STATE OF NORTH CAROLINA
UTILITIES COMMISSION
RALEIGH

DOCKET NO. W-1000, SUB 5

BEFORE THE NORTH CAROLINA UTILITIES COMMISSION

In the Matter of		
Petition of Utilities, Inc., for Transfer of	)	
the Certificate of Public Convenience and	)	
Necessity for Providing Sewer Utility	)	ORDER APPROVING
Service on North Topsail Island and	)	TRANSFER AND
Adjacent Mainland Areas in Onslow	)	DENYING ACQUISITION
County from North Topsail Water and	)	ADJUSTMENT
Sewer, Inc., and for Temporary Operating	)	
Authority	)	

HEARD IN: Commission Hearing Room 2115, Dobbs Building, 430 North Salisbury Street, Raleigh, North Carolina, on September 30, 1999, at 9:30 a.m.; and North Topsail Beach Town Hall, North Topsail Beach, North Carolina, on October 12, 1999, at 7:00 p.m.

BEFORE: Commissioner Sam J. Ervin, IV, Presiding; and Commissioners Ralph A. Hunt, Judy Hunt, William R. Pittman, and J. Richard Conder

APPEARANCES:

For Utilities, Inc.:

Edward S. Finley, Jr., Hunton & Williams, Attorneys at Law, Post Office Box 109, Raleigh, North Carolina 27602

For Onslow County:

M. Gray Styers, Jr., and Benjamin R. Kuhn, Kilpatrick Stockton LLP, Attorneys at Law, 3737 Glenwood Avenue, Suite 400, Raleigh, North Carolina 27612

For the Using and Consuming Public:

James D. Little, Staff Attorney, Public Staff - North Carolina Utilities Commission, Post Office Box 29520, Raleigh, North Carolina 27626-0520

BY THE COMMISSION: On June 23, 1999, Utilities, Inc. (UI), filed a Petition pursuant to G.S. 62-111(a) and 62-116 to acquire the certificate of public convenience and necessity to operate the sewage treatment facilities of North Topsail Water and Sewer, Inc. (North Topsail or NTWS), in the North Topsail Beach and Sneads Ferry area in Onslow County, North Carolina. UI stated that it had entered into an asset purchase agreement with Joseph N. Callaway, Trustee in Bankruptcy for Marlow Bostic, owner of one-half of the outstanding corporate stock of NTWS, to transfer the utility franchise and assets subject to Commission approval. UI further stated that the purchase price under the agreement is $2,700,000 and UI requested rate base treatment of the purchase price. UI also requested temporary operating authority pending issuance of a final order on the Petition. On July 2, 1999, UI filed a motion requesting the Commission to establish a hearing at the earliest possible date and require customer notice. On July 8, 1999, UI filed an addendum to its application containing five-year pro forma projections of revenues and expenses.

The matter was brought before the Commission at its Regular Staff Conference on July 26, 1999. The Public Staff stated that it opposed the inclusion of the $2.7 million purchase price in rate base and would oppose the deferral of the acquisition adjustment issue because the Public Staff would oppose the transfer to UI if a purchase acquisition adjustment were allowed. The Public Staff also opposed the granting of temporary operating authority, and UI withdrew that request. The Public Staff requested that the Commission address several issues in this proceeding: a management plan, current employees, a refund plan for overcollection of gross-up on contributions-in-aid-of-construction (CIAC), appropriate tap fees, and system-specific rates.

By Order issued August 3, 1999, the Commission concluded that a hearing should be scheduled as soon as possible to decide the transfer, the purchase acquisition adjustment issue, and the other issues raised by the Public Staff. The matter was scheduled for public hearing on September 23, 1999, in the Town of North Topsail Beach for the sole purpose of receiving customer testimony and for September 30, 1999, in Raleigh for the purpose of taking testimony of UI, the Public Staff, and other parties of record.

The Public Staff also requested the Commission to issue a protective order with respect to unclaimed refunds held by NTWS. By Order issued August 3, 1999, the Commission denied the request for a protective order and stated that it would address the unclaimed refund issue at the same time the transfer petition was heard.

On September 13, 1999, Onslow County filed a Petition to Intervene. This Petition was allowed by Order issued September 17, 1999. The intervention and participation of the Public Staff is recognized pursuant to Commission Rule R1-19(e).

By Order issued September 23, 1999, the hearing in North Topsail Beach was continued until October 12, 1999, because of a recent hurricane.

The matter came on for hearing before the Full Commission in Raleigh as scheduled. UI presented the prefiled direct and rebuttal testimony of Carl J. Wenz, Vice President, Regulatory Affairs; and the rebuttal testimony of Carl Daniel, Vice President of Carolina Water Service, Inc. of North Carolina, a UI subsidiary. The Public Staff presented the prefiled joint testimony of Windley Henry, Staff Accountant; John Robert Hinton, Financial Analyst; Jack Floyd, Utilities Engineer; and Andy Lee, Director, Water Division.

On October 5, 1999, UI filed a Motion requesting the Commission to bifurcate its decision on whether to approve the transfer from other decisions, such as whether the purchase price should be included in rate base. Alternatively, UI requested the Commission to expedite the remaining procedural steps necessary to obtain an order. By Order issued October 12, 1999, the Commission denied the Motion.

The matter came on for hearing in North Topsail Beach on October 12, 1999, before Commissioners Ralph A. Hunt and Sam J. Ervin, IV. The following members of the public testified: Ed Miller, Richard J. Wenzel, Glen Adams, Bob Tate, Ron Lewis, David Clark, Charles Koenig, Richard Twiford, Ginny Hillyer, John B. Henderson, III, and Otis Sizemore. Onslow County attempted to introduce certain testimony from Ronald Lewis, County Manager, and David Clark, Public Works Director. The Hearing Commissioners sustained UI's objections to that testimony; however, Mr. Lewis was allowed to testify as a public witness. On October 15, 1999, Onslow County filed exceptions, a proffer of evidence, and a request for leave to file testimony. By Order issued October 21, 1999, the Commission affirmed its ruling at the October 12, 1999, hearing but allowed Onslow County to proffer the evidence filed with its motion.

On November 10, 1999, the Attorney General filed a Notice of Intervention and Comments in this docket in opposition to the request of UI for a broad policy favoring acquisition adjustments to encourage transfers.

On November 12, 1999, UI filed a Motion to Strike and/or Reject the Notice of Intervention and the Comments of the Attorney General, citing the Attorney General's failure to intervene in a timely fashion or otherwise seek to participate in the evidentiary hearings. UI argued that G.S. 62-20, which authorizes the Attorney General to intervene in Commission proceedings on behalf of the using and consuming public, "does not permit untimely, prejudicial interventions in contravention of the Commission's rules without even so much as a request for leave to intervene."

On November 18, 1999, the Attorney General filed a response to UI's Motion. In his response, the Attorney General acknowledged his late intervention and stated that he

did not seek to introduce new evidence, but that he wanted to address one important issue which is central to this case--the acquisition premium sought by UI. The Attorney General also acknowledged that "While there may be circumstances in which the right of intervention could be abused and other parties prejudiced, that case has not presented itself here."

By Order dated November 23, 1999, the Commission denied UI's Motion to Strike and/or Reject the Notice of Intervention and Comments of the Attorney General.

Based on the foregoing, the evidence adduced at the hearing, and the entire record in this matter, the Commission now makes the following

FINDINGS OF FACT

Jurisdictional

1. NTWS is a duly franchised public utility as defined by G.S. 62-3(23). NTWS provides sewer utility service on North Topsail Beach and certain other areas on the mainland of Onslow County pursuant to a certificate of public convenience and necessity granted by the Commission in 1982.

2. UI is a corporation duly organized under the laws of the State of Illinois and is authorized to do business in the State of North Carolina. Through affiliated companies, UI owns and operates water and sewer utility companies in Pender, Craven, and Carteret Counties.

3. NTWS provided sewer utility service to 1,943 residential and commercial customers as of June 30, 1999.

4. The assets of NTWS presently are held in trust by Joseph N. Callaway, Bankruptcy Trustee, under the control of the United States Bankruptcy Court for the Eastern District of North Carolina in the Marlow Bostic bankruptcy proceeding.

5. UI and Mr. Callaway have entered into an Asset Purchase Agreement, dated May 7, 1999, under which UI will purchase the NTWS assets for $2.7 million.

6. The reasonable original cost net investment of NTWS at June 30, 1999, was $976,907, consisting of the following components:

Plant in service	$ 7,452,235
Accumulated tap on fees	(3,308,613)
Contributions in aid of construction	(2,368,689)
Accumulated depreciation	(798,026)
Original cost net investment	$ 976,907

7. UI has requested that the $1,723,093 it is paying in excess of the $976,907 NTWS original cost net investment be placed in UI's rate base as a debit plant acquisition adjustment to be amortized over a 50-year period.

8. UI has requested no increase in NTWS rates, and UI has agreed that it will not seek an adjustment in NTWS rates for three years and has agreed to the withdrawal of NTWS's pending request for a 22% rate increase in Docket No. W-754, Sub 26 if UI's purchase price is included in rate base.

9. UI has expressed its willingness to make NTWS a part of Carolina Water Service, Inc. of North Carolina (CWS) and reduce the rates in NTWS to those currently charged by CWS if the purchase price for NTWS is included in rate base.

Background on Marlow Bostic's Operation of NTWS[1]

10. In 1981, the Commission received information that Marlow Bostic was operating a sewer facility on North Topsail Island without a franchise from the State.

11. In 1982, NTWS applied for and received a franchise to operate the sewer facility for an area being developed on the north end of Topsail Island by North Topsail Shores, a partnership between Marlow Bostic and Roger Page.

12. A deed in the public records shows an initial conveyance of Tracts 1-6 of NTWS from Mr. Bostic and his wife and from Roger Page and his wife to North Topsail Water and Sewer, Inc., on December 30, 1983. At the same time, two deeds of trust were executed, naming Mr. Bostic and Mr. Page as beneficiaries.

13. On May 11, 1993, NTWS moved for a rate increase in Docket No. W-754, Sub 17. On July 13, 1993, the Commission entered an interim order granting a rate increase in that docket. The Commission allowed the interim rate increase based on its finding that NTWS was unable to pay its current operating expenses and that emergency interim rate relief was warranted.

14. The North Carolina Attorney General moved on July 28, 1993, in Docket No. W-754, Sub 17, for reconsideration of the interim rate order and to expand the scope of the pending rate case. The Attorney General objected to the Commission's interim order on the grounds that the Commission allowed a 40% increase in the rate, that the Commission did not require NTWS to post a bond in the event that refunds would be required if the final rate increase was less than 40%, and that only 18 months had passed since NTWS' prior rate increase. The Attorney General supplemented its objection on

[1]Evidence supporting findings of fact 10 through 51 is found in UI Wenz Exhibit I, submitted with Mr. Wenz' direct testimony.

August 16, 1993, with a copy of a federal court order in which the court found that Mr. Bostic was responsible for fraudulent transfers of NTWS property, which highlighted, the Attorney General maintained, Mr. Bostic's inability to offer customers reliable service.

15. As a result of these objections, on September 2, 1993, the Commission issued an Order in Docket W-754, Sub 17, granting the Attorney General's motion to expand the rate case proceeding to include an investigation concerning financial solvency, inadequate management and the need to appoint an emergency operator.

16. In connection with a hearing in the docket, the Public Staff submitted the testimony of Gina Casselberry on September 27, 1993. According to Ms. Casselberry's testimony, she conducted a preliminary audit of NTWS, which included a field inspection, review of NTWS's records, review of customer complaints, review of DEM files and an analysis of existing revenues at existing and proposed rates. Among other things, Ms. Casselberry noted that NTWS had leased equipment from Atlantic Enterprises, a company affiliated with Mr. Bostic, but NTWS assumed the expense of repairing all of the leased equipment. Moreover, when she asked for information from NTWS regarding supporting documentation for its lease arrangements with Atlantic Enterprises, the company failed to respond, and its breakdown of cash disbursements to Atlantic Enterprises was incomplete.

17. Subsequent to the hearing, on October 8, 1993, the Commission issued an Order in Docket No. W-754, Sub 17, reducing interim rates effective November 1, 1993. In addition, on November 10, 1993, based on the Public Staff's recommendation, the Commission authorized Mr. Bostic to transfer his 50% interest in NTWS to Thomas Morgan as trustee/escrow agent until such time as NTWS was either sold or returned to Mr. Bostic. The Commission also ordered that Mr. Bostic was to cease having any part in the operation of NTWS, Bennie Tripp was named sole manager and operator of NTWS, Mr. Bostic was barred from interfering in any way with Mr. Tripp's management of NTWS and NTWS was ordered to continue depositing tap fees into escrow.

18. On January 27, 1994, the Commission issued its final Order in Docket No. W-754, Sub 17, finding that Mr. Bostic had agreed that he would not participate further in the operation of NTWS; that as a result of numerous judgments and debts, NTWS was at risk that the utility operations would be interrupted because of execution or other action taken to satisfy these debts and that the Commission needed to investigate the extent of NTWS's outstanding debts, judgments and liens; that NTWS's relationship with Atlantic Enterprises was less than arms' length and that prior approval was required for future transactions.

19. The Commission also stated that although in NTWS's prior rate case in Docket No. W-724, Sub 12, the Commission had ordered reconveyance of the NTWS property that had been transferred to Mr. Page and Mr. Bostic and then leased back to

NTWS in 1988, the federal court fraud action had resulted in a court order barring Mr. Bostic from any such conveyance. The title to that land, therefore, remained clouded. The Commission concluded that it was inappropriate at that time to order NTWS to take back the tracts from Mr. Bostic by eminent domain in light of the federal court's order holding that the land could not be transferred until the judgment in the federal case (over $12 million) was satisfied.

20. The Commission further noted that negotiations were ongoing to attract additional capital investors or for the sale of NTWS. With respect to the outstanding liens and judgments against NTWS, the Commission specifically found that the penalties assessed against the company could not be recovered from NTWS's customers through rates, assessments or tap fees and should be paid only from such funds that would prevent draining an adequate capital reserve needed for the operation of the utility.

21. Following the Commission's Order allowing a partial rate increase, the Public Staff also became aware that a federal tax lien had been filed against NTWS on October 1, 1993, and that the utility had been making payments to the IRS in the amount of $2,500/month. The Public Staff moved to require the company to stop making payments to the IRS on the grounds that the lien was appropriately only against Mr. Bostic and not against the utility. Apparently, Mr. Bostic had hired employees for his other real estate development projects, but claimed those people on NTWS' tax returns. The IRS then found that no withholding taxes had been paid and filed the lien against the company. On June 3, 1994, the Commission granted the Public Staff's motion.

22. In the ongoing proceedings, the Commission subsequently ruled on April 7, 1995, that only Bennie Tripp could file state and federal tax returns on behalf of NTWS, and that Mr. Tripp should open new bank accounts for NTWS, with only Mr. Tripp having the ability to write checks for NTWS.

The Refund Proceedings

23. In 1991, the Public Staff and NTWS entered into a stipulation that provided that NTWS would refund to its customers $241,150 it had overcollected related to federal income taxes on contributions-in-aid-of-construction. NTWS agreed to refund this money over a three year period, beginning July 1, 1992.

24. When NTWS failed to file its refund plan as required, the Public Staff moved for a show cause hearing allowing NTWS to show why it should not be held in contempt. Following the show cause hearing, on September 23, 1992, the Commission was told by NTWS that the system might be sold. The Public Staff indicated, however, that the bankruptcy proceedings of one of the partners would hold up any sale.

25. Without a ruling from the Commission, the Public Staff moved on April 7, 1993, for an immediate interim order based on the Public Staff's concern over the financial integrity of the NTWS and NTWS's intentions regarding the refunds due its customers. The Public Staff also became aware that NTWS was about to receive in excess of $100,000 in tap-on fees for a new subdivision. The Public Staff felt that "in order to preserve some degree of control over the finances of this utility, the Commission should immediately order the Company to place any tap-on fees into an escrow account that could only be used to make refunds required in the docket, unless the Company specifically applied to the Commission to use all or part of the funds, specifying how the funds would be used."

26. Following the Public Staff's motion to pay all tap-on fees into an escrow account, the North Carolina Division of Environmental Management (DEM) moved to require that those funds be expended to satisfy DEM's default judgments as a result of certain civil penalties for the violations arising in relation to other court actions.

27. The North Carolina Attorney General's office also filed a motion in support of the Public Staff's motion to deposit the tap-on fees into escrow. The Attorney General noted that the September 23, 1992 hearing had revealed that: (1) NTWS had not yet planned and carried out refunds because of a lack of financial resources; (2) NTWS had not yet planned and carried out the construction of a gravity sewer line in the Golden Acres subdivision because of a lack of financial resources; (3) NTWS had conveyed land used for spray fields to Mr. Page and Mr. Bostic, but that the shareholders, at the request of the Public Staff, reconveyed the land to NTWS, but a federal court set aside the reconveyance; (4) NTWS used its tap fees to meet operating expenses of the utility; (5) the General Manager of the NTWS was not aware that Mr. Page and Mr. Bostic were the owners; (6) NTWS was faced with numerous outstanding penalties or proceedings for environmental violations. In addition, the Attorney General noted that: (1) a number of complaint proceedings were pending concerning tap fee charges that North Topsail sought to impose; (2) a sale had not occurred of the utility despite NTWS's contentions at the show cause hearing that NTWS needed to garner more time to provide a refund plan; (3) there had been substantial storm damage to the sewer system.

28. NTWS did not file a response to the Attorney General's motion.

29. As a result of such motions, on April 23, 1993, the Commission ordered that NTWS immediately place into escrow all tap-on fees it received and that it could not expend those funds without permission pending a full hearing on May 11, 1993.

30. Following the hearing, the Coastal Resources Commission (CRC) filed a supplemental brief, asserting that the tap fees placed in escrow should be used first to pay for repairs needed to bring one of NTWS's sewer lines into compliance with DEM regulations; second, to pay the outstanding judgments for penalties assessed by CRC and,

last, to pay customer refunds. CRC's brief pointed out that "the evidence presented at the hearing reveals that the current management of North Topsail is irresponsible both fiscally and for purposes of compliance with the various environmental and health laws to which North Topsail is subject." CRC also noted that "It is clear from the evidence presented that the management of North Topsail, in particular officers Marlow Bostic and Roger Page, run the company primarily for the benefit of their own separate development interests."

31. The Attorney General also submitted a post-hearing list of recommendations for the use of the escrow funds for the benefit of the using and consuming public. The Attorney General noted that at the May 11, 1993 hearing, NTWS's manager, Bennie Tripp, admitted that the company was delinquent for more than $40,000 in its electric bills and that the company was not performing current maintenance at the sewer plant required under its environmental permit. Further evidence at the hearing established that NTWS, under Mr. Bostic's ownership, required close Commission supervision to ensure compliance with its orders and that penalties did little to force compliance. In addition, the Attorney General noted that "serious questions have been raised as to whether the current owners and operators of the Company (those in charge) would make a good faith effort to serve its customers." For example, the Attorney General pointed to the fact that NTWS had conveyed its land to Mr. Bostic and Mr. Page in June, 1988 without permission from the Commission and that such conveyance was not revealed until a September 23, 1992, hearing before the Commission. The Attorney General also pointed out that Mr. Page and Mr. Bostic had been involved in a number of improprieties and mismanagement with respect to the relocation of S.R. 1568, including using one of Mr. Page's business entities to serve as the project engineer and gaining ocean front property as part of the relocation deal. Because of these concerns, the Attorney General strongly urged "considerable Commission involvement in and supervision over the utility's operations."

32. NTWS's attorney responded to the need to disburse the escrow funds to pay NTWS's outstanding electric bill or face disconnection on June 7, 1993. NTWS also stated that if the CRC's request was followed to use the escrow funds to pay judgments from environmental penalties, the utility would not have the cash to pay for the repairs needed to bring the utility into compliance.

33. In the years since the escrow account was established, the Commission has issued numerous orders allowing NTWS to borrow or expend money from the escrow account to pay for improvements or for operations:

- On June 2, 1994, the Commission ordered that NTWS could borrow $45,000 from the tap-on fee escrow account to make repairs to its spray irrigation fields and that NTWS would not be required to pay back into the escrow account the $25,000 engineering accounts.

- On October 18, 1994, the Commission authorized NTWS to use up to $188,665 from the escrow account for certain equipment and office building needs, to be paid back at $600/month. The same order also allowed NTWS to borrow $37,300 to pay its past due electric bill, the loan to be paid back at $1000/month.

- On April 23, 1996, the Commission authorized NTWS to use up to $120,000 from the escrow account for additional equipment and office building needs, as long as the escrow funds were not used for a $90,000 request for construction of a pump station. The Commission also authorized NTWS to borrow up to $55,000 from the escrow account to pay for the replacement of the PVC spray field sprinkler head risers.

- On June 21, 1996, the Commission allowed NTWS to use up to $25,200 from escrow to improve and replace a pipe leading from the third lagoon.

- On October 8, 1996, the Commission allowed NTWS to use up to $148,850 from the escrow account to pay for Hurricane Fran repair and to borrow up to $60,000 to cover revenue shortfalls to be paid back when the revenues were eventually collected.

- On May 27, 1997, NTWS was authorized to use up to $368,697 from the escrow account to purchase new property and the construction of a new flow meter.

- On December 17, 1997, NTWS was authorized to use up to $51,250 from the escrow account to cover costs associated with the purchase of a truck and computers, landscaping for the new office and the construction of a driveway, a security gate and a parking lot at the new business office.

- On June 9, 1998, NTWS was ordered to establish a new interest bearing capital account with respect to the existing connection fee escrow account, in which $545,000 would be deposited, to cover the costs associated with the purchase of a service truck, a tractor, a back hoe and a track hoe, the costs of mapping the sewer system, the telemetry for the pump stations, soil testing of new property and a building addition. In addition, NTWS was authorized to borrow up to $36,000 from the escrow account to pay off certain accounts payable, to be paid back at $2000/month.

- On January 13, 1999, NTWS was authorized to use up to $100,000 from the escrow account to cover the costs associated with the purchase of three spray field irrigation pumps and other necessary modifications to the existing facilities.

- On February 9, 1999, NTWS was authorized to use up to $33,000 from the escrow account to cover the costs associated with conducting advanced soil testing of the existing spray irrigation fields under DWQ permit requirements.

- On April 27, 1999, NTWS was authorized to use up to $25,300 from the escrow account to cover costs associated with purchase of fertilizer, lime and gypsum for the irrigation fields, to be reimbursed to the account beginning in June 1999 at $4,216/month.

- On June 18, 1999, NTWS was authorized to use up to $35,700 from the escrow account to cover the costs associated with the purchase of lagoon valves.

Operational Violations

34. In April 1989, DEM issued a notice of violation concerning NTWS's spray field. On September 21, 1990, DEM restricted any additional connections until the problems were solved. In addition, Mr. Bostic entered into a land asset transfer and land lease agreement for the spray fields in 1988 without securing an easement for use as a spray field. Mr. Bostic conveyed the land for the spray fields to himself and Mr. Page, and then Mr. Bostic and Mr. Page entered into a lease agreement with NTWS to use the land in exchange for certain specified rent.

35. In addition, DEM issued a notice of violation in August, 1991, to NTWS after an inspection revealed that wastewater was flowing to an unfinished pump station in the Village of Stump Sound.

Federal Court and Bankruptcy Proceedings

36. Federal court proceedings grew out of Mr. Bostic's plan to develop a tract of land on North Topsail Island to build a residential/resort community with a marina, home sites, a sewer facility and other amenities. Pursuant to his plan, Mr. Bostic distributed promotional literature to homesite purchasers outlining his plan and making many misrepresentations about the development of the site. In fact, Mr. Bostic had not received the necessary permits to go forward with the development of the property.

37. In 1991, a number of Mr. Bostic's purchasers brought individual actions against Mr. Bostic and Mr. Page in federal district court in Wilmington on claims of fraud and unfair and deceptive trade practices. These cases were consolidated and tried before Magistrate Judge Alexander Denson. Mr. Bostic and Mr. Page were held jointly and severally liable for the sum total of $12,483,951.73 on these judgments, which included punitive damages.

38. On the same day that the first judgment was rendered on April 10, 1992, Mr. Bostic conveyed certain of his real property to NTWS. Three days later, on April 13, 1992, Mr. Bostic conveyed additional real property to his son. Soon thereafter, Magistrate Judge Denson conducted a hearing in which Mr. Bostic promised to reconvey the properties and further promised that he would not convey any other property without full consideration until the judgments in the case were satisfied. Plaintiffs then went forward with their post-judgment discovery and served Mr. Bostic with interrogatories and document requests on July 23, 1992. Mr. Bostic ignored the discovery requests.

39. Upon being ordered to file a response, Mr. Bostic served his answer on October 12, 1992. The answers, however, were deficient, and Mr. Bostic was again compelled to answer and was threatened with contempt. At a February, 1993 hearing, Magistrate Judge Denson ordered Mr. Bostic to provide truthful and complete answers to plaintiffs' discovery. More hearings ensued, and Mr. Bostic was given several more opportunities to provide answers and was given notice of plaintiffs' particular allegations on a claim of contempt. Finally, on May 27, 1993, Magistrate Judge Denson held a fact-finding hearing on the motion for contempt and certified the facts for review by the district court.

40. On August 6, 1993, Judge Fox held a show cause hearing for Mr. Bostic to show why he should not be held in contempt for failure to abide by the court's orders to respond fully and truthfully to the discovery requests. Following the hearing, Judge Fox made a number of findings of fact, including the following: Mr. Bostic misrepresented his ownership of Golden Acres, Inc. (the corporate entity selling real estate lots to the plaintiffs) and fraudulently transferred shares to his wife following the entry of the judgment; and Mr. Bostic willfully attempted to conceal ownership of a number of parcels of real property from the plaintiffs. The court then found Mr. Bostic in civil contempt and further found that confinement was necessary to achieve Mr. Bostic's compliance with the court's orders compelling complete and full disclosure to plaintiffs of his assets and further ordered Mr. Bostic to pay plaintiffs $30,000 in attorneys' fees. Finally, the court ordered that Mr. Bostic be tried for criminal contempt predicated on his misrepresentation of his ownership interest in Golden Acres, Inc., and his failure to make full disclosure of his real estate ownership. The trial was to be held in Wilmington during the court's October 12, 1993, session.

41. While serving his jail time for contempt, Mr. Bostic filed for voluntary bankruptcy under Chapter 11 (ostensibly to avoid the federal court judgment). He hired an attorney, Buzzy Stubbs, to represent him in the bankruptcy. Although in a Chapter 11 proceeding the debtor-in-possession is normally responsible for calling a creditors' meeting and filing the appropriate disclosure statement and plan for reorganization, the Bankruptcy Administrator petitioned the court to have a Trustee appointed to oversee the reorganization and to have the assets sold to satisfy Mr. Bostic's debts. The bankruptcy then proceeded under the Trustee (Joseph Callaway), who has sold off virtually all of

Mr. Bostic's real estate and has now focused on the remaining issue of selling the North Topsail sewer facility.

42. During the first creditors' meeting called by Mr. Bostic, he again took the stance that he did not own the assets held by his wife. The bankruptcy administrator then delivered a recording of the meeting to the U.S. Attorney's office for possible prosecution or investigation as a misrepresentation during the official bankruptcy proceedings, but the U.S. Attorney did not proceed with the matter.

43. As part of the bankruptcy proceedings, the court approved a Plan of Reorganization, which gave the court continuing jurisdiction to approve sales of Mr. Bostic's assets. Among Mr. Bostic's assets was a one half ownership interest in NTWS. Mr. Bostic's ownership interest in NTWS was transferred to the bankruptcy estate. The other half of the NTWS stock was owned by Roger Page, Mr. Bostic's former real estate development partner. Through an out-of-court agreement, and in lieu of filing for bankruptcy, Mr. Page surrendered control of his shares in NTWS to his two major creditors, Bank of America and Branch Bank and Trust Company (collectively, the Banks).

44. On April 20, 1999, Bankruptcy Trustee, Joseph Callaway, moved the Bankruptcy Court for an order allowing the sale of NTWS, free and clear of all liens and encumbrances. Pursuant to the proposed sale, all liens and claims against Mr. Bostic or NTWS would be satisfied out of the sale proceeds, and the purchaser would obtain NTWS unencumbered.

45. The initial sale agreement accompanying the motion was between NTWS and AquaSource, Inc., a Texas corporation. Under the first proposed sale agreement, AquaSource was to purchase NTWS for $2,250,000. The Banks, as beneficial owners of Mr. Page's stake in NTWS, agreed to reserve objection to the sale limited only to the grounds of the adequacy of the sale price and that any claims of the Banks or Mr. Page to NTWS would be satisfied and extinguished through the sale proceeds. In addition, Mr. Bostic's judgment creditors agreed that their claims would be satisfied out of the sale proceeds and that they too would surrender any rights or claims in NTWS upon its sale.

46. Under the proposed sale, any sale of NTWS requires and is subject to obtaining regulatory consent from the Commission. Any claim of the Commission to the NTWS assets, however, would be transferred to the sale proceeds. This includes claims in paragraph 13 of the Commission's Order of January 27, 1994, regarding gross-up for income taxes on CIAC.

47. The motion to sell NTWS was served on the Commission, giving it the opportunity to review the sale agreement and raise any objections. Under the terms of the sale agreement and order, regulatory pricing and terms remain the province and

jurisdiction of the Commission, and the purchaser will remain subject to the Commission's authority for future operation of NTWS assets.

48. UI's May 7, 1999 contract with the Bankruptcy Trustee arose from a subsequent UI upset bid and auction before the Bankruptcy Court in which UI's last bid of $2.7 million exceeded the last bid of AquaSource of $2.65 million.

Other Court Actions Against Mr. Bostic

49. In N.C. Dep't of Environmental Health v. Marlow Bostic, (Superior Court, Onslow County), a number of actions were brought against Mr. Bostic in Superior Court, Onslow County, to recover civil penalties for various environmental violations. The records show four such actions, all resulting in default judgments against Mr. Bostic. Three default judgments were entered prior to the Public Staff's efforts to have all tap-on fees deposited in escrow. Those defaults totaled $75,955.10. Subsequently, another default judgment was entered against Mr. Bostic in the sum of $16,520 on July 8, 1993. These judgments then created liens on NTWS's property.

50. In United States v. Mr. Bostic, Roger Page and North Topsail Water and Sewer, Inc., 92 CV 101 (U.S. Dist. Ct. E.D.N.C.), a Clean Water Act action for injunctive relief was brought to require defendants to restore environmental damage from discharge of pollutants onto wetlands. Defendants entered into a consent judgment on November 16, 1994, and clean up is complete.

51. In the Matter of Coastal Resources Commission Decision Against North Topsail Water and Sewer, Inc., 96 N.C. App. 468, 386 S.E.2d 92 (1989) in 1982, Mr. Bostic applied to the DEM for a permit to construct a spray irrigation wastewater treatment facility on "estuarine waters" in Onslow County. DEM issued the permit on May 11, 1982. After construction began, Mr. Bostic began excavations on the tract that were not depicted in the development plan submitted to the DEM. The Division of Coastal Management (DCM) then investigated and issued a notice of violation on February 24, 1984, directing Mr. Bostic to install an earthen dam in the tributary that the construction had disrupted. After Mr. Bostic initially ignored the order, he began piecemeal correction, and he did not fully comply until over a month later. As a result, DCM assessed three civil penalties against Mr. Bostic in the amount of $24,000 on a finding that Mr. Bostic had willfully violated the Coastal Area Management Act. On appeal, the Court of Appeals agreed with the DCM that Mr. Bostic had willfully refused to comply with the DCM's directive and had engaged in "a pattern of intentional resistance."

Transfer-Related Issues

52. UI has the technical, managerial, and financial capacity to own and operate the NTWS sewer system.

53. Although NTWS is a financially-troubled public utility, there are no serious operational problems currently affecting the system. The sewer system is currently being operated in a satisfactory manner.

54. All other things remaining equal, inclusion of the proposed acquisition adjustment in rate base would support a $12.00 per month or 38% increase in NTWS's residential rates.

55. The purchase price of $2.7 million that UI agreed to pay for the North Topsail system, which was established through an arms length bidding process, was prudent.

56. UI is obligated to purchase North Topsail whether the proposed acquisition adjustment is included in rate base or not.

57. Approval of the proposed acquisition adjustment is not in the public interest since the benefits to customers resulting from the allowance of rate base treatment of an acquisition adjustment in this case would not outweigh the resulting burden or harm to customers associated therewith.

58. The proper level of connection fees is $1,200 per residential equivalent unit.

59. The appropriate amount of bond to be required of UI is $200,000.

60. The overcollection of gross-up on CIAC should be refunded.

61. The balance in the escrow account should be maintained by UI for purposes of making capital improvements to the NTWS sewer system.

62. UI's management plan is acceptable.

63. The transfer of the franchise and assets of NTWS to UI is in the public interest and should be approved.

CONCLUSIONS

The Public Staff testified that it supports the proposed transfer provided that, among other things, an acquisition adjustment is not allowed. UI contends that there are two pivotal questions for the Commission to address. First, is NTWS a troubled system? Second, if NTWS is troubled, do the benefits of the proposed acquisition outweigh the costs to ratepayers?

In other words, it is UI's position that in order for an acquisition adjustment to be considered, the system must be troubled and the benefits to the customers must outweigh

the cost of including the acquisition adjustment in rate base. UI, through its testimony and cross-examination of the Public Staff, sought to demonstrate that NTWS is a troubled system and that there are benefits to the acquisition that would outweigh the costs to ratepayers. The Public Staff, however, takes the position that NTWS is not a troubled system and, therefore, the acquisition adjustment should not be allowed into rate base.

Onslow County, an intervenor in this proceeding, opposes the proposed transfer on the grounds that it is not consistent with the public convenience and necessity, especially considering the fact that UI is requesting to roll the acquisition adjustment into rate base. It is Onslow County's position that the public interest would be best served if the County acquires NTWS because Onslow County is in a better position to provide the best service at the lowest rates and to promote economic development throughout the County. However, no request for such an acquisition is before the Commission at this time.

The Attorney General takes the position that an acquisition premium is not appropriate in this case. According to the Attorney General, the broad policy advocated by UI favoring acquisition adjustments would, if adopted, harm consumers by increasing the transfer price paid for utility systems and would pose an unfair burden on consumers.

No testimony or evidence was presented in this docket calling into question the testimony of UI witness Wenz outlining UI's suitability as a purchaser of NTWS. Indeed, UI and its subsidiaries have long been considered to be professional, competently operated, well-capitalized water and sewer companies. The Commission has adopted policies encouraging the transfer of small, independently-operated, thinly-capitalized utilities to utilities like UI. UI has not conditioned its request to obtain the franchise for NTWS on Commission inclusion of the purchase price in rate base. The Commission concludes that UI possesses the financial and operational expertise and wherewithal to receive and operate the franchise and assets of the sewer facilities serving the North Topsail service area. Therefore, the Commission approves UI's request to obtain the franchise and assets of NTWS. The only substantive contested issue in this docket is whether UI should be permitted to include its $2.7 million purchase price in rate base. The Public Staff, the Attorney General, and Onslow County oppose this UI request. For reasons set forth below, the Commission determines that the transfer should be approved, but that UI may not include its proposed acquisition adjustment in rate base.

The Transfer is in the Public Interest and Should be Approved
NTWS is a Financially-Troubled, but not Operationally-Troubled, Public Utility

Today, NTWS continues to be a financially-troubled, although not an operationally-troubled, public utility. Since 1993, the owner of 50 percent of the NTWS stock, Marlow Bostic, has been in Chapter 11 bankruptcy. In order to liquidate the assets of Mr. Bostic, his 50-percent share of NTWS stock has been transferred to the bankruptcy trustee. Mr. Page owns the other 50 percent of the NTWS stock. Mr. Page's stock, held

by bank creditors, also has been transferred to the bankruptcy trustee so that the trustee can sell NTWS through the bankruptcy proceeding free of claims and so that the proceeds of the sale can be used to satisfy creditors' claims. Consequently, since 1993, NTWS has been tied up in the bankruptcy proceedings. NTWS's assets, stock, earnings and good will have been held by the bankruptcy trustee to be sold for the benefit of creditors. The owners have been unable to provide or attract equity capital. NTWS has been unable to attract long-term debt capital because NTWS has been inextricably tied up in the bankruptcy proceeding. NTWS has no sources of traditional capitalization. Since 1993, the bankruptcy trustee has had NTWS on the market for sale, and the Public Staff has discussed the sale with at least sixteen potential purchasers, but until 1999 no purchaser was willing to make an offer of purchase.

Prior to 1993, NTWS was owned and operated by those developing properties in the North Topsail area. The owners conducted their affairs in a fashion that placed the financial well being of NTWS at risk. NTWS refused or was unable to pay its bills, resulting in numerous outstanding claims and judgments. As of May 1993, NTWS had power bills in arrears from Jones-Onslow EMC of $40,000, state environmental penalties from DEM and CRC reduced to judgment of $75,000, bills from McKim and Creed Engineers of $20,000, an outstanding loan from Atlantic Enterprises of $19,848, a loan from Centura Bank of $23,000, a bill from New River Marina for diesel fuel of $8,389 and an unquantified debt to Onslow County. On January 27, 1994, the Commission determined that these outstanding financial obligations placed NTWS at risk that utility operations would be interrupted due to execution or other actions taken to satisfy the amounts owed. As of today, nearly six years later, a number of these obligations and judgments are still outstanding.

Subsequent to the institution of the Mr. Bostic bankruptcy proceeding in 1993 and the Commission's January 1994 Order removing Mr. Bostic from management of NTWS, NTWS has been forced to rely on existing or future customers for its capital needs. Residential connection fees are established at $2,000 per connection, except where a pump station must be installed in which case the connection fee is $3,000. According to the Public Staff, NTWS's actual average cost of making a connection and a pro rata cost of anticipated capital improvements is only $1,200. Because NTWS operates under a DWQ imposed moratorium limiting new connections, NTWS has required those seeking to connect to the system in the future to prepay the connection fee in order for them to reserve the capacity for when it will be needed. To date, 728 customers have prepaid the connection fees to reserve future capacity. NTWS has collected $1,491,000 in connection fees from these future customers. The estimated cost to connect these customers to the system is $398,132. Consequently, NTWS has collected $1,092,828 more from these future customers than NTWS will spend to connect them to the system. NTWS uses this source of customer-supplied capital to make improvements and repairs to the system and as a source of cash working capital.

As of June 30, 1999, NTWS had a balance of $806,000 in the connection fee escrow fund. However, $287,000 of that amount has been earmarked for projects the Commission already has authorized for funding from the escrow fund. Of the uncommitted balance of $519,563, $398,132 must be used to connect the future customers to the system. Thus, as of June 30, 1999, $121,431 is left in the escrow fund as the unencumbered balance free for NTWS to use as a source of capital to meet any outstanding or future needs.

NTWS's reliance on the connection fee escrow fund is no legitimate source of capital for a financially-viable utility that is not dependent upon the Commission for extraordinary ratemaking devices. In the first place, future North Topsail customers should not be required to supply capital to make existing repairs and improvements and provide a source of cash working capital to meet current day-to-day operations. Capital to meet these needs should come from the owner of the system who has the responsibility to meet the utility's capital needs. Even current ratepayers only should be responsible for paying rates that are set to allow pro rata recovery of the prudently employed capital invested to provide current service and a reasonable return on the unrecovered balance.

With respect to the situation at North Topsail, future customers, on the other hand, should not be responsible for supplying any capital. A non-troubled, viable utility should have sufficient capacity to meet reasonably expected growth in its service area without a requirement that future customers pay a connection fee in excess of the costs of connection to reserve a place when and if they need service. North Topsail customers should only be required to pay a connection fee at the time the utility is called upon to incur the cost to connect them to the system.

Under the scenario presently in place for NTWS, the inability to obtain outside capital has resulted in a situation where Peter is being robbed to pay Paul. Future customers are supplying capital to enable current service. When and if these future customers are ready to be connected and need to receive service from the sewer plant and facilities, the services which their capital has been used to finance will already have been used up by someone else. Secondly, the future 728 customers have been required to pay approximately twice as much as the cost to connect them and the cost of the future capital additions they may cause NTWS to incur. Public Staff witness Floyd testified that the $1,200 connection fee average cost is established to recover the labor and materials cost of connection, plus the cost of a fourth lagoon presently required under the DWQ environmental permit.

NTWS is financially-troubled because the connection fee escrow fund is an inadequate and inappropriate source of capital. Even where the connection fees have been established at the historical level well in excess of costs, the amount of capital in excess of costs of connection is too small to meet all of NTWS's capital needs. As of June 30, 1999, NTWS had $121,000 in uncommitted funds in the escrow fund.

Public Staff Exhibit No. 2 lists the expenditures from the escrow fund from July 1993 through June 1999. Six times NTWS spent escrow fees in excess of $121,000. In October 1996, NTWS spent $208,850 from the escrow fund for Hurricane Fran related expenses. Public Staff witness Floyd testified that this was an essential expenditure that could not have been deferred or postponed.

NTWS is located geographically where it is extremely vulnerable to hurricanes. In fact, North Topsail is one of the most vulnerable spots for hurricane damage on the East Coast. Hurricane damage has been experienced often and recently in the past. Hurricane damage could occur unexpectedly in the future. Were NTWS to experience $208,850 in hurricane damage today, NTWS would have insufficient capital to make the repairs and would have nowhere to look for outside capital to make up the shortfall. Despite Public Staff claims to the contrary, a VISA card and credit with a few vendors are not adequate sources of capital to meet these very real contingencies.

Additionally, the Public Staff recommends that the connection fees be reduced to $1,200 on average. The $1,200 is established to recover only the costs of connection and the cost of the fourth lagoon.[2] If the connection fees are reduced prospectively to $1,200, there will be no new source of uncommitted capital for any unanticipated future needs or to serve as a source of working capital that can be borrowed for noncapital repairs.

Public Staff testimony and conclusion that NTWS is not a financially-troubled system are without adequate foundation. The Public Staff ignores the pendency of the bankruptcy proceedings and NTWS's inability to obtain outside capital. Not once does the Public Staff in its testimony and conclusions on NTWS's financial viability even mention the Bostic bankruptcy and the fact that the bankruptcy prevents NTWS from obtaining any outside capital.

The support for the Public Staff conclusion is also questionable for other reasons. The Public Staff supports its conclusion that NTWS is financially viable with Public Staff Exhibits 5 and 6. Exhibit 5 relies upon "Viability Policies and Assessment Methods for Small Water Utilities" measurements of financial distress. According to the exhibit, a distressed system has a distress score of 2.78 or below. For 1998, according to the exhibit, NTWS had a score of 2.94, only 1.6 above the distress score. However, the Public Staff included no score for the profit trend. The profit trend is based on the ratio of retained earnings over common stock equity. For 1994, the profit trend was (0.374), determined by comparing retained earnings of (302,005) to common stock equity of 807,042. The profit trend for 1998 was considerably worse -- retained earnings of (1,550,714) and total common equity of (1,450,714). By including no score for profit trend in 1998, the Public Staff overstated the measurement of NTWS's financial health and

[2] The $1,200 assumes the cost of the fourth lagoon is $1 million. Mr. Floyd testified that the cost of the fourth lagoon is $1.5 million.

distorted NTWS's distress score. Even assuming no deterioration from 1994, thus using the (0.374) for profit trend, the total distress score for NTWS becomes 2.57, below the distress score threshold of 2.78.

When he was cross-examined on Public Staff Exhibit 5, Public Staff witness Hinton backtracked on the Public Staff conclusion that NTWS is financially viable. With respect to the 2.94 distress score for NTWS for 1998, Mr. Hinton testified that "while it doesn't say it's a viable system, nor does it say it's a distressed system." Witness Hinton also testified that "In sum, the distress score shows that it is not a distressed system but nonetheless it's also showing that it's not a viable system. It is in that gray area."

In Exhibit 6 the Public Staff relies on the Standard and Poor's (S&P) financial benchmarks to conclude that NTWS has an attractive level of cash flow coverage. Of a potential 25 ratios for the five years of financial data the exhibit measures, 12 have "no meaningful figure." The reason that the exhibit has so little ostensibly meaningful data and otherwise shows that there is cash flow coverage is that NTWS cannot borrow and therefore has no meaningful debt or interest expense. Without debt or interest expense, no one should be surprised that net income is sufficient to cover the nominal level of interest expense that exists. Also, the net income from continuing operations cannot legitimately be used to cover any interest expense because net income must be paid into another escrow fund to repay judgments obtained by state agencies for NTWS's failure to pay environmental fines.

NTWS is a financially-troubled sewer utility because its owner/operator has been replaced and regulatory officials have been forced to serve as surrogates to fill many of the traditional roles of management. NTWS has been forced to look to the Commission-established connection fee escrow fund as its source of funding both for operation and maintenance items and improvements. Before NTWS can use the escrow fund, however, NTWS must obtain regulatory approval. Under the procedure established by the Commission, NTWS must consult with and apply to the Public Staff to use any portion of the escrow fund. After the Public Staff completes its analysis, the request is brought to the Commission. The Commission must resolve any differences between the Public Staff and NTWS and otherwise determine whether the requested expenditures should be authorized. All of these steps occur before the expenditures from the escrow fund are made.

UI argues that NTWS is a troubled sewer utility from an operations perspective. Both parties indicated that NTWS is effectively on a sewer permit moratorium. This moratorium was made effective by DWQ, which issues the sewer expansion permits and has jurisdiction over compliance with these permits. DWQ has issued numerous sewer extension permits that provide for a fixed number of connections based upon the design flows anticipated from the users connecting to the system. The capacity of the aggregate sewer extension permits is approximately 629,000 gallons per day, which is the permitted

flow of the wastewater treatment facility. This effectively places a moratorium on new sewer extension permits, not new customer connections. NTWS has continued to connect new customers to its collection system. It has done so by reallocating flows and connections from previously issued sewer extension permits, under permission granted to NTWS by DWQ and this Commission. Records of NTWS clearly indicate that its customer base had continued to expand, without threat of punitive action by DWQ. Based on the foregoing, the Commission is of the opinion that the sewer collection system is adequately serving the needs of the customers who are using the collection system.

It is clear that prior to 1994, NTWS was in a state of noncompliance with its environmental permit issued by DWQ. Since 1994, however, NTWS management has operated its facilities in a sound and reasonable manner. Further, customers testifying at the hearing on October 12, 1999, also indicated that service by the current management of NTWS is satisfactory. Only one customer mentioned a problem, which was an occasional odor from the island pumping station at the NC 210 bridge. The rest were complimentary.

The evidence supports the conclusion that NTWS management routinely makes prudent use of its available capital resources to provide an adequate quality of service to its customers. Furthermore, the NTWS system does not suffer from various system deficiencies, ongoing environmental regulatory violations and frequent customer complaints that typify operationally-troubled systems. The Commission finds and concludes that the facilities owned and operated by NTWS are in satisfactory condition and are currently sufficient to provide sewer utility service to the customers. Without some evidence of inadequate service currently or in the recent past, the Commission cannot conclude that NTWS is operationally troubled. The record in this case is devoid of such evidence. Accordingly, the Commission concludes that NTWS is not an operationally-troubled system.

The record clearly establishes that the "public convenience and necessity" would be served by the transfer of North Topsail to an owner other than its current stockholders. At this point, the stock of North Topsail is still owned by Marlow Bostic and Roger Page, neither of whom were able to ensure the operation of North Topsail in an acceptable manner. A sale of North Topsail is inevitable given the necessity for the United States Bankruptcy Court for the Eastern District of North Carolina to utilize the stock in North Topsail owned by Mr. Bostic and Mr. Page to satisfy the claims of their creditors. A sale of North Topsail to an adequately-capitalized owner will clearly serve the public interest by eliminating the unusual procedures which have been utilized to finance the operation, maintenance, and expansion of the North Topsail system and ensuring that sufficient resources will be available to ensure the provision of adequate service to current and future North Topsail customers. UI is clearly a competent, adequately-capitalized, professionally-operated water and sewer utility.

Accordingly, the Commission concludes that UI possesses the financial and operational expertise and wherewithal to receive and operate the franchise and assets of NTWS. The transfer proposed herein will benefit the customers of NTWS by ensuring the long-term viability of their sewer system, in that it will be owned and operated by a professional utility company with the technical, managerial and financial capability to ensure the long-term provision of adequate service. Accordingly, the Commission approves UI's request to obtain the franchise and assets of NTWS. Such approval furthers the goal of promoting transfers of troubled systems to professional, well-capitalized owners.

With regard to the position taken by Onslow County that the public interest would be best served if the County rather than UI acquires NTWS, the Commission notes that the County did not participate in the bankruptcy bidding process to acquire NTWS and that there is no request to transfer NTWS to the County pending before the Commission. UI is the only transfer applicant.

The Benefits of UI's Ownership Do Not Outweigh the Costs of Including the Purchase Price in Rate Base

Notwithstanding the fact that NTWS is a financially-troubled system, the Commission determines that UI's purchase price should not be included in rate base because the benefits to NTWS's ratepayers from UI's ownership do not outweigh any costs that may result from establishing rate base in this fashion. Although reaching the same result as that advocated by the Public Staff with respect to this issue, the Commission cannot adopt either the Public Staff's conclusion that North Topsail is not a "troubled" utility or the analysis which both UI and the Public Staff have utilized to support their ultimate conclusions with respect to the acquisition adjustment issue. After examining the relevant policy considerations and the prior decisions of the Commission, the Commission concludes that the outcome in an acquisition adjustment case should hinge upon whether the party seeking rate base treatment for an acquisition adjustment has established by the greater weight of the evidence that the purchase price which the purchaser has agreed to pay is prudent and that the benefits of including the acquisition adjustment in rate base outweigh any resulting burden to ratepayers. After conducting such an analysis, the Commission concludes that inclusion of the acquisition adjustment in North Topsail's rate base would be inappropriate because UI is obligated to purchase North Topsail regardless of our decision with respect to the acquisition adjustment issue and because UI has failed to meet its burden of proving that the benefits to affected customers from the inclusion of the acquisition adjustment in rate base outweigh the resulting harm.

The Commission's evaluation of utility mergers is governed by G.S. 62-111(a), which provides, in pertinent part, that "[n]o franchise now existing or hereafter issued under the provisions of this Chapter. . .shall be sold, assigned, pledged or transferred. . .

except after application to and written approval by the Commission, which approval shall be given if justified by the public convenience and necessity." G.S. 62-111(a) requires the Commission to "inquire into all aspects of anticipated service and rates occasioned and engendered by the proposed transfer, and then determine whether the transfer will serve the public convenience and necessity." State ex rel. Utilities Commission v. Village of Pinehurst, 99 N.C. App. 224, 299, 393 S.E.2d 111 (1990), aff'd 331 N.C. 278, 415 S.E.2d 199 (1992). As a result, the Commission must determine on the basis of an examination of all relevant facts and circumstances whether the proposed transfer, either as proposed by the applicant or as modified to reflect the imposition of conditions as authorized by G.S. 62-113, is in the best interest of the relevant members of the using and consuming public.

The Commission establishes the rate base of North Carolina utilities by ascertaining "the reasonable original cost of the public utility's property used and useful, or to be used and useful within a reasonable time after the test period, in providing the service to the public within the State, less that portion which has been consumed by previous use recovered by depreciation," plus, to a limited extent not applicable here, construction work in progress. G.S. 62-133(b)(1). Although the appellate courts have apparently never had the opportunity to determine the meaning of the reference to "reasonable original cost" in G.S. 62-133(b)(1) in an instance when property previously dedicated to the public service is purchased by another public utility at a premium over net book value, the Commission has dealt with this issue on numerous occasions. We do not, however, appear to have ever enunciated a single, specific method for determining whether requests such as that advanced by UI in connection with this transfer application should be granted or denied.

The appropriateness of including an acquisition adjustment in rate base came before a Commission Hearing Examiner in In re Carolina Water Service, Inc., of North Carolina, Docket Nos. W-354, Subs 39, 40, 41, Seventy-Sixth Report of the North Carolina Utilities Commission: Orders and Decision 739 (1986) (Carolina Water I); the Hearing Examiner's decision became that of the Commission after no party excepted to his proposed resolution of the acquisition adjustment issue. In re Carolina Water Service, Inc., of North Carolina, Docket No. W-354, Subs 39, 40, 41, Seventy-Sixth Report of the North Carolina Utilities Commission: Orders and Decisions 769 (1986). After noting that requests for rate base treatment of acquisition adjustments should be dealt with on a case-by-case basis, the Hearing Examiner opined that "the benefits of the acquisition to the acquired customers and to existing customers [may] merit the inclusion of the debit acquisition adjustment" in rate base in some instances. Carolina Water I 739, 756 (1986). The Hearing Examiner approved inclusion of an acquisition adjustment associated with the Mecklenburg systems in rate base because the prior owner had failed to operate the systems properly, existing customers had better prospects for receiving adequate service as a result of the transfer, the sale price for the systems had been negotiated at arms length and was prudent, and the inclusion of the Mecklenburg systems in Carolina Water Service's rate base would tend to decrease rates for all other Carolina Water Service

customers. Carolina Water I 739, 756-757 (1986). The Hearing Examiner reached the opposite conclusion with respect to the Chapel Hills and High Meadows systems since the record did not establish that the prior owner would have failed to make necessary system improvements in the absence of a transfer, the amount which Carolina Water Service had spent on service improvements was unclear, there had been no violations assessed against the High Meadows system, the record did not demonstrate that the sales had been conducted at arms length and that the purchase prices were reasonable, the circumstances surrounding the transfers were unclear, the purchases had been effectuated without prior Commission approval, and it was doubtful that the benefits to customers outweighed the costs. Carolina Water I 739, 757-758 (1986). The Hearing Examiner finally noted that a blanket refusal to allow the inclusion of acquisition adjustments in rate base might provide an undue stimulus to utility construction in lieu of asset purchases; that the potential harm from the inclusion of an acquisition adjustment in rate base could be minimized by carefully scrutinizing each "transaction to ensure that it is prudent, at arms length, and that the benefits accruing to the customers outweigh the costs of inclusion in rate base of the excess purchase price;" and that allowing the inclusion of acquisition adjustments in rate base might encourage the transfer of small, poorly-operated systems to more qualified operators. Carolina Water I 739, 758 (1986).

The Commission subsequently discussed the acquisition adjustment issue in a 1990 Carolina Water Service general rate case, where it stated that, "[a]s a general proposition, when a public utility buys assets that have previously been dedicated to public service as utility property, the acquiring utility is entitled to include in rate base the lesser of the purchase price or the net original cost of the acquired facilities in the hands of the transferor at the time of the transfer." In re Carolina Water Service, Inc., of North Carolina, Docket Nos. W-354, Subs 74, 79, 81, Eightieth Report of the North Carolina Utilities Commission; Orders and Decisions 342, 394 (1990) (Carolina Water II). The Commission adopted this general principle on the grounds "that the investor in utility property should only be entitled to recover his own investment" and that "public utility ratepayers normally should only be responsible for reimbursing an investor once for the cost of public utility property through depreciation expense recovered through rates and through payment of a return on the unrecovered investment." Carolina Water II 342, 394 (1990). After making this initial statement, the Commission analyzed the facts and circumstances surrounding each acquisition adjustment challenged by the Public Staff, generally refusing to allow the inclusion of these amounts in rate base on the grounds that "the developers contributed the system, and presumably intended to recover their costs through lot sales;" that the extent to which "they actually recovered their utility system investment through lot sales, or are still doing so, is irrelevant at this point for regulatory purposes;" and that the record did not reflect whether any other system improvements had, in fact, been made. Carolina Water II 342, 395-396 (1990). As a result, the Commission indicated a strong general policy against the inclusion of acquisition adjustments in rate base subject to exceptions in appropriate instances. See also: In re Transylvania Utilities, Inc., Docket No. W-1012, Sub 2, 3 (1995) (Transylvania) ("the Commission agrees with the

Hearing Examiner that the Company has not carried the burden of proof that the benefits to ratepayers outweigh the cost of inclusion in rate base of the excess purchase price or that system deficiencies would have gone unaddressed if not for the acquisition by the acquiring company").

The Commission recently considered an acquisition adjustment issue in connection with an application by Heater Utilities, Inc., to purchase a water utility system in the Hardscrabble Plantation subdivision. In that case, the Public Staff argued that, under a "three prong" test allegedly established in Carolina Water I, Heater should not be allowed to include an acquisition adjustment in rate base unless "[t]he benefits to ratepayers. . . outweigh. . .the cost of inclusion in rate base of the excess purchase price," "[s]ystem deficiencies would have gone unaddressed if not for the acquisition by the acquiring company," and "[t]he acquisition was the result of arms' length bargaining." In re Heater Utilities, Inc., Docket No. W-274. Sub 122, 9 (1997) (Hardscrabble). In rejecting the Public Staff's argument, the Commission noted that the Hearing Examiner "discussed a large number of specific facts" in Carolina Water I, "including: (1) service improvements that would have gone unaddressed; (2) increased rates; (3) arms' length bargaining; (4) prudent purchase price; (5) benefits to acquired and acquiring customers; (6) average per customer rate base of the acquiring company as opposed to the per customer purchase price; (7) operating efficiencies; and (8) spreading costs under unified rate structure and other items" and pointed out that "[t]he three-prong test" upon which the Public Staff relied "does not appear, verbatim, in [the Hearing Examiner's] order." Hardscrabble 10 (1997).

Heater, on the other hand, claimed that the test adopted by the Hearing Examiner in Carolina Water I focused on "whether the purchase price was prudent, whether the purchase price resulted from arms' length bargaining, and whether the "benefits to consumers. . .outweigh[ed] the cost of including the purchase price in rate base." Hardscrabble 10-11 (1997). Although the Commission concluded that the entire cost of the Hardscrabble system had been recovered through fees paid to the developers of the system, Hardscrabble 9 (1997), and that there were no deficiencies in the Hardscrabble system, Hardscrabble 11 (1997), it refused to treat these facts as dispositive since "it. . . would conflict with sound regulatory policy and practice, to send a signal to the water utility industry that a small system should be allowed to deteriorate so that it can command a higher sales price, since the acquiring company could then obtain rate base treatment on its purchase price." Hardscrabble 11 (1997). After concluding that the purchase price that Heater paid for the Hardscrabble system was lower than its existing per-customer investment, that the Hardscrabble system was in good condition and located near other Heater-owned systems, that the purchase of the Hardscrabble system would tend to reduce rates for other Heater customers, and that the transfer of the Hardscrabble system to Heater would allow customers located on that system to receive service from a professionally-operated utility and prior to refusing to allow Heater to change its uniform rates to customers of the Hardscrabble system, the Commission concluded "that Heater should be allowed to make the requested debit acquisition adjustment to rate base" since

"[t]he Commission has articulated a position of encouraging the orderly transfer of water systems from developers and small owners to reputable water utilities like Heater" and since "its decision herein, based on the facts and circumstances presented, promotes and serves the public interest and is in the public interest." Hardscrabble 11 (1997).

The Commission Orders discussed above do not clearly state a single, definitive test for resolving acquisition adjustment issues in water and sewer transfer cases. Carolina Water I does not, for example, explicitly mention the three-prong test upon which the Public Staff relied in Hardscrabble or establish the appropriateness of using an eight-factor test like that emphasized by the Public Staff at one point in this case. Although Carolina Water I does recite the three factors upon which Heater relied in Hardscrabble, that test does not neatly cover or place equal emphasis upon all of the factors mentioned by the Hearing Examiner in Carolina Water I or explicitly place the burden of proof in acquisition adjustment cases upon the applicant utility as apparently required by Carolina Water II and Transylvania. The lack of clarity in the nature of the test which should be employed in resolving acquisition adjustment issues is heightened when one compares the language of Carolina Water II, which expresses a strong skepticism about allowing rate base treatment of acquisition adjustments, and the equally clear language of Hardscrabble, which stresses the benefits of transferring small water and sewer utilities to larger, more professional operations. As a result, it is appropriate for the Commission to begin its analysis in this case by developing a test for identifying the circumstances in which rate base treatment of acquisition adjustments is appropriate based upon the relevant provisions of North Carolina law and considerations of sound regulatory policy.

A majority of regulatory agencies in the United States have decided that, all other things being equal, acquisition adjustments should not be afforded rate base treatment. According to Bonbright, "most commissions are skeptical of transfers between utilities at excess costs, so rate base adjustments are generally not made unless the utility can demonstrate actual, distinct and substantial benefits to all affected ratepayers." J. Bonbright, A. Danielson, and D. Kamerschen, Principles of Public Utility Rates 286 (1987). See also: 1 A. Priest, Principles of Public Utility Regulation 189 (1969) (although the majority of regulatory commissions have refused to include acquisition adjustments in rate base, such treatment has been allowed where "the transaction was at arm's-length," "resulted in operating efficiencies," "received regulatory approval as having been in the public interest," or "made possible a desirable integration of facilities"). The adoption of such a general rule is clearly appropriate, for the routine inclusion of acquisition adjustments in rate base would tend to create an incentive for purchasers to pay a high price to acquire utility assets, confident in the knowledge that such payments would be recouped from ratepayers. As a result, the approach the Commission should adopt ought to place the burden of proof on the acquiring utility to demonstrate the appropriateness of including an acquisition adjustment in rate base.

Assuming the appropriateness of adopting a general rule prohibiting the inclusion of acquisition adjustments in rate base in the absence of a showing of special circumstances justifying a contrary decision, the next question becomes one of identifying the circumstances under which rate base treatment of acquisition adjustments should be deemed proper. As should be apparent from an analysis of the Commission's previous Orders concerning this subject, a wide range of factors have been considered relevant in attempting to resolve this question, including the prudence of the purchase price paid by the acquiring utility; the extent to which the size of the acquisition adjustment resulted from an arms length transaction; the extent to which the selling utility is financially or operationally "troubled;" the extent to which the purchase will facilitate system improvements; the size of the acquisition adjustment; the impact of including the acquisition adjustment in rate base on the rates paid by customers of the acquired and acquiring utilities; the desirability of transferring small systems to professional operators; and a wide range of other factors, none of which have been deemed universally dispositive. Although the number of relevant considerations seems virtually unlimited, all of them apparently relate to the question of whether the acquiring utility paid too much for the acquired utility and whether the customers of both the acquired and acquiring utilities are better off after the transfer than they were before that time. This method of analysis is consistent with sound regulatory policy since it focuses on the two truly relevant questions which ought to be considered in any analysis of acquisition adjustment issues. It is also consistent with the construction of G.S. 62-111(a) adopted in State ex rel. Utilities Commission v. Village of Pinehurst, 99 N.C. App. 224, 393 S.E.2d 111 (1990), aff'd 331 N.C. 278, 415 S.E.2d 199 (1992), which seems to indicate that all relevant factors must be considered in analyzing the appropriateness of utility transfer applications. As a result, contrary to the approaches advocated by both UI and the Public Staff, the Commission should refrain from allowing rate base treatment of an acquisition adjustment unless the purchasing utility establishes, by the greater weight of the evidence, that the price the purchaser agreed to pay for the acquired utility was prudent and that both the existing customers of the acquiring utility and the customers of the acquired utility would be better off [or at least no worse off] with the proposed transfer, including rate base treatment of any acquisition adjustment, than would otherwise be the case.

Although the Public Staff attempted to show that the purchase price which UI agreed to pay for the North Topsail system was imprudent, the Commission concludes that UI has met its burden of proof with respect to this issue. The Commission takes judicial notice that the North Topsail system is located in an area which is experiencing or is likely to experience significant growth. G.S. 62-65(b). A prudent purchaser might well elect to pay more than net book value for a sewer utility with no immediate operational problems, such as North Topsail, on the assumption that acquiring the right to operate that utility's system had independent value over and above the net book value of the acquired utility's assets. In addition, the purchase price which UI agreed to pay was established at an auction conducted under the auspices of the United States Bankruptcy Court for the Eastern District of North Carolina which was intended, for obvious reasons, to maximize

the purchase price obtained for the North Topsail system. The price at which UI purchased North Topsail was only $50,000 greater than the last bid submitted by its principal rival during the auction. According to the bidding procedures followed during the auction process, additional bids were required to be submitted in $50,000 increments. As a result of the fact that the purchase price paid by UI was clearly established through an arms length bidding process and the fact that the price which UI ultimately agreed to pay was the minimum amount apparently necessary to prevail in the bidding process, the Commission is satisfied that the purchase price which UI agreed to pay for the North Topsail system was prudent.

In addition to its relevancy to a determination of whether approval of the transfer is in the public interest as previously discussed above, the issue of whether North Topsail should be labeled a "troubled" utility, is also undoubtedly relevant to a proper resolution of the acquisition adjustment issue. The Commission does not, on the other hand, agree that a determination of whether North Topsail is "troubled" should be deemed dispositive of the acquisition adjustment issue as both UI (Tr. Vol. 2, p. 115) (the ultimate issue is whether North Topsail is a "troubled" system and, if so, whether the benefits associated with the proposed acquisition outweigh the cost so as to justify inclusion of the acquisition adjustment in rate base) and the Public Staff (Public Staff Proposed Order, pp. 15, 19-27) (the Commission should analyze the acquisition adjustment issue utilizing the test enunciated by UI) seem to suggest. To the contrary, treating the question of whether North Topsail is a "troubled" utility in this manner is inconsistent with Commission's decision in Hardscrabble and effectively eliminates the necessity for the Commission to consider all relevant factors as required by G.S. 62-111(a).

The fervor of the parties' advocacy with respect to the "troubled" system issue should not obscure the relative clarity of the record with respect to this question. The evidence which the parties used to debate this point included considerable discussion of North Topsail's past travails. The Commission disagrees with UI's contention that our determination of whether North Topsail is a "troubled" system should rest, to an apparently large extent, on North Topsail's indubitably checkered history. The Commission is required to decide whether a transfer of the North Topsail system to UI, including the extent to which the acquisition adjustment should be included in rate base, is currently in the public interest. An analysis of past events is relevant to this issue to the extent that earlier developments impact North Topsail's current situation.

Nevertheless, the customers of North Topsail are not plagued with any serious operational problems at the present time. No customers advanced any serious service quality complaints at the October 12, 1999 public hearing. As a result, the Commission is persuaded that, barring any unforeseen emergency such as another major hurricane, the North Topsail system is currently being operated in a satisfactory manner. In addition, the record does not suggest that an acquisition by UI will have any immediate impact on the quality of the service which North Topsail provides to its customers. That

determination, however, does not end the inquiry. The long-term prospects for North Topsail under current ownership and management are not unclouded. The record reveals the existence of potential long-term operational problems arising from limitations upon the capacity of North Topsail's system, including restrictions upon its ability to add new customers. Although the Public Staff may well be correct in asserting that these problems will ultimately be resolved even without a change in ownership or management, the simple fact remains that the limitations in question do exist now. In addition, the record shows that North Topsail does not have access to adequate capital. Although current management has undoubtedly improved North Topsail's ability to serve customers, restored the system to good working order after several major hurricanes, and operated the system well given existing resource constraints, the undisputed evidence of record establishes that, all other things being equal, North Topsail customers would be better off in the event that the system was owned and operated by an adequately-capitalized and professionally-run entity. As a result, the Commission has concluded that North Topsail is a financially-troubled utility. Nevertheless, that conclusion, considered in isolation, is not dispositive of the acquisition adjustment issue.

In that regard, the Commission notes that UI's willingness to purchase the North Topsail system was not conditioned on inclusion of the acquisition adjustment in rate base. Instead, the contract between UI and the Bankruptcy Trustee clearly obligates UI to purchase North Topsail whether or not the Commission approves inclusion of the proposed acquisition adjustment in rate base. At least one other adequately-capitalized utility attempted to buy North Topsail without seeking rate base treatment for an acquisition adjustment. Under this set of circumstances, the customers of North Topsail will get the benefit of ownership and operation by an adequately-capitalized and professionally-run utility regardless of whether the Commission approves inclusion of the acquisition adjustment in rate base or not. For this reason, much of the argument advanced by UI is less than compelling. As a result, the Commission concludes that we should decide the acquisition adjustment issue on the basis of an assumption that current North Topsail customers will receive service from an adequately-capitalized, professionally-run utility regardless of our decision with respect to the acquisition adjustment issue and that the benefits to customers necessary to justify inclusion of the acquisition adjustment in rate base must be found elsewhere.

The fact that UI's obligation to purchase North Topsail is not conditioned on approval of the proposed acquisition adjustment distinguishes this case from the numerous recent Commission decisions upon which UI places emphasis. For example, the Commission expressly noted in In re Heater Utilities, Inc., Docket No. W-274, Sub 215, 2 (1999), that "[t]he contracts for transfer filed with the application are conditioned upon Heater's obtaining Commission approval of an acquisition adjustment allowing Heater to receive rate base treatment of the full $520,000 purchase price." Similarly, in In re Heater Utilities, Inc., Docket Nos. W-274, Subs 233, 234, 235, 236, and 237 (1999), the Commission approved the transfer of various water and sewer utility systems from

MidSouth to Heater under a contract which conditioned this transaction "upon Heater obtaining an acquisition adjustment to allow Heater to receive future rate making treatment as [sic] rate base for the full purchase price." Furthermore, the contract for the transfer of the Bragg Estates subdivision from Water, Inc., to Brookwood Water Corporation at issue in In re Brookwood Water Corporation, Docket No. W-177, Sub 46 (1999), expressly provided that the purchase price to be paid by Brookwood to Water, Inc., for the Bragg Estates subdivision was to be the greater of the net original cost investment which Water Inc., had in the Bragg Estates system as determined by the Commission or $15,000 and that the proposed transfer was "null and void" in the event that "the Commission [did] not approve the entire purchase price as rate base." Finally, the Commission's decision in In re Brookwood Water Corporation, Docket No. W-177, Sub 47, 2 (1999), noted that Brookwood's agreement to purchase the Wrightsboro system from Scotsdale Water & Sewer, Inc., "was conditioned on Commission approval of full rate base treatment of the purchase price," which, in turn, included an acquisition adjustment. As a result of the fact that all of these cases involved sale agreements in which the benefits resulting from the proposed transfer were contingent upon Commission approval of the proposed acquisition adjustment, none of these cases support approval of an acquisition adjustment in this case.

Admittedly, the Hardscrabble decision cannot be distinguished on this basis, since the record in Hardscrabble reflects that Heater expressed the intention to consummate the purchase of the Hardscrabble system regardless of the Commission's resolution of the acquisition adjustment issue. Nevertheless, the facts at issue there are sufficiently different from those at issue here to support a different result. At the same time that the Commission approved Heater's request for rate base treatment of an acquisition adjustment in Hardscrabble, it refused to allow Heater to charge its uniform rates, saving Hardscrabble customers from a substantial increase. The Commission also noted in that case that, even after the inclusion of the acquisition adjustment in rate base, Heater's $100 per-customer investment in the Hardscrabble system was substantially less than the $575 per-customer investment which Heater had in the rest of its systems. Finally, the Commission emphasized that the likely effect of encouraging the transfer of the Hardscrabble system to Heater through a decision to approve the inclusion of the acquisition adjustment in rate base would be to place downward pressure on Heater's uniform rates. In this case, on the other hand, inclusion of the acquisition adjustment in rate base would increase North Topsail's per-customer investment from $503 to $1,390, more than eight times the per-customer acquisition adjustment approved in Hardscrabble. In addition, unlike Hardscrabble, the effect of allowing the inclusion of the acquisition adjustment in rate base in this instance would be to place upward pressure on the uniform rates charged by UI's largest North Carolina subsidiary in the event that the two systems were to be consolidated. As a result, the fact that the per-customer impact of including the acquisition adjustment at issue here in rate base is so much greater than was the case in Hardscrabble and the fact that another potential purchaser was willing to forgo inclusion of the acquisition adjustment in rate base makes the two cases fundamentally different.

The only additional benefit which may flow to North Topsail customers from inclusion of the acquisition adjustment in rate base in this case stems from UI's offer to withdraw North Topsail's pending application for a general rate increase and to refrain from seeking to increase rates for affected customers for three years. Although such an offer might, under some circumstances, suffice to justify inclusion of an acquisition adjustment in rate base, the Commission is not persuaded that such is the case in this instance. In analyzing this issue, one should remember that the burden of proof is on UI to establish that the benefits of the proposed transfer, including rate base treatment of the acquisition adjustment, outweigh the associated burdens. The undisputed evidence establishes that, all other things remaining equal, inclusion of the acquisition adjustment in rate base would support a $12.00 per month or 38% increase in North Topsail's ordinary residential rates. Although UI has argued that a number of factors, such as customer growth, increased efficiencies, and economies of scale, could well offset some or all this rate increase, the extent to which such factors would have that effect is, at best, uncertain. In the absence of a decision to include the proposed acquisition adjustment in rate base, UI would, presumably, pursue the application for a 22% rate increase which North Topsail filed with the Commission in 1999. Although the record is not entirely clear on this point, the Commission assumes that many of the same factors which allegedly support a 22% increase now would still be present at the time that UI's self-imposed rate increase moratorium expires (a change in the treatment of the overcollected CIAC gross-up may have some impact on the validity of this statement), so that the proper basis for comparison is whether customers are better off with a 22% increase now or a 60% (modified as necessary to reflect the passage of time) increase at the end of three years. Assuming an 8.5% discount rate and a twenty-year calculation period, North Topsail's ratepayers are better off with an immediate 22% increase than with a 60% increase in three years on a net present value basis.

Moreover, the extent to which North Topsail is entitled to a 22% increase at the present time is unclear. The Public Staff contends that North Topsail is only entitled to a 1.67% increase at present; at an absolute minimum, observers of the regulatory process in North Carolina can safely assume that North Topsail's request for increased rates is unlikely to be approved without at least some modification. On the other hand, there does not appear to be any dispute that, all else remaining equal, the inclusion of the proposed acquisition adjustment in rate base will result in a 38% increase for North Topsail's customers separate and apart from other factors. Once again, if one assumes that North Topsail is entitled to either a 1.67% increase or a 10% increase now, the net present value of such an increase calculated over the next twenty years using an 8.5% discount rate is less than the net present value of a 39.67% or a 48% increase, respectively, three years from now calculated using the same assumptions. As a result, the Commission is simply not persuaded that North Topsail's customers are better off, over the long term, with a 38% increase plus any currently justifiable increase, adjusted to reflect the passage of time, three years from now compared to any currently-justified increase implemented in the near future. As a result, given that the immediate improvement in service conditions is not

likely to be of overwhelming significance, that the benefits of having an adequately-capitalized owner will be available to North Topsail customers regardless of our decision with respect to this issue, and that the rate impact of the inclusion of the acquisition adjustment in rate base is likely to be greater than the alternatives, the Commission cannot conclude that the benefits of the proposed transfer as outlined by UI outweigh the costs.

In apparent recognition of this problem, UI also indicated that, following completion of the transfer, it would consider consolidating the North Topsail system with its Carolina Water Service systems and charging North Topsail's customers on the basis of the uniform rates currently in effect for Carolina Water Service's customers. The Commission is not persuaded that this proposal overcomes the difficulties outlined above. First, the implementation of this proposal would require Commission authorization at the conclusion of a separate proceeding. As of the present date, UI has not applied for the authority to consolidate North Topsail with Carolina Water Service; there is no guarantee that the Commission would give its blessing to such a transaction if it were to be proposed. Second, the record reflects that substitution of Carolina Water Service's uniform rates for those currently charged by North Topsail would still result in a rate increase for those North Topsail customers with individual pump stations who pay their own pumping expense. Third, and most important, the effect of implementing this proposal would simply be to transfer the burden resulting from the inclusion of the acquisition adjustment in rate base from current North Topsail customers to all customers served by Carolina Water Service. It thus appears that Carolina Water Service customers would receive absolutely no benefit whatsoever in return for the assumption of this burden. As a result, the Commission is unable to conclude that, in the event that UI decides to consolidate the North Topsail system with its Carolina Water Service subsidiary, all affected customers will be better off following a Commission decision to approve the transfer as proposed by UI than would otherwise be the case.

Although UI argues that there are a number of other benefits which it believes will accrue to customers from a transfer of North Topsail to UI, including the ability to reduce connection fees prospectively to costs, UI's ability to post the required bond, the likelihood that UI will be able to refund the overcollected CIAC gross-up, and the Commission's ability to relinquish its role in managing NTWS to UI, all of these additional benefits simply reflect the fact that the new owner of North Topsail will be a financially-viable entity and that such a financially-viable owner will require less Commission supervision and have more financial resources than are currently available to North Topsail. In essence, UI would have the Commission conclude that the benefits which would accrue to customers from transferring ownership of North Topsail to a solvent, competent utility such as UI are sufficient to justify inclusion of the acquisition adjustment in rate base. Nevertheless, at bottom, it appears to the Commission that all of the benefits which would accrue to North Topsail customers from an acquisition by UI will exist whether or not the acquisition adjustment is included in rate base. For that reason, the Commission cannot approve the proposed transfer coupled with rate base treatment of the proposed

acquisition adjustment. A decision refusing to approve the transfer in the manner requested by UI is consistent with the Commission's prior acquisition adjustment decisions and with considerations of sound regulatory policy. On the other hand, approval of UI's proposal would, in effect, amount to a decision that an acquisition adjustment would be included in rate base any time that a large, professionally-operated utility acquires a smaller system, an approach which is inconsistent with this Commission's precedent and considerations of sound regulatory policy.

Connection Fees Should Be Established at $1,200

Connection fees should be reduced to $1,200 per residential equivalent unit, equal to 360 gpd, with a minimum of $1,200 for each connection or dwelling unit. Commercial customers would pay a connection fee based on design flow of the business to be served, with a minimum of $1,200. Multi-unit construction would pay $1,200 times the number of units served.

Currently, residential connection fees are $2,000 for a new service connection not requiring the installation of a pumping station and $3,000 for a connection that requires the installation of a pumping station. In its application, UI proposed no change in connection fees. The Public Staff proposes to reduce connection fees to the cost of labor and materials to make the connections plus the $1,000,000 cost of a fourth lagoon. The Public Staff maintains that connection fees at this level would provide UI with the same level of CIAC and is consistent with the connection fees authorized for UI's other affiliated companies.

At the hearing and in its proposed order, UI agreed with the Public Staff recommendation that connection fees charged after the transfer should be reduced. The Commission determines that the level of connection fees agreed to by the parties should be approved prospectively without altering the rights of those who have prepaid connection fees prior to the transfer.

Bond Should be Established at $200,000

The bond for UI with respect to NTWS required pursuant to G.S. 62-110.3(a) should be established at $200,000. The Public Staff addressed the five criteria that must be considered by the Commission in setting the bond amount pursuant to G.S. 62-110(a). In summary, the Public Staff determined that UI is affiliated with companies providing water and sewer utility service in North Carolina; UI's record of operation is satisfactory; there is projected growth of 3%; there is no need to construct new facilities, as the existing facilities were capable of accommodating the flows anticipated for at least the next 15 years; that the NTWS facilities are in excellent condition; and that NTWS has made expenditures to repair damage caused by adverse weather events. The Public Staff recommended a bond of $200,000, which is the largest amount of damage NTWS has

suffered as a result of a single hurricane. UI does not object to the bond. The Commission agrees with the parties as to the size of the bond.

NTWS was initially franchised prior to September 1987, when the bonding legislation was enacted. G.S. 62-110.3(b), however, imposes a bonding requirement on contiguous extensions regardless of when a franchise was issued. Furthermore, G.S. 110.3(c) authorizes the Commission, at any time, to reevaluate the amount of a bond based on changed circumstances. The Commission is of the opinion that the proposed transfer is such a change.

UI Should Refund Overcollected CIAC Gross-Up

The sum of $337,200, representing the overcollection of gross-up on CIAC, that NTWS has been unable or unwilling to refund, should be refunded by UI. In Docket No. W-754, Sub 12, the Commission ordered NTWS to refund $241,150 plus accrued interest to customers for overcollection of the gross-up for income taxes on CIAC by filing a refund plan and beginning repayment in July 1992. On August 20, 1992, in response to a motion of the Public Staff, the Commission found that NTWS had failed to file a plan and make refunds as ordered. At a Show Cause Hearing on September 23, 1992, in Docket No. W-754, Sub 12, NTWS submitted financial information prepared by its accountant and testified about the financial problems it was experiencing. The Commission approved a Joint Stipulation in Docket No. W-754, Subs 12 and 14 treating the gross-up as cost-free capital and deducting it from rate base. The Commission stated that if NTWS were transferred or sold, the gross-up should be refunded to the CIAC contributor as originally stipulated by NTWS and as ordered by the Commission.

In this docket, the Public Staff recommends that $337,200 be refunded to the CIAC contributors as originally ordered by the Commission. Also, the Public Staff recommended that UI file a refund plan.

At an earlier proceeding in this docket, Joseph N. Callaway, Bankruptcy Trustee in the Mr. Bostic bankruptcy proceeding, asserted that the unclaimed portion of the $337,200, if any, was part of the assets of the bankruptcy estate that should be included within the funds to be distributed to creditors.

Although UI does not wish to become embroiled in the dispute over the disposition of the CIAC gross-up, UI does not contest refunding the $337,200 to the contributors to the extent these funds are released by the Bankruptcy Trustee and are provided from the preexisting fund. UI submitted a refund plan with its proposed order. The refund plan outlines a procedure to identify contributors, make refunds, and treat unclaimed refunds as cost-free capital.

The Commission concludes that the amount of $337,200 should be refunded to the contributors of the CIAC; provided, however, that any unclaimed refunds will be retained by UI as cost-free capital. With support from the Public Staff, UI will be expected to obtain records from NTWS and proceeds from the Trustee with which to make refunds.

UI Should Maintain the Connection Fee Escrow Account for Capital Improvements

In Docket Nos. W-754, Subs 12 and 14, the Commission established a connection fee escrow account. Connection fee receipts are placed in this escrow account, and specific Commission approval is required before spending any of the funds in the account. Since the escrow account was set up, the Commission has allowed NTWS to use the funds to upgrade the sewer system and purchase land, building, vehicles and other utility assets.

In this docket, the Public Staff recommends that the balance in the connection fee escrow account on the date NTWS is sold be maintained by UI for the purposes of capital improvements for use only to upgrade and improve NTWS's sewer system. The Public Staff recommends that UI be required to file annually a report with the Commission listing the balance in the account, investment income received and expenditures made from the account. The Public Staff recommends that the balance in the escrow account will only affect rate base once expenditures are made from it and that UI increase both plant in service and CIAC for any amount spent out of the escrow fund.

UI expresses no objection to the Public Staff proposal. However, UI expresses its willingness to administer the escrow account in accordance with the Commission's wishes and directives without the need to file an annual report. UI is willing for the Commission to rely upon UI to use the escrow account funds reasonably and prudently and for the Commission to assess the prudence of UI's administration of the escrow fund in subsequent rate cases.

The Commission approves the recommendation for UI to maintain the connection fee escrow account to upgrade and improve the NTWS sewer system and to account for funds expended from the account. As connection fees are being reduced and UI will be responsible for funding most capital additions through its own resources, UI is released from the responsibility of placing connection fees collected after the transfer into the escrow account. The Commission concludes that it is unnecessary for UI to file an annual report, but the Commission will require UI to demonstrate its prudence in managing the escrow account in subsequent general rate cases.

UI's Management Plan is Acceptable

At the Public Staff's request, the Commission in its Order establishing hearing required UI to provide a proposed management plan for NTWS after Ui's acquisition. In

his direct testimony UI witness Wenz stated that a detailed plan could be formulated only after UI gains experience in operating the system. Mr. Wenz testified that UI had no immediate plans for cutbacks, but if UI can operate the system more efficiently, UI will do so. Mr. Wenz testified that if North Topsail can be operated with fewer people, after giving reasonable notice, UI would look for opportunities for current North Topsail employees elsewhere in the UI organization.

The Public Staff encourages UI to retain the current NTWS personnel, based on the Public Staff's belief that such employees will be critical to the continued satisfactory operation of the system. The Public Staff recommends that four months' notice be required prior to termination of any employee for any reason other than nonfeasance or malfeasance of duties.

The Commission concludes that UI's willingness not to make any immediate cutback in NTWS employees and to provide notice and seek to place such employees elsewhere in the UI system is adequate protection. The Commission finds good cause to approve UI's management plan.

IT IS, THEREFORE, ORDERED as follows:

1. That the transfer of the franchise to provide sewer utility service in North Topsail Beach, North Carolina, from North Topsail Water and Sewer Inc., to Utilities, Inc., be, and the same is hereby, approved, contingent upon Utilities, Inc., complying with decretal paragraph 2 below.

2. That Utilities, Inc., shall complete one of the attached bonds (Appendices A-1, A-2, or A-3) and return said bond to the Commission. If the bond selected is Appendix A-1, UI shall deposit the appropriate surety in the amount of $200,000 with Branch Banking & Trust Company, Attention: Julia Percivall, Trust Administrator, 3605 Glenwood Avenue, Raleigh, North Carolina 27612. If the bond selected is Appendix A-2 or Appendix A-3, UI shall file the appropriate surety and commitment letter (see Filing Requirement for Bonding, Appendix A-4) with the Commission.

3. That the request by Utilities, Inc., that the amount it is paying in excess of NTWS's original cost net investment be placed in its rate base as a debit plant acquisition adjustment be, and the same is hereby, denied.

4. That connection fees to be collected subsequent to the transfer shall be reduced to $1,200 per residential equivalent unit, equal to 360 gpd, with a minimum of $1,200 for each connection or dwelling unit. Commercial customers shall pay a connection fee based on the design flow of the business to be served, with a minimum of $1,200. Multi-unit construction shall pay $1,200 times the number of units served.

5. That, not later than 30 days from the date of this Order, the Public Staff shall review UI's refund plan for the refund of the overcollection of gross-up on CIAC and file its comments. The Commission will approve a refund plan by further Order.

6. That the connection fee escrow account established by the Commission in Docket Nos. W-754, Subs 12 and 14 shall be transferred to Utilities, Inc., as a source of funds used to upgrade the sewer system and Utilities, Inc., shall be relieved of the responsibility to place future connection fees into the escrow account.

7. That Utilities, Inc., shall follow the management plan approved herein.

8. That, upon Commission approval of the bond, surety and commitment letter, a further Order shall be issued granting a Certificate of Public Convenience and Necessity, approving a Schedule of Rates, and requiring public notice.

ISSUED BY ORDER OF THE COMMISSION.

This 6th day of January, 2000.

NORTH CAROLINA UTILITIES COMMISSION

Geneva S. Thigpen

Geneva S. Thigpen, Chief Clerk

mh010700.03

Commissioner Judy Hunt concurring and dissenting.

Chairman Jo Anne Sanford and Commissioner Robert V. Owens, Jr., did not participate in this decision.

DOCKET NO. W-1000, SUB 5

COMMISSIONER JUDY HUNT, CONCURRING AND DISSENTING: I agree with the Commission in approving the transfer, but disagree with the decision to deny acquisition adjustment.

The acquisition adjustment should be allowed for the following reasons:

1) Good public policy - encourages larger, more efficient, well-capitalized water companies to acquire smaller under-capitalized, troubled water companies.

2) Commission precedent - Commission has in recent past allowed acquisition adjustment in certain cases such as financially troubled; this company certainly qualifies as financially troubled because it is in bankruptcy.

\s\ Judy Hunt
Judy Hunt, Commissioner

NCUC DOCKET NO. W-1000, SUB 5 APPENDIX A-1

BOND

_____ of _____,
(Name of Utility) (City)
_____, as Principal, is bound to the State of North
(State)
Carolina in the sum of _____
_____ Dollars ($_____)
and for which payment to be made, the Principal by this bond binds himself, his, and its successors and assigns.

THE CONDITION OF THIS BOND IS:

WHEREAS, the Principal is or intends to become a public utility subject to the laws of the State of North Carolina and the rules and regulations of the North Carolina Utilities Commission, relating to the operation of a water or sewer utility _____
_____
(describe utility)
_____ and,

WHEREAS, North Carolina General Statutes § 62-110.3 requires the holder of a franchise for water or sewer service to furnish a bond with sufficient surety, as approved by the Commission, conditioned as prescribed in G.S. § 62-110.3, and Commission Rules R7-37 and/or R10-24, and,

WHEREAS, the Principal has delivered to the Commission _____
_____
(description of security)
with an endorsement as required by the Commission, and,

WHEREAS, the appointment of an emergency operator, either by the Superior Court in accordance with G.S. §62-118(b) or by the Commission with the consent of the owner, shall operate to forfeit this bond, and

WHEREAS, this bond shall become effective on the date executed by the Principal, and shall continue from year to year unless the obligations of the Principal under this bond are expressly released by the Commission in writing.

NOW THEREFORE, the Principal consents to the conditions of this Bond and agrees to be bound by them.

This the _____ day of _____ 2000.

_____
(Name)

NCUC DOCKET NO. W-1000, SUB 5 APPENDIX A-2

BOND

_____ of _____,
(Name of Utility) (City)
_____, as Principal, is bound to the State of North
(State)
Carolina in the sum of_____
_____Dollars ($_____) and for which payment to be made, the
Principal by this bond binds _____ and _____ successors and assigns.
(himself)(itself) (his)(its)

THE CONDITION OF THIS BOND IS:

WHEREAS, the Principal is or intends to become a public utility subject to the laws of the State of North Carolina and the rules and regulations of the North Carolina Utilities Commission, relating to the operation of a water and/or sewer utility _____

(describe utility)
_____ and,

WHEREAS, North Carolina General Statutes § 62-110.3 requires the holder of a franchise for water and/or sewer service to furnish a bond with sufficient surety, as approved by the Commission, conditioned as prescribed in G.S. § 62-110.3, and Commission Rules R7-37 and/or R10-24, and

WHEREAS, the Principal has delivered to the Commission an Irrevocable Letter of Credit from _____
(Name of Bank)
with an endorsement as required by the Commission, and,

WHEREAS, the appointment of an emergency operator, either by the Superior Court in accordance with G.S. 62-118(b) or by the Commission with the consent of the owner, shall operate to forfeit this bond, and

WHEREAS, if for any reason, the Irrevocable Letter of Credit is not to be renewed upon its expiration, the Bank shall, at least 60 days prior to the expiration date of the Irrevocable Letter of Credit, provide written notification by means of certified mail, return receipt requested, to the Chief Clerk of the North Carolina Utilities Commission, Post Office Box 29510, Raleigh, North Carolina 27626-0510, that the Irrevocable Letter of Credit will not be renewed beyond the then current maturity date for an additional period, and

WHEREAS, failure to renew the Irrevocable Letter of Credit shall, without the necessity of the Commission being required to hold a hearing or appoint an emergency operator, allow the Commission to convert the Irrevocable Letter of Credit to cash and deposit said cash proceeds with the administrator of the Commission's bonding program, and

WHEREAS, said cash proceeds from the converted Irrevocable Letter of Credit shall be used to post a cash bond on behalf of the Principal pursuant to North Carolina Utilities Commission Rules R7-37(e) and/or R10-24(e), and

WHEREAS, this bond shall become effective on the date executed by the Principal, and shall continue from year to year unless the obligations of the Principal under this bond are expressly released by the Commission in writing.

NOW THEREFORE, the Principal consents to the conditions of this Bond and agrees to be bound by them.

This the _____ day of _____ 2000.

_____
(Principal)

BY: _____

NCUC DOCKET NO. W-1000, SUB 5 APPENDIX A-3

BOND

_____ of _____, _____,
(Name of Utility) (City) (State)
as Principal, and _____, a corporation created and existing under
(Name of Surety)
the laws of _____, as Surety (hereinafter called "Surety"), are
(State)
bound to the State of North Carolina in the sum of _____ Dollars ($_____) and for which payment to be made, the Principal and Surety by this bond bind themselves and their successors and assigns.

THE CONDITION OF THIS BOND IS:

WHEREAS, the Principal is or intends to become a public utility subject to the laws of the State of North Carolina and the rules and regulations of the North Carolina Utilities Commission, relating to the operation of a water and/or sewer utility _____
(Describe utility)
_____ and,

WHEREAS, North Carolina General Statutes § 62-110.3 requires the holder of a franchise for water and/or sewer service to furnish a bond with sufficient surety, as approved by the Commission, conditioned as prescribed in § 62-110.3, and Commission Rules R7-37 and/or R10-24, and

WHEREAS, the Principal and Surety have delivered to the Commission a Surety Bond with an endorsement as required by the Commission, and

WHEREAS, the appointment of an emergency operator, either by the Superior Court in accordance with G.S. § 62-118(b) or by the Commission with the consent of the owner, shall operate to forfeit this bond, and

WHEREAS, if for any reason, the Surety Bond is not to be renewed upon its expiration, the Surety shall, at least 60 days prior to the expiration date of the Surety Bond, provide written notification by means of certified mail, return receipt requested, to the Chief Clerk of the North Carolina Utilities Commission, Post Office Box 29510, Raleigh, North Carolina 27626-0510, that the Surety Bond will not be renewed beyond the then current maturity date for an additional period, and

WHEREAS, failure to renew the Surety Bond shall, without the necessity of the Commission being required to hold a hearing or appoint an emergency operator, allow the Commission to convert the Surety Bond to cash and deposit said cash proceeds with the administrator of the Commission's bonding program, and

WHEREAS, said cash proceeds from the converted Surety Bond shall be used to post a cash bond on behalf of the Principal pursuant to North Carolina Utilities Commission Rules R7-37(e) and/or R10-24(e), and

WHEREAS, this bond shall become effective on the date executed by the Principal, for an initial _____ year term, and shall be automatically renewed for additional _____
(No. of Years) (No. of Years)
year terms, unless the obligations of the principal under this bond are expressly released by the Commission in writing.

NOW, THEREFORE, the Principal and Surety consent to the conditions of this bond and agree to be bound by them.

This the _____ day of _____ 2000.

_____
(Principal)

BY: _____

_____
(Corporate Surety)

BY: _____

APPENDIX A-4

Filing Requirements for Bonding

Type of Bond

	Cash / Certificate of Deposit Bond	Irrevocable Letter of Credit Bond	Commercial Surety Bond
Bond A-1	X 1/		
Bond A-2		X 1/	
Bond A-3			X 1/
Cash / CD	X 2/		
Letter of Credit		X 3/	
Surety Bond			X 4/
Commitment Letter		X 5/	X 5/

(To be filed with the Chief Clerk - where applicable)

1/ Copy of the Original Bond - Preferably on the forms prescribed in the Commission Order dated July 19, 1994, in Docket No. W-100, Sub 5 (Bond forms are usually attached to Order Requiring Bond for each specific franchise).

2/ Notification from Branch Banking & Trust Company (BB&T is the Commission's custodian for bond sureties) that cash or CD surety has been received for a given bond.

3/ Copy of Original Non-Perpetual Irrevocable Letter of Credit [Letter of Credit must comply with Rule R7-37 New Section (e)(4) as adopted by the Commission in its Order dated July 19, 1994, In Docket No. W-100, Sub 5.]

4/ Copy of Original Non-Perpetual Commercial Surety Bond [See No. 3 above]

5/ Copy of Commitment Letter

(a) This letter need only contain a statement indicating whether the utility is required to pledge utility company assets (collateral and type) to secure the bond or irrevocable letter of credit; and

(b) The premium paid by the utility (if any) to the bank and/or lending institution for their accommodation of the borrower.