MEMORANDUM

TO:COMMISSIONER HANSEN

COMMISSIONER NELSON

COMMISSIONER SMITH

TONYA CLARK

FROM:SCOTT WOODBURY

DATE:NOVEMBER 4, 1998

RE:CASE NO. UWI-W-98-2

UNITED WATER / SOUTH COUNTY WATER

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 (South County) for an order approving the sale and transfer of the South County water system to United Water.  The purchase price is $2,810,000.  United Water further requests approval of certain rate and ratemaking matters, including a schedule for phased in rates and the right of United Water to include in 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.  The Application was accompanied by the filed testimony of both companies.

United Water provides water service to approximately 58,000 customers in and around the city of Boise.  South County provides service to approximately 3,825 customers in Ada County.  Tr. p. 116. As represented in the Application and repeated in the Company’s testimony filing, the current owners of South County desire to sell the water system because they are becoming increasing 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, it is stated that South County 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 system improvements. Also factoring into the shareholders decision to sell the South County company is the advanced stage of the majority of shareholders and a financial institution requirement of personal 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

South County Water CompanyBarton L. Kline

Commission StaffScott D. Woodbury

Purchase Price

Pursuant to Stock Purchase Agreement dated June 5, 1998, the stated purchase price for the South County Water system is $2,810,000.  The purchase price which resulted from arms length negotiations 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)$1,009,011

TOTAL$2,810,000

Tr. pp. 10, 192.

Book Value:  $1,488,122 (6/30/97)

The stated book value of South County, calculated by Staff as of a later date to be $1,523,486 (12/31/97) based on a limited audit is undisputed.  Tr. p. 190; Exhibit 101.  Staff found no discrepancies in South Water records which it found accurately presented South County investment and water system plant in service.  Tr. p. 190.  Staff proposes that the plant valuation on the day of closing be used.  Tr. p. 208.

Plant Held for Future Use:  $312,867

South County seeks as part of the negotiated sales price to include or add to South County rate base $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 was provided to and used by South County customers since 1975.  Commenting on its proposal to include as rate base 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 rate basing of the $312,867 and inclusion of the amount in the sales price.  Staff proposes a reduction of $312,867 in the $2,810,000 purchase price United Water should be authorized to pay for South County.  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.  South County in that case recommended a rate base of only $202,000.  Tr. p. 217.

Staff notes 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 rate base $312,867 of contributed property after 24 years.  Tr. p. 233.  The Commission was reminded 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.

Acquisition Adjustment (Premium) $1,009,011

As a further condition precedent in the underlying Stock Purchase Agreement (6/05/98) 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 for reasons expressed below supports the Company proposed ratemaking treatment of the acquisition adjustment and related amortization. Tr. pp. 204-206, 209.

Regarding standard accounting 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, 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.  The purchasing utility needs to receive specific authorization to do so by the Commission.  Tr. p. 204.

Rate Phase-In and Related Return on Investment

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 to avail themselves of alternate 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 considerably more water per year than United Water customers (324 ccf South County v. 220 ccf UWI).  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 will increase by approximately $11 and $33, respectively.  A change from monthly to bi-monthly billing will make the impact of the increase even more acute.  Tr. p. 158.

Because of growth in customer base, a need to increase fire protection and a need to solve water quality concerns, it is estimated that in the absence of the sale South County customers within the next two years because of capital investment required to continue operations (estimated $875,000 for distribution analysis & study, mapping, storage, source well, and telemetry; Exhibit 2, Tr. p. 12) will realize an estimated 30% increase in their rates, an amount equivalent to the proposed first year phase-in rate increase.  Tr. pp. 31, 35, 40, 201, 202, 214, 215, Exhibit 108.  It was represented that the economic effect of  interconnection may result in an avoided capital cost of $306,000.  Exhibit 2, Tr. p. 12.

Staff in cross questioned whether it was the Company’s proposal that the phase-in apply only to present current existing customers, suggesting that new customers do not face rate shock. The Company noted only that neighboring customers may not understand why their rates are different.  Tr. pp. 55-57.

Testimony reflecting that United Water would receive the authorized return on its investment (9.12%) with an increase of only 13.8% to South County rates in the first year, the Company was questioned by the Commission as to why the first year phase-in was greater than 13.8%.  Tr. p. 16. The Company responded that the move to 60% 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 was the Company’s receptivity to extending the phase-in period beyond five years, possibly a year or two.  Tr. pp. 81, 82.

Staff is opposed to deaveraged rates for South County customers, contending that such rates would be inequitable to other UWI customers that are averaged.  Tr. p. 171.  Staff supports rate uniformity and the Company’s proposed rate phase-in.  Tr. pp. 154, 162.  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, higher necessary technical expertise and raise rates.  Tr. p. 161.  But should it be required to do so?

United Water, Staff calculates, can purchase South County without adverse effect on existing United Water customers.  Exhibit 107.  (Compare UWI investment per customer $1,467; South County $761 using $2,810,000 purchase price — Tr. p. 16.)  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.

With the proposed additional UWI investment ($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%.

Sale Consequences (Benefits to UWI and South County Water Customers)

Analysis of this transaction by the parties included the following enumeration of identified (non-price) benefits accruing to both UWI and South County customers:

The purchase of South County by UWI and interconnection of the two systems (estimated interconnection costs $6,000) will result in operational efficiencies through shared water supply and storage (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. replace aging facilities and comply with regulatory requirements, and will provide a revenue benefit to existing UWI ratepayers exceeding cost of service as South County rates are phased into current UWI rates.  Tr. pp. 15, 16, 154, 155, 161, 179, 181, 201.

The physical effect 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 the upcoming 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 noticeably 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 a state certified laboratory (water quality)).  Tr. pp. 14, 157.

Should the phase-in rates be approved as proposed to an immediate flash cut to UWI rates, South County customers will realize an estimated savings of approximately $1.7 million (Year 1 $700,000, Year 2 $525,000, Year 3 $350,000, and Year 4 $175,000).  Tr. pp. 184, 185.  It is reasonable, Staff contends, to look at the $1.75 million difference as being the return to those customers of the depreciation amount attributed to the sale of those facilities ($1,292,315, Exhibit 101).  Tr. p. 231.  Reference Boise Water Corp. v. Idaho Public Utilities Commission, 578 P.2d 1089, 99 Idaho 158 (Idaho 1978).

Recognizing the value of dialogue with customers, 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 the efficient use of water resource, the Company will provide and offer in the South County area to said customers its (1) residential water audit program, (2) water efficient landscaping classes, (3) school programs, and (4) other related customer information.  Tr. pp. 21-28.

Regarding water quality in the present South County system, South County notes that it is 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 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 expresses concern over problems encountered with water quality in several of its wells, the ever increasing burden of regulation, and the Safe Drinking Water Act requirements (customer confidence reports, additional water testing, capacity development requirements).  It knows there are solutions but states it lacks the experience and money to bring them about.  Tr. p. 96.

Despite the increase in rates 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 in the sale to United Water is approved.  Tr. p. 106.

Commission Decision:

●Should the sale be approved as proposed? With modification?

●How does the Commission wish to treat the purchase price elements:

Book Value ($1,488,122)

Plant Held for Future Use ($312,867)

Acquisition Premium ($1,009,011)

●Re:  Proposed phase-in of rates (structure; length)

●Re:  Proposed rate base treatment of purchase price

●Re:  Benefits accruing to South County customers (price versus intangible)

● Re:  Benefits accruing to United Water customers (revenue exceeding cost of service)

●Re:  Idaho Code § 61-328, Sale of electric utility property

“if the commission shall find that the public interest will not be adversely affected, that the cost and rates for supplying service will not be increased by reason of such transaction. . .”

applicability of standard to water

Scott Woodbury

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