# APPENDIX A

Staff Recommendation

Case Nos. WO-2005-0206 & SO-2005-0207
(consolidated)

March 28, 2005

Official Case File Memorandum

**M E M O R A N D U M**

TO: MO PSC Official Case File
Case Nos. WO-2005-0206 & SO-2005-0207 (consolidated)

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Water & Sewer Department
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**/s/ Dale W. Johansen** **03/28/05**
Project Coordinator Date

**/s/ Cliff E. Snodgrass** **03/28/05**
General Counsel's Office Date

SUBJECT: Staff Recommendation Regarding the Sale of the Regulated Utility Assets of Silverleaf Resorts, Inc. to Algonquin Water Resources of Missouri, LLC

DATE: March 23, 2005

**PROCEDURAL HISTORY**

On January 4, 2005*, Silverleaf Resorts, Inc., (Silverleaf, Company, or Seller), and Algonquin Water Resources of Missouri, LLC (Algonquin or Buyer) (collectively, the Joint Applicants) filed two Joint Applications requesting authority from the Commission for Silverleaf to sell all of its Missouri water system assets and sewer system assets to Algonquin. Additionally, the Joint Applications sought the transfer of Silverleaf's certificates of convenience of and necessity (certificates) to Algonquin, or alternatively the issuance of new certificates to Algonquin for Silverleaf's existing water and sewer service areas, so that Algonquin would have the authority to operate the systems being acquired. Further, the Joint Applicants requested authority to perform according to their Asset Purchase Agreement, and to perform any other lawful acts necessary to complete the proposed transactions. At the time they filed the Joint Applications, the Joint Applicants also filed motions to consolidate the Joint Applications, asserting that the sales of the water system assets and the sewer system assets are governed by one and the same transaction, that the two applications involve common questions of law, and for administrative expediency.

On January 6, the Commission issued its Order Directing Notice, Consolidating Cases, Setting Date for Submission of Intervention Requests, and Directing Filing, in which it required that notice of the Joint Applications be issued, granted the request to consolidate the Joint Applications (under Case No. WO-2005-0206), set February 4 as the deadline for intervention requests and directed the Staff to file its recommendation regarding the Joint Applications no later than March 7.

No requests to intervene in this case were filed on or before the February 4 intervention deadline, nor have any such requests been filed since that date.

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* Unless noted otherwise, all dates herein refer to the year 2005.

On March 7, the Staff filed a *Request for Extension of Time to Submit Recommendation*, in which it requested that it be granted an extension to March 21 to file its recommendation. On March 16, the Commission issued its Order Directing Filing, in which it granted the Staff's request to extend the filing date of the Staff's recommendation to March 21. On March 21, the Staff filed a second *Request for Extension of Time to Submit Recommendation*, in which it requested that it be granted an extension to March 23 to file its recommendation. Also on March 21, the Commission issued its Order Directing Filing, in which it granted the Staff's request to extend the filing date of the Staff's recommendation and directed the Staff to file its recommendation no later than 4:00 p.m. on March 28.

## THE JOINT APPLICANTS

Silverleaf is a Texas corporation, duly authorized to do business in Missouri, with its headquarters in Dallas, Texas. Silverleaf provides regulated water and sewer services to the Ozark Mountain Resort near Kimberling City in Taney County; the Timber Creek Resort near DeSoto in Jefferson County; and the Holiday Hills Resort near Branson in Stone County. Silverleaf has approximately 720 water service customers and approximately 250 sewer service customers.

Algonquin is a newly formed Missouri limited liability company in good standing, with its headquarters located at Litchfield Park, Arizona. Algonquin's sole member is Algonquin Water Resources of America (AWRA), a Delaware corporation that is an indirect, wholly-owned subsidiary of Algonquin Power Income Fund, a publicly-traded Canadian income trust, which holds some $800 million in energy and infrastructure-related assets in the United States and Canada. AWRA serves 50,000 water service and wastewater service connections in the southern United States through numerous subsidiaries.

## STAFF'S INVESTIGATION

As noted at the beginning of this Memorandum, Staff members from the Auditing Department, the Engineering & Management Services Department, the Water & Sewer Department and the General Counsel's Office participated in the Staff's investigation of the Joint Applications. All participants in the Staff's investigation were provided the opportunity to review and comment on the initial draft of this Memorandum, which Graham Vesely of the Auditing Department created. Comments received from the reviewers were then incorporated into the initial draft to create the final version of this Memorandum.

Items reviewed as a part of the Staff's investigation included the Joint Applications and the attachments to the applications, including the subject asset purchase agreement. Additionally, the Staff performed a review of Silverleaf's books and records, as well as the Company's prior small company rate increase submissions, for the purpose of determining the Company's current ratemaking rate base, which in turn was used to determine if the proposed transactions involve an acquisition adjustment. The Staff also reviewed Silverleaf's existing depreciation rates to determine if any changes to the rates are needed. Additionally, the Staff reviewed the financial impact of the proposed transactions on Algonquin to determine if they might have an adverse impact on Algonquin.

In addition to the items noted above, the Staff reviewed the status of the Joint Applicants' annual report submissions and assessment payments, and reviewed the Commission's active cases to determine if the Joint Applicants have any other matters pending before the Commission. Additionally, the Staff reviewed available information regarding the compliance history of Silverleaf's systems with regard to the regulations of the Department of Natural Resources and the Commission, generally reviewed the status of the condition of Silverleaf's water and sewer systems, and evaluated Algonquin's capabilities of operating the subject systems.

Regarding a review of customer comments responding to the notice of the Joint Applications, which the Company mailed to its customers on January 26, the Staff notes that it did not receive any comments from Silverleaf's customers.

## STAFF'S FINDINGS & CONCLUSIONS

### ACQUISITION PREMIUM ISSUES IDENTIFIED BY THE STAFF

#### Recovery of Acquisition Premiums

Consistent with established policy, it is the Staff's position that Algonquin should not be allowed to recover any of the acquisition premiums discussed below, either directly or indirectly, through adjustments to the calculation of its customer rates. (It is also the Staff's position that Algonquin should not be allowed to recover any claimed merger savings through its customer rates, where the recovery of such savings would allow Algonquin to either directly or indirectly recover any of the acquisition premiums discussed below. Additionally, it is the Staff's position that Algonquin should not be allowed to recover any transaction or transition costs associated with its purchase of Silverleaf's utility through its customer rates.)

#### Purchase Price vs. Recorded Net Book Value of Assets

Based on a review of the pro-forma balance sheet included in Appendix F to the Joint Applications, and information provided to the Staff regarding Missouri's allocated portion of the total purchase price set out in the Asset Purchase Agreement (Appendix C to the Joint Applications), which is $3,8000,000, it is clear that Algonquin will be paying more than the net book value (original cost less accumulated depreciation) of the Missouri utility assets that it is seeking authority to purchase from Silverleaf. Based on the above-referenced information, the amount of the acquisition premium is approximately $720,000 – *even without consideration of any of the other acquisition premium issues discussed below*.

#### Contributed Plant

The pro-forma balance sheet included in Appendix F to the Joint Applications does not appear to make a distinction between the utility plant assets funded through investments made by the utility company, and the assets funded through contributions-in-aid-of-construction or contributed to the utility company (collectively, contributed plant). The Company and the Staff have had previous disagreements regarding the plant items that should be treated as contributed plant under the terms of the Company's tariff, which has also resulted in disagreements regarding the plant that should be included in the calculation of the Company's ratemaking rate base.

Regarding the Company's tariffs, this matter is covered by the Schedule of Service Charges and Rule No. 14 of the water tariff, and by Rule No. 5 and Rule No. 10 of the sewer tariff.

To the extent that Silverleaf's regulatory books and records include plant balances that are not calculated consistent with its tariff provisions regarding this matter, it is likely that the plant balances reflected in the above-referenced pro-forma balance sheet are overstated. Based on its review of available information, the Staff believes this to be the case and further believes that the amount of this overstatement is approximately $1,351,550.

Construction Cost Overruns

As a result of the work done by the Staff in the most recent Silverleaf cases, Case Nos. SO-2002-1039 & WO-2002-1040, the Staff concluded that approximately $207,180 of the costs associated with the construction of Well No. 2 in the Holiday Hills water system should be disallowed from plant-in-service. In the Staff's view, these costs resulted from errors on the Company's part in failing to properly coordinate the design of the new project with the as-built conditions of another previously completed project.

In reaching its conclusion regarding this matter, the Staff made a distinction between the costs for work that was not planned, but would have been necessary all along, and costs that were avoidable – such as those caused by delays and re-work that affected the new project, and those caused by the Company's failure to properly verify and document existing as-built conditions. From an accounting perspective, avoidable cost overruns should be written off as a loss in the period they are incurred, and should not be allowed to become part of the original cost of the plant assets in question. The adjustment the Staff made for this matter was reflected in the revenue requirement summaries presented to the Silverleaf in the above-referenced cases, and the Company was also provided the opportunity to review the Staff's work papers regarding those summaries in general and this matter in particular.

To the extent that Silverleaf has not adjusted its regulatory books and records consistent with the Staff's position regarding this matter, it is likely that the full original cost of this project is reflected in the pro-forma balance sheet included in Appendix F to the Joint Applications. Based on its review of available information, the Staff believes this to be the case and further believes that the resulting overstatement of the book value of this project is approximately $207,180.

Plant-In-Service and Depreciation Reserves

In addition to the specific matters discussed in the two previous sections, there are on-going differences in various plant and depreciation reserve balances between the Staff and Silverleaf, which originated with the first rate case audit done of Silverleaf's Missouri utilities. These differences, which have consistently been reflected in the results of the Staff's past earnings reviews pertaining to Silverleaf's operations, have carried into the present time and it is thus likely that they affect certain of the plant balances shown in the pro-forma balance sheet included in Appendix F to the Joint Applications. Based on its review of available information, the Staff believes this to be the case and further believes that the plant and depreciation reserve balances shown on the referenced balance sheet are misstated by totals of approximately $1,223,890 and $721,450, respectively.

Summary of the Staff's Calculated Rate Base and Related Acquisition Premium

The Staff's calculated value of the ratemaking rate base for Silverleaf's utility assets totals approximately $1,454,400 as of December 31, 2004. Based on this rate base value and Missouri's allocated portion of the total purchase price set out in the Asset Purchase Agreement, which as noted previously is $3,800,000, the acquisition premium involved in Algonquin's proposed purchase of Silverleaf's utility assets is approximately $2,345,600. A worksheet showing the Staff's calculated ratemaking rate base value of Silverleaf's utility assets is attached hereto and identified as Attachment 1.

RATEMAKING ISSUE IDENTIFIED BY THE STAFF

As with the construction cost overrun issue discussed above, this issue involves the construction of Well No. 2 in the Holiday Hills water system. Based on information that the Staff obtained from Silverleaf, the purpose of this project was to accommodate an expected increase in customer demand for water service related to the Company's plan to expand its Holiday Hills resort facilities. The reasoning supporting this project is detailed in an Engineering Report dated March 1997 that was prepared by Wasteline Engineering, Inc. on Silverleaf's behalf, and which was submitted to the Missouri Department of Natural Resources as part of the process for obtaining a construction permit for the project. This report was also provided to the Staff in conjunction with its work in Case Nos. SO-2002-1039 & WO-2002-1040.

At the time of the field work that the Staff performed in connection with its overall investigation related to the above-referenced cases, which was done in late 2002, the Well No. 2 project had been completed and the well was being used to augment the water supply for the Holiday Hills system. Once this second well was brought on line, Silverleaf's records show that the Holiday Hills system was able to operate without any service at all from the first well during the high water demand months of August and September 2002. However, it was also clear from a review of Silverleaf's records that the second well was not needed to provide water service to the then existing level of customers. As a result, the Staff concluded that Well No. 2 was not "used and useful" from a ratemaking viewpoint. In fact, this conclusion was consistent with the conclusions found in the above-referenced Engineering Report, wherein, with regard to the existing water supply system, it was stated "that no improvements are required to serve the current customers".

Since 1997, the number of customer units being served by the Holiday Hills water system has increased from 290 to 450 at the end of 2004. However, the addition of Well No. 2 was designed to support 800 customer units at the resort. Based on this information, it is the Staff's position that only the portion of the reasonable and necessary costs of this project (the total project cost less the cost overruns discussed previously in this Memorandum) required to meet the actual current water demand should be included in plant-in-service for purposes of calculating the Company's ratemaking rate base. The result of this position is that the remaining balance of the reasonable and necessary costs of the project is considered plant held for future use, and should thus not be charged to current customers. However, if customer growth does occur in the future in this system, then more of the reasonable and necessary project costs can be added to rate base. Based on its review of available information, the Staff's calculated balance of this plant held for future use is approximately $264,430.

While the Staff does not believe that this issue constitutes an acquisition premium, it is an issue that the Staff believes should be brought to the attention of the parties to the case and the Commission. Lastly, the Staff notes that its position on this issue was reflected in the results of Silverleaf's "earnings status" reported by the Staff for the affected service area in the context of Case No. WO-2002-1040.

## ADDITIONAL MATTERS REVIEWED BY THE STAFF

### Impact of the Proposed Transactions on Algonquin

As noted previously, Algonquin is part of Algonquin Water Resources of America (AWRA), AWRA is an indirect wholly owned subsidiary of the publicly-traded entity Algonquin Power Income Fund (the Fund), and AWRA currently serves approximately 50,000 water and wastewater connections in Arizona and Texas.

The Fund is listed on the Toronto Stock Exchange under the ticker symbol of APF.UN. The Fund was established in 1997 to own energy and infrastructure related assets in the U.S. and Canada. The Fund has grown to hold approximately $800 million in assets.

According to the Algonquin Power web site, "Standard and Poor’s has assigned the Fund a ‘SR-2’ Canadian stability rating. A stability rating of ‘SR-2’ indicates a very high level of stability in expected distributions and the outlook is stable. The Fund believes that the Standard and Poor’s ‘SR-2’ stability rating confirm the strength and stability of the asset portfolio comprising the Fund and endorse the execution of the risk diversification strategy being pursued by the Fund."

Based upon the information contained in the Joint Applications and the attachments thereto, and other sources that were relied upon, the Staff does not believe that the proposed transactions will adversely affect the financial condition of Algonquin, particularly when evaluated at the level of its parent companies – so long as Algonquin does not pay a significant acquisition premium for the assets it is proposing to purchase, as it would not be allowed recovery of such a premium pursuant to the Staff's position in this case.

### Depreciation Rates

Based on its review of Silverleaf's current depreciation rates, the Staff is of the opinion that no changes are needed and that Algonquin should continue to utilize these rates for the purpose of maintaining its regulatory books and records.

### Algonquin's Use of Silverleaf's Existing Tariffs

As noted in Paragraph 14 of the Joint Applications, Algonquin plans to continue to utilize Silverleaf's tariffs subsequent to the purchase of Silverleaf's water and sewer systems, and to accomplish this it will file the tariff sheets needed to adopt Silverleaf's tariffs as its own. In this regard, Algonquin will need to file a tariff title page, a tariff adoption page and an index page for each of Silverleaf's tariffs. Additionally, in order for there to clearly be no "break" in the continued effectiveness of the provisions of Silverleaf's tariffs, the Staff believes that Algonquin should be specifically authorized to operate under Silverleaf's tariffs until such time that the necessary tariff sheets are submitted and approved.

Transfer of Existing Certificates vs. Granting New Certificates

Regarding the matter of the transfer of Silverleaf's certificates to Algonquin or the issuance of new certificates to Algonquin for Silverleaf's certificated service areas, the Staff believes that the Commission should act consistent with its past practices regarding this matter. In asset transfer cases involving water and/or sewer companies, the Commission has historically taken the position that certificates are not "transferable" and has thus canceled the certificate of the seller and issued a new certificate to the buyer, with both actions normally set to be effective upon the closing of the asset transfer transactions. The Staff believes that this practice is appropriate and sees no reason to depart from that practice in this instance.

Condition of Silverleaf's Water & Sewer Systems

Regarding the overall condition of Silverleaf's water and sewer systems, the Staff notes that it is not aware of any specific deficiencies, capacity issues, service problems or DNR compliance matters that need attention at this time.

Algonquin's Operation of Silverleaf's Water & Sewer Systems

Although Algonquin is a newly formed company, the Staff notes that Algonquin's parent company, Algonquin Water Resources of America, serves approximately 50,000 water and wastewater connections in the United States through other subsidiaries. Two such subsidiaries mentioned in the Joint Applications are the Litchfield Park Service Company of Phoenix, Arizona and the Bella Vista Water Company of Sierra Vista, Arizona (see paragraph 5 of the Joint Applications). Additionally, and perhaps most importantly, the Staff has been advised that Silverleaf's current local managers and operations personnel will remain in their current positions and become employees of Algonquin. The Staff further notes that its experiences with these personnel have generally been positive, and that these personnel normally respond in a timely and positive manner when operations-related matters are brought to their attention.

Annual Reports, Assessments & Other Pending Actions

As noted in the Joint Applications, and confirmed by the Staff, Silverleaf is current with respect to the submission of its annual reports and the payment of its Commission assessments, and is not the subject of any pending actions involving service or rates. As a new company in Missouri, Algonquin has not yet been required to submit annual reports or pay Commission assessments, and is only involved in the subject Joint Applications before the Commission.

## STAFF'S RECOMMENDATION

Based on the above, it is clear that there are significant issues regarding the matter of the amount of the acquisition premium that may exist as a result of Missouri's allocated portion of the overall purchase price set forth in the Asset Purchase Agreement and the actual net book value of Silverleaf's utility assets. As a result, the Staff recommends that the Commission issue an order that: (1) establishes a date for a settlement conference for this case; (2) directs the parties to participate in the settlement conference for the purpose of resolving as many of the acquisition premium issues identified herein as is possible; and (3) directs the parties to advise the Commission, within 10 days after the date of the settlement conference, whether an evidentiary hearing will be needed in this case.

# Attachment 1 to Case File Memo

# Summaries of Ratemaking Rate Base

**Silverleaf Resorts, Inc.**

**Summaries of Ratemaking Rate Base**

| **Timber Creek Service Area** | **Staff** | | | **Company** | **Difference** |
|---|---|---|---|---|---|
| | Water | Sewer | Total | Total | Total |
| Total Plant in Service | $ 1,036,675 | $ 752,795 | $ 1,789,470 | $ 1,573,320 | $ 216,150 |
| Non-CIAC Plant Reserve | $ 200,000 | $ 240,040 | $ 440,040 | $ 440,040 | $ - |
| Net Plant in Service | $ 836,675 | $ 512,755 | $ 1,349,430 | $ 1,133,280 | $ 216,150 |
| CIAC | $ 308,375 | $ 185,785 | $ 494,160 | $ - | $ 494,160 |
| Rate Base | $ 528,300 | $ 326,970 | $ 855,270 | $ 1,133,280 | $ (278,010) |

| **Ozark Mountain Service Area** | **Staff** | | | **Company** | **Difference** |
|---|---|---|---|---|---|
| | Water | Sewer | Total | Total | Total |
| Total Plant in Service | $ 271,455 | $ 317,940 | $ 589,395 | $ 556,985 | $ 32,410 |
| Non-CIAC Plant Reserve | $ 87,820 | $ 157,265 | $ 245,085 | $ 217,400 | $ 27,685 |
| Net Plant in Service | $ 183,635 | $ 160,675 | $ 344,310 | $ 339,585 | $ 4,725 |
| CIAC | $ 149,665 | $ 141,835 | $ 291,500 | $ - | $ 291,500 |
| Rate Base | $ 33,970 | $ 18,840 | $ 52,810 | $ 339,585 | $ (286,775) |

| **Holiday Hills Service Area** | **Staff** | | | **Company** | **Difference** |
|---|---|---|---|---|---|
| | Water | Sewer | Total | Total | Total |
| Total Plant in Service | $ 1,288,530 | $ - | $ 1,288,530 | $ 2,263,860 | $ (975,330) |
| Non-CIAC Plant Reserve | $ 176,320 | $ - | $ 176,320 | $ 870,095 | $ (693,775) |
| Net Plant in Service | $ 1,112,210 | $ - | $ 1,112,210 | $ 1,393,765 | $ (281,555) |
| CIAC | $ 565,890 | $ - | $ 565,890 | $ - | $ 565,890 |
| Rate Base | $ 546,320 | $ - | $ 546,320 | $ 1,393,765 | $ (847,445) |

| **Total Company Rate Base** | |
|---|---|
| Staff Total | $ 1,454,400 |
| Company Total | $ 2,866,630 |
| Total Difference | $ (1,412,230) |

| **Acquisition Premium** | |
|---|---|
| Staff Total Rate Base | $ 1,454,400 |
| Allocated Sale Price | $ 3,800,000 |
| Acquisition Premium | $ (2,345,600) |

Notes:

(1) Numbers Shown as of 12/31/04

(2) Difference = Staff minus Company