

## HOUSE OF REPRESENTATIVES STAFF ANALYSIS

**BILL #:** HB 207 Acquisition of Water and Wastewater Systems

**SPONSOR(S):** McClain

**TIED BILLS:** **IDEN./SIM. BILLS:** SB 658

REFERENCE	ACTION	ANALYST	STAFF DIRECTOR or BUDGET/POLICY CHIEF
1) Energy & Utilities Subcommittee	15 Y, 0 N	Keating	Keating
2) Government Operations & Technology Appropriations Subcommittee			
3) Commerce Committee			

### SUMMARY ANALYSIS

When the Public Service Commission approves a sale, assignment, or transfer of an existing water or wastewater utility system to a PSC-regulated utility, it establishes a rate base value for the acquired utility system. The value of the acquired utility's rate base is determined using the utility's net book value, i.e., the original cost of the utility's assets when first dedicated to public service, less depreciation. This rate base is the amount upon which the acquiring utility may earn a fair rate of return established by the PSC.

If the purchase price of a utility system is greater than its net book value, no part of the difference is included in rate base absent a showing of extraordinary circumstances. This showing may be made through evidence that the transaction is anticipated to yield cost efficiencies and improvements in service quality and regulatory compliance, among other things. If the PSC determines that extraordinary circumstances exist, it will allow the acquiring utility to include all or part of the difference in its rate base as a "positive acquisition adjustment." This adjustment will be reflected in the utility's rates that are set during the utility's next general rate case.

The bill allows certain PSC-regulated water and wastewater utilities (those with over 10,000 customers) who acquire an existing water or wastewater utility system to establish rate base for the acquired utility system based on the lesser of: (1) the purchase price negotiated by the two utilities; or (2) the "fair market value" of the acquired utility, as determined by the average of appraisals conducted by two licensed appraisers chosen from a list established by the PSC. Appraisal fees and transaction costs may also be included. The bill provides that one appraiser will represent and be paid by the acquiring utility, and that a second appraiser will represent and be paid by the utility to be acquired. The bill provides some guidelines for the appraisals, including the use of a required engineering assessment. To use this fair market value approach, the utility must provide the PSC certain information specified in the bill. If the required information is provided, the PSC must approve within 6 months.

The bill is not expected to have a fiscal impact on state or local governments. The bill may encourage transactions involving the purchase of smaller utility systems by eligible utility systems. In some cases, these transactions may yield needed infrastructure improvements, cost efficiencies, and improvements in service quality and regulatory compliance. Where such benefits are achieved, the combined rate impact of these benefits may or may not outweigh the rate impact of valuing the acquired utility system's rate base above the system's net book value. Thus, in some cases, the bill could result in customer rates being higher than they otherwise would be solely due to valuation of the acquired utility system.

The bill provides an effective date of July 1, 2020.

# FULL ANALYSIS

## I. SUBSTANTIVE ANALYSIS

### A. EFFECT OF PROPOSED CHANGES:

#### Present Situation

##### *Regulated Water and Wastewater Utilities*

In various areas throughout Florida, water and wastewater services are provided through privately-owned and operated utilities. These privately-owned utilities, sometimes referred to as investor-owned utilities, range in size from very small systems, owned by individuals as sole proprietorships and serving only a few dozen customers in a small neighborhood, to systems owned by large interstate corporations which serve tens of thousands of customers in multiple Florida counties.

For privately-owned utilities operating within a single Florida county, the county has the option to regulate rates and service or allow the Public Service Commission (PSC) to regulate those utilities.<sup>1</sup> Regardless of whether the county has opted to regulate those utilities, the PSC has jurisdiction over all water or wastewater utility systems whose service transverses county boundaries, except for systems owned and regulated by intergovernmental authorities.<sup>2</sup> As of December 2018, the PSC had jurisdiction over 150 utilities in 38 counties.<sup>3</sup> Still, the vast majority of water and wastewater customers in the state are served by water and wastewater utilities not regulated by the PSC, primarily by systems owned, operated, managed, or controlled by governmental authorities.

For each utility within its jurisdiction, the PSC has exclusive authority to regulate the utility's rates and service.<sup>4</sup> The PSC must establish rates that are just, reasonable, compensatory, and not unfairly discriminatory.<sup>5</sup> In doing so, the PSC must consider the value and quality of the service and the cost of providing the service, which includes, but is not limited to: debt interest; the requirements of the utility for working capital; maintenance, depreciation, tax, and operating expenses incurred in the operation of all property used and useful in the public service; and a fair return on the investment of the utility in property used and useful in the public service.<sup>6</sup> The PSC has consistently interpreted the "investment of the utility" to be the original cost of the property when first dedicated to public service.<sup>7</sup>

##### *Acquisition of Utility Systems*

Each utility subject to the PSC's jurisdiction must obtain a certificate of authorization to provide water or wastewater service.<sup>8</sup> A PSC-regulated utility may not sell, assign, or transfer its certificate of authorization, facilities, or majority organizational control without approval by the PSC. Likewise, PSC approval is required for the transfer of a utility system exempt from PSC jurisdiction, such as a system owned or operated by a governmental authority, to a PSC-regulated utility. To grant approval, the PSC must determine that the sale, assignment, or transfer is in the public interest and that the acquiring utility will fulfill the commitments, obligations, and representations of the utility to be acquired.<sup>9</sup> The PSC considers, among other things, the financial ability of the buyer to maintain and operate the acquired utility and the technical ability of the buyer to provide service.<sup>10</sup>

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<sup>1</sup> S. 367.171, F.S. If a county chooses to allow regulation by the PSC, it may rescind this election only after 10 continuous years of PSC regulation.

<sup>2</sup> *Id.*

<sup>3</sup> Florida Public Service Commission, *Facts and Figures of the Florida Utility Industry*, p. 31 (Jun. 2019).

<sup>4</sup> S. 367.011, F.S.

<sup>5</sup> S. 367.081, F.S.

<sup>6</sup> *Id.*

<sup>7</sup> Florida Public Service Commission (FPSC), *Agency Analysis of 2020 House Bill 207*, p. 1 (Jan, 6, 2020).

<sup>8</sup> S. 367.031, F.S.

<sup>9</sup> S. 367.071(1), F.S.

<sup>10</sup> Rule 25-30.037 (2), F.A.C.

When the PSC approves a sale, assignment, or transfer of an existing utility system to a PSC-regulated utility, the PSC may establish the rate base for the utility being transferred.<sup>11</sup> The PSC establishes the value of an existing utility's rate base using "original cost." Using original cost, the value of a utility's rate base is determined using the depreciated original cost, or net book value, of the property devoted to the public service. This rate base is the amount upon which the utility may earn a fair return, as established by the PSC.<sup>12</sup>

A utility system may be acquired at a price higher or lower than the net book value of its assets. If the purchase price is greater than net book value, no part of the difference is included in a utility's rate base absent a showing by the utility of extraordinary circumstances.<sup>13</sup> In determining whether a utility has demonstrated extraordinary circumstances, the PSC will consider evidence including:

- Anticipated improvements in quality of service;
- Anticipated improvements in compliance with regulatory mandates;
- Anticipated rate reductions or rate stability over a long-term period;
- Anticipated cost efficiencies; and
- Whether the purchase was made as part of an arms-length transaction.<sup>14</sup>

If the PSC determines that extraordinary circumstances exist, it will allow the acquiring utility to include all or part of the difference in its rate base as a "positive acquisition adjustment." This adjustment will be reflected in the utility's rates that are set during the utility's next general rate case.

A review of 78 water and wastewater utility transfers addressed by the PSC between August 15, 2002,<sup>15</sup> and September 14, 2018, shows that the purchase price of a utility system exceeded its net book value in 39 cases. A positive acquisition adjustment was requested in two of those cases, but the requests were withdrawn prior to the PSC's decision in each case.

### Effect of Proposed Changes

The bill allows certain PSC-regulated water and wastewater utilities who acquire an existing water or wastewater utility system to choose to establish rate base for the acquired utility system without regard to the system's original cost. Instead, such utilities may elect to establish rate base for the acquired system based on the lesser of: (1) the purchase price negotiated by the two utilities; or (2) the "fair market value" of the acquired utility, as determined by the average of appraisals conducted by two licensed appraisers chosen from a list established by the PSC. The acquired system's rate base may also include reasonable fees paid to appraisers, if approved by the PSC, and reasonable transaction and closing costs incurred by the acquiring utility. If the rate base established through this mechanism exceeds the acquired utility system's net book value, the effect is the same as if the acquiring utility had received a positive acquisition adjustment that increases the value of the acquired system's rate base. No consideration of anticipated benefits is required.

The bill provides that one appraiser will represent and be paid by the acquiring utility, and that a second appraiser will represent and be paid by the utility to be acquired. The bill does not specify who may choose the two appraisers. The bill requires each appraiser to determine the fair market value of the utility to be acquired by using the Uniform Standards of Professional Appraisal Practice<sup>16</sup> and

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<sup>11</sup> S. 367.071(5), F.S.

<sup>12</sup> FPSC, *supra* note 7, at 1.

<sup>13</sup> Rule 25-30.0371(2), F.A.C.

<sup>14</sup> *Id.*

<sup>15</sup> The PSC's rule on positive acquisition adjustments was adopted August 4, 2002.

<sup>16</sup> The Uniform Standards of Professional Appraisal Practice (USPAP) is the generally recognized ethical and performance standards for the appraisal profession in the United States. USPAP was adopted by Congress in 1989, and contains standards for all types of appraisal services, including real estate, personal property, business, and mass appraisal. See The Appraisal Foundation, *What is USPAP?*,

[https://www.appraisalfoundation.org/imis/TAF/Standards/Appraisal\\_Standards/Uniform\\_Standards\\_of\\_Professional\\_Appraisal\\_Practice/TAF/USPAP.aspx?hkey=a6420a67-dbfa-41b3-9878-fac35923d2af](https://www.appraisalfoundation.org/imis/TAF/Standards/Appraisal_Standards/Uniform_Standards_of_Professional_Appraisal_Practice/TAF/USPAP.aspx?hkey=a6420a67-dbfa-41b3-9878-fac35923d2af) (last visited Jan. 11, 2020).

employing cost, market, and income approaches.<sup>17</sup> The bill provides that the original source of funding for the utility being acquired is not relevant for purposes of each appraiser's evaluation of fair market value.

Under the bill, the acquiring utility and the utility system being acquired must jointly retain a licensed engineer to assess the tangible assets of the system being acquired. The bill specifies that this assessment must be used by the two appraisers chosen to determine the fair market value of the system being acquired.

A utility that chooses to use this mechanism to establish rate base for an acquired utility system must submit an application to the PSC that includes the following:

- Copies of the two required appraisals performed by the chosen appraisers, including the average of the appraisals;
- The required engineering assessment, including each deficiency identified in the engineering assessment and a 3-year plan for prudent and necessary infrastructure improvements;
- The projected rate impact for the selling utility's customers for the next 5 years;
- The contract of sale;
- The estimated appraisal fees, and the estimated transaction and closing costs to be incurred by the acquiring utility; and
- A tariff, including rates equal to the rates of the utility to be acquired.

If the utility's application includes all of these required elements, the bill provides that the PSC must issue a final order approving or denying the application within 6 months of filing, though the bill does not specify any grounds for denial. The order must indicate the rate base value established through this mechanism for the acquired utility system.

The bill specifies that it applies only to acquiring utilities that provide water and wastewater services to more than 10,000 customers and are engaged in a "voluntary and mutually agreeable" acquisition of a water and wastewater system. Currently, it appears that there are three PSC-regulated utilities to which the bill may apply.<sup>18</sup> All other PSC-regulated utilities that acquire a water or wastewater system would continue to operate under the PSC's current rules that use the original cost approach to establish rate base and that allow a positive acquisition adjustment only upon a demonstration of extraordinary circumstances.

If the mechanism created by the bill is used to establish rate base for an acquired utility system, that rate base value must be used by the PSC to establish rates for the acquiring utility during the utility's next general rate case. The bill specifies that the PSC, in setting future rates for customers of the acquired system, may classify the system as a separate entity, consistent with the public interest.

## B. SECTION DIRECTORY:

**Section 1.** Creates s. 367.0712, F.S., related to the determination of rate base value for an acquired water or wastewater utility system.

**Section 2.** Provides an effective date of July 1, 2020.

## II. FISCAL ANALYSIS & ECONOMIC IMPACT STATEMENT

### A. FISCAL IMPACT ON STATE GOVERNMENT:

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<sup>17</sup> The cost approach considers the current cost of reproducing or replacing a building, minus an estimate for depreciation, plus the value of the land (and entrepreneurial incentive, if applicable). The market (sales comparison) approach considers the value indicated by recent sales of comparable properties on the market. The income approach considers the value that the property's net earning power will support. See The Appraisal Foundation, *Understanding the Appraisal*, [https://www.appraisalinstitute.org/assets/1/7/understand\\_appraisal\\_1109\\_\(1\).pdf](https://www.appraisalinstitute.org/assets/1/7/understand_appraisal_1109_(1).pdf) (last visited Jan. 11, 2020).

<sup>18</sup> FPSC, *supra* note 7, at 4. As noted in the *Drafting Issues or Other Comments* section of this analysis, this provision of the bill could be clarified as to its specific application.

1. Revenues:

None.

2. Expenditures:

None.

B. FISCAL IMPACT ON LOCAL GOVERNMENTS:

1. Revenues:

None.

2. Expenditures:

None.

C. DIRECT ECONOMIC IMPACT ON PRIVATE SECTOR:

The bill may encourage the three eligible utilities to acquire smaller utility systems, potentially resulting in better access to low cost capital for infrastructure improvements<sup>19</sup> that may be needed for the acquired systems. Further, the acquisition of a smaller utility system by an eligible utility may result in other cost efficiencies and improvements to quality of service and regulatory compliance.

While these results are desirable, there is no guarantee that they will occur,<sup>20</sup> as they are not required and will depend on the specific circumstances surrounding each individual acquisition. If economic efficiencies and lower capital costs are achieved, the combined rate impact of these benefits may or may not outweigh the rate impact of valuing the acquired utility system's rate base above the system's net book value. Thus, the bill could result in customer rates being higher than they otherwise would be solely due to valuation of the acquired utility system.<sup>21</sup>

The owners of acquired utility systems may benefit more often from purchase prices above their net book value and, therefore, may be more willing to sell to a larger utility that may provide cost efficiencies, better management, and infrastructure improvements.

D. FISCAL COMMENTS:

The bill provides that the PSC must issue a final order approving or denying an application within six months of filing. The PSC asserts that compliance with this time limit will require all utility transfers of this type to be set directly for a formal administrative hearing, which may impose additional resource costs on the utilities and customer representatives, including the Office of Public Counsel.<sup>22</sup> However, because the bill does not establish grounds for denial of a complete application, the approval process may not involve significant hearing resources.

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<sup>19</sup> *Id.* at 2. If any such improvements are made, the impact of those improvements on rate base (and, in turn, customer rates) would be in addition to the impact of the acquisition itself on rate base.

<sup>20</sup> *Id.*

<sup>21</sup> *Id.*

<sup>22</sup> *Id.* at 3.

### III. COMMENTS

#### A. CONSTITUTIONAL ISSUES:

##### 1. Applicability of Municipality/County Mandates Provision:

Not applicable. This bill does not appear to affect county or municipal governments.

##### 2. Other:

None.

#### B. RULE-MAKING AUTHORITY:

The bill requires the PSC to adopt implementing rules.

#### C. DRAFTING ISSUES OR OTHER COMMENTS:

##### *Appraisals*

The bill does not specify who may choose the two appraisers used to determine a utility system's fair market value. The bill could be clarified on this point.

The PSC notes that it has no expertise in property appraisal and suggests that an agency with such expertise may be a more appropriate choice to establish the list of approved appraisers required by the bill.<sup>23</sup>

While the bill does not specify who may choose the two appraisers, the bill provides that one appraiser will represent and be paid by the acquiring utility and the other appraiser will represent and be paid by the utility system being acquired. Thus, it appears that one appraiser effectively works for the buyer and the other effectively works for the seller. Under the bill, both parties stand to benefit from a higher valuation of the utility system to be acquired: the seller's proceeds would be higher, and the buyer would ultimately be authorized to earn a return on a higher rate base. This may create a perverse incentive for the appraisals to come in higher than they might otherwise.

##### *Other Drafting Issues*

Under the bill, the acquiring utility and the utility system being acquired must jointly retain a licensed engineer to assess the tangible assets of the system being acquired. The bill does not specify what type of information this assessment should include. This may be clarified through implementing rules.

The bill specifies that it applies only to "acquiring utilities that provide water and wastewater services to more than 10,000 customers and are engaged in a voluntary and mutually agreeable acquisition of a water and wastewater system." A strict reading of this provision makes the bill applicable only to utilities that offer *both* water and wastewater services to more than 10,000 customers. If the intent is to make the bill applicable to utilities that offer *either* water *or* wastewater services to more than 10,000 customers, this provision could be clarified. Further, a strict reading of this provision makes the bill apply only to the acquisition of a water *and* wastewater system. Because water and wastewater systems are usually separate systems, this provision could be clarified to specify that it applies to acquisition of a water system and to acquisition of a wastewater system.

### IV. AMENDMENTS/ COMMITTEE SUBSTITUTE CHANGES

None.

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<sup>23</sup> *Id.* at 4.