625; Exhibit 104) and Green Acre Properties (\$46,500; Exhibit 106). Tr. pp. 130, 131; Order No. 11762 (Exhibit 4). The net valuation approved by the Commission was accepted in that case by South County in a filed “affidavit of unqualified acceptance” (Exhibit 6; Exhibit 104). Tr. pp. 104, 196, 197. Reconsideration was not requested and the Commission’s Order was not appealed. It is undisputed, South County contends, that the \$312,867 represents facilities and utility plant which were provided to and used by South County customers since 1975. Commenting on its proposal to include the value of an amount rejected by the Commission 24 years ago, South County responds that this is the last opportunity the Company shareholders will have to obtain some value for the plant. Tr. pp. 109, 111, 112.

Contending that South County stockholders have no equity invested in contributed property, Commission Staff opposes both rate basing of the \$312,867 and inclusion of the amount in the sales price. Tr. p. 219. Staff notes that in the South County certificate case, Mr. Stokes himself recommended that the Commission treat a portion of the water system development costs as contributed property, i.e., \$257,719. Exhibit 102. South County in that case recommended a rate base of only \$202,465. Tr. p. 217; Exhibit 102.

Staff represents that in meetings with South County and United Water preceding the UWI/South County Purchase and Sale Agreement and this filing, it was agreed that South County would carry the burden of proof in persuading the Commission to include the \$312,867 of contributed property in the sale price after 24 years. Tr. p. 233. The Commission was reminded by Staff of the presumption that developers recover the cost of water systems in the sale of lots. Tr. p. 234. Should the \$312,867 be excluded from South County rate base, United Water notes that there

is no Company proposal that an equivalent amount simply be added to the acquisition adjustment. Tr. pp. 43, 44.

We find: We find no justification to include an additional \$312,867 in the plant value. The proper treatment for this was determined 24 years ago and was not then nor has it since been challenged. The Commission's prior decision is final and non-appealable. Contributed property was then and is still appropriately excluded from rate base. The requested addition to rate base was not a capital investment of South County stockholders. We therefore find it reasonable to reduce the amount of the authorized purchase price by \$312,867 and to deny United Water's proposed related rate basing of said amount. Subtracting \$312,867 from the proposed purchase price of \$2,810,000 results in an adjusted purchase price of \$2,497,133.

Acquisition Adjustment (Premium) \$1,009,011

As a condition precedent in the underlying Stock Purchase Agreement, United Water must be permitted in future rate proceedings to earn on the total purchase price, a price which includes an acquisition premium of \$1,009,011. Tr. pp. 9, 40. The Company proposes a 40-year amortization of the acquisition adjustment. Tr. p. 9. Staff does not oppose the Company proposed ratemaking treatment of the acquisition adjustment and related amortization. Tr. pp. 204-206, 209. Staff contends the acquisition premium request by UWI is supported by the reduced return and expenses incurred by United Water relative to South County. Analysis shows that an additional \$744,268 in rate base can be supported by reduction in return and expenses. (Tr. Exh. 1.) When added to the \$306,000 of avoided investment (Tr. Exh. 2), a purchase premium of over \$1,009,000 could be justified.

Regarding standard accounting practice for purchase of existing regulated water systems, Staff represents that purchase of water system assets would be recorded at the original cost of the seller. The seller's accumulated depreciation, contributions in aid of construction (CIAC) and other customer advances would also be transferred to the buyer. Any premium paid in excess of the net book value of the assets would be recorded as an acquisition adjustment. Tr. p. 204.

Regarding regulatory treatment of acquisition adjustments, Staff notes that in normal practice the acquisition adjustment would not be recognized in the calculation of rate base nor would depreciation/amortization expense of the acquisition adjustment be included in the revenue

requirement. For approval of different accounting treatment the purchasing utility needs to receive the express authorization of the Commission. Tr. p. 204.

We find: We find the acquisition premium of \$1,009,011 to be reasonable. We find the acquisition premium is a result of negotiated arms-length bargaining and find it reasonable to approve this amount as an element of the authorized purchase price. On the specific facts of this case, we also find it reasonable to authorize the rate basing of the acquisition premium amount, amortized over 40 years, a period tied to the life of the related assets. In authorizing the ratebasing of the acquisition premium, we note that we depart from traditional ratemaking procedures. It is not lightly that we do so and we do not intend that this be perceived as establishing precedent for future acquisitions. We find Staff analysis regarding the appropriateness of approving and rate basing the acquisition premium to be persuasive. United Water's investment for South County customers based on a purchase price of \$2,497,133 is approximately \$653 per customer, considerably less than the Company's average investment per customer, \$1,467. With the proposed phase-in of rates we adopt as described below, the Company will be foregoing additional customer associated revenue and may in the first year actually earn less than its authorized 9.12% return. In structuring such a phase-in the Commission recognizes the perceived hardship imposed on South County customers by an immediate flash-cut to United Water rates. We also acknowledge that the Company, in exchange for a one year shortfall, receives a long term benefit in being permitted to rate base its acquisition premium. We find that such a phase-in provides an equitable transitional benefit to existing South County customers.

Rate Phase-In and Related Return on Investment Analysis

In this case United Water proposes a five year phase-in period for transition of South County customers to United Water rates. (Year 1, 60% UWI tariff rate; Year 2, 70%; Year 3, 80%; Year 4, 90%; Year 5, 100%.) At full phase-in South County customers will realize an increase in their rates of over 100%. Tr. p. 154. The 5-year rate phase-in period, United Water contends, will minimize rate shock and provide South County customers with the opportunity to change their water consumption patterns and avail themselves of alternative irrigation water services in areas where such waters are available. Tr. pp. 18, 40, 41, 136.

It is noted that under present rates the average South County customer uses 324 ccf annually. That is considerably more water per year than the 220 ccf United Water customers use.

Tr. pp. 17, 18, 21. At current levels of consumption and at 100% of existing UWI rates, average winter/summer monthly charges to South County customers would increase by approximately \$11 and \$33, respectively. A change from monthly to bi-monthly billing will make the impact of the increase seem more acute. Tr. p. 158.

While the Company's Application made no proposal as to the rates that new customers in the South County service area should pay during a phase-in period, during the hearing Mr. Linam said he would leave it to the Commission to decide. He did note that he saw a little problem with neighbors paying different rates. Tr. pp. 55-57.

Staff expressed its opposition to de-averaged rates for South County customers, contending that such rates would be inequitable to other UWI customers with averaged rates. Tr. p. 171. Staff supports rate uniformity and United Water's proposed rate phase-in. Tr. pp. 154, 162.

The proposed purchase of South County by United Water, Staff calculates, will have no adverse effect on existing United Water customers. Exhibit 107. Assuming continuation of present consumption levels and a flash cut to present UWI rates the \$2,810,000 purchase price would produce an overall rate of return on investment to United Water of 28.3%. At present South County rates the Company could invest only \$2,197,000 and realize its authorized 9.12% overall rate of return. At 60% of UWI rates the Company could invest as much as \$4,230,000 and realize a 9.12% return. Tr. pp. 198, 199.

Testimony reflected that United Water would realize its authorized return on investment (presently 9.12%) with an increase in the first year of only 13.8% to South County rates. The Commission questioned the Company as to why the first year phase-in was greater than 13.8%. Tr. p. 16. The Company responded that the move to 60% of UWI rates in the first year was not an iron clad method but simply a reasonable approach to move South County customers to parity within four years. Tr. pp. 69, 70. Also discussed in response to Commission questioning was the Company's receptiveness to extending the phase-in period beyond five years, possibly a year or two. Tr. pp. 81, 82.

With the proposed additional UWI investment for distribution analysis and study, mapping, storage and telemetry, (\$569,000; Exhibit 2) the Company's total investment in South County would increase to \$3,379,000. The resultant return at full UWI rates would be 23.65%, at South County rates 6.17%, and at 60% UWI rates 11.25%. Tr. p. 200. Should the disputed

\$312,867 be excluded from the sales price, the overall return at 60% UWI rates would increase from 11.25% to 12.32%. At 100% UWI rates the return would increase from 23.65% to 25.99%.

We find: The difference in rates charged by South County and United Water has been the principal reason expressed by customers opposing the transaction. We find the Company proposal to phase-in rates to be a responsible and reasonable method of addressing customer concerns and mitigating the rate shock that would otherwise result. Certainly without the Company's phase-in proposal our decision in this case would have been more difficult. We find a required transition to full United Water rates to be reasonable and necessary. United Water is essentially an integrated water system with averaged rates. The de-averaging of rates for an isolated geographic area or customer segment presents unacceptable issues of inequity and discrimination. Although the Company has proposed a five-year transition, we find it reasonable to provide South County customers with a longer period up-front to assess their water usage, to possibly adjust their water consumption habits and to connect (if available) to other irrigation sources.

The rate phase-in that we find reasonable to approve for existing South County customers is a six-year phase-in period. Year 1 will be, at existing South County rates, but changed to bi-monthly billing. Year 2 will be at 60% of UWI's tariff rate; Year 3 at 70%; Year 4 at 80%; Year 5 at 90%; Year 6 at 100%). The extra year adds approximately \$988,000 to the estimated five-year \$1,750,000 difference between phase-in and immediate full UWI rates, and results in a net savings to South County customers of \$2,738,000. The phase-in period that we authorize is available only to existing and not to new customers. We find that new customers in the South County area, whether new by the result of new construction or sale/purchase, are not subject to rate shock and cannot be perceived as having any reasonable expectation of lower South County rates.

Certificate Nos. 143 and 274

We find: In considering the benefits accruing to both South County (phase-in rates, program expense, and a myriad of intangible operational benefits) and United Water customers (revenue exceeding cost of service), we find that the proposed sale/transfer under the terms approved is in the public interest. We find that United Water possesses the technical, managerial and financial ability to provide reliable and adequate service to South County customers. We find that United Water is able to provide quality water, that it has the ability to serve present and future growth in the South County area, that it has the ability to address critical water supply issues such as fire protection

and backup capability, and that it has the ability and wherewithal to accommodate unforeseen circumstances and emergencies.

We find that the Company's filing satisfies the underlying statutory and procedural requirements for certificate applications. Assuming United Water and South County accept the changes directed by the Commission and go forward with the sale and transfer, we find that the public interest will be served by allowing United Water to amend its Certificate of Public Convenience and Necessity No. 143 to include the area presently served by South County (Application. Exhibits 3 & 4; *Idaho Code* §§ 61-526 and 61-528; Commission Rules of Procedure, IDAPA 31.01.01.112), to authorize United Water to provide water service to existing and future customers in said area, and to cancel South County's Certificate of Public Convenience and Necessity No. 274 and its related obligation to provide water service.

CONCLUSIONS OF LAW

The Commission has jurisdiction over United Water Idaho Inc. and South County Water Company, Inc., water companies, and the issues presented in Case No. UWI-W-98-2 pursuant to the power and authority granted under Idaho Code, Title 61 and the Commission's Rules of Procedure, IDAPA 31.01.01.000 *et seq.*

ORDER

In consideration of the foregoing and as more particularly described and qualified above, IT IS HEREBY ORDERED and the Commission does hereby deny the request of South County Water Company to add \$312,867 of contributed plant to its rate base and book value.

IT IS FURTHER ORDERED and the Commission does hereby approve the sale and transfer of South County common stock to United Water for an authorized purchase price of \$2,497,133 adjusted to the closing date (depreciated original cost of South County's assets plus acquisition premium) and authorizes the rate basing of said amount in future rate proceedings by United Water.

IT IS FURTHER ORDERED and the Commission does hereby approve a transitional six year phase in of rates for existing South County area customers. United Water is directed to file related tariff sheets for Commission approval.

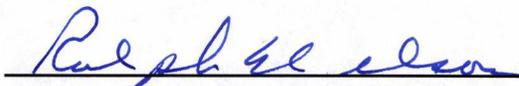
IT IS FURTHER ORDERED that as of the date of closing the South County Water Company Certificate of Public Convenience and Necessity No. 274 is canceled and the obligation of South County to provide water service to the related certificated area is terminated.

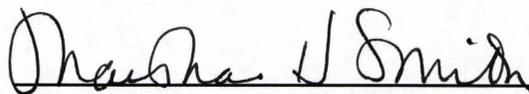
IT IS FURTHER ORDERED that as of the date of closing the Certificate of Public Convenience and Necessity No. 143 of United Water Idaho Inc. be amended to reflect addition of the particular area previously described and reflected in South County Certificate No. 274. United Water Idaho Inc. is directed to prepare and file an amended Certificate for Commission approval.

THIS IS A FINAL ORDER. Any person interested in this Order may petition for reconsideration within twenty-one (21) days of the service date of this Order. Within seven (7) days after any person has petitioned for reconsideration, any other person may cross-petition for reconsideration. See *Idaho Code* § 61-626.

DONE by Order of the Idaho Public Utilities Commission at Boise, Idaho this *19th* day of November 1998.


DENNIS S. HANSEN, PRESIDENT


RALPH NELSON, COMMISSIONER


MARSHA H. SMITH, COMMISSIONER

ATTEST:


Myrna J. Walters
Commission Secretary

vld/O:UWI-W-98-2.sw

ORDER NO. 27798

-12-