

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Water and wastewater
industry annual reestablishment
of authorized range of return on
common equity of water and
wastewater utilities pursuant to
Section 367.081(4)(f), F.S.

DOCKET NO. 010006-WS
ORDER NO. PSC-01-2139-PHO-WS
ISSUED: November 2, 2001

Pursuant to Notice and in accordance with Rule 28-106.209, Florida Administrative Code, a Prehearing Conference was held on October 22, 2001, in Tallahassee, Florida, before Commissioner Michael A. Palecki, as Prehearing Officer.

APPEARANCES:

J. STEPHEN MENTON, ESQUIRE, Rutledge, Ecenia, Purnell & Hoffman, P.A., P.O. Box 551, Tallahassee, Florida 32302-0551
On behalf of FLORIDA WATERWORKS ASSOCIATION.

STEPHEN BURGESS, ESQUIRE, c/o The Florida Legislature, 111 West Madison Street, Room 812, Tallahassee, Florida 32399-1400
On behalf of OFFICE OF PUBLIC COUNSEL.

RALPH R. JAEGER, ESQUIRE, Florida Public Service Commission, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850
On behalf of the COMMISSION STAFF.

PREHEARING ORDER

I. CONDUCT OF PROCEEDINGS

Pursuant to Rule 28-106.211, Florida Administrative Code, this Order is issued to prevent delay and to promote the just, speedy, and inexpensive determination of all aspects of this case.

DOCUMENT NUMBER-DATE

13861 NOV-25

FPSC-COMMISSION CLERK

II. CASE BACKGROUND

On June 1, 2001, the Commission issued Proposed Agency Action Order No. PSC-01-1226-PAA-WS, proposing to establish authorized range of returns on common equity as required by Section 367.081(4)(f), Florida Statutes, in the year 2001. However, the Florida Waterworks Association timely filed its protest of this Order. Pursuant to this protest, a hearing has been scheduled to be held on November 5, 2001, to establish the authorized range of returns on common equity. Opening statements, if any, shall not exceed ten minutes per party.

III. JURISDICTION

This Commission is vested with jurisdiction over the subject matter by the provisions of Chapter 367.081(4)(f), Florida Statutes. This prehearing conference will be governed by said Chapter as well as Chapter 120, and Chapters 25-9, 25-30, 25-22, and 28-106, Florida Administrative Code.

IV. PROCEDURE FOR HANDLING CONFIDENTIAL INFORMATION

A. Any information provided pursuant to a discovery request for which proprietary confidential business information status is requested shall be treated by the Commission and the parties as confidential. The information shall be exempt from Section 119.07(1), Florida Statutes, pending a formal ruling on such request by the Commission, or upon the return of the information to the person providing the information. If no determination of confidentiality has been made and the information has not been used in the proceeding, it shall be returned expeditiously to the person providing the information. If a determination of confidentiality has been made and the information was not entered into the record of the proceeding, it shall be returned to the person providing the information within the time periods set forth in Section 367.156, Florida Statutes.

B. It is the policy of the Florida Public Service Commission that all Commission hearings be open to the public at all times. The Commission also recognizes its obligation pursuant to Section 367.156, Florida Statutes, to protect proprietary confidential business information from disclosure outside the proceeding.

1. Any party intending to utilize confidential documents at hearing for which no ruling has been made, must be prepared to present their justifications at hearing, so that a ruling can be made at hearing.

2. In the event it becomes necessary to use confidential information during the hearing, the following procedures will be observed:

- a) Any party wishing to use any proprietary confidential business information, as that term is defined in Section 367.156, Florida Statutes, shall notify the Prehearing Officer and all parties of record by the time of the Prehearing Conference, or if not known at that time, no later than seven (7) days prior to the beginning of the hearing. The notice shall include a procedure to assure that the confidential nature of the information is preserved as required by statute.
- b) Failure of any party to comply with 1) above shall be grounds to deny the party the opportunity to present evidence which is proprietary confidential business information.
- c) When confidential information is used in the hearing, parties must have copies for the Commissioners, necessary staff, and the Court Reporter, in envelopes clearly marked with the nature of the contents. Any party wishing to examine the confidential material that is not subject to an order granting confidentiality shall be provided a copy in the same fashion as provided to the Commissioners, subject to execution of any appropriate protective agreement with the owner of the material.
- d) Counsel and witnesses are cautioned to avoid verbalizing confidential information in such a way that would compromise the confidential information. Therefore, confidential information should be presented by written exhibit when reasonably possible to do so.

- e) At the conclusion of that portion of the hearing that involves confidential information, all copies of confidential exhibits shall be returned to the proffering party. If a confidential exhibit has been admitted into evidence, the copy provided to the Court Reporter shall be retained in the Division of the Commission Clerk and Administrative Services' confidential files.

V. POST-HEARING PROCEDURES

Each party shall file a post-hearing statement of issues and positions. A summary of each position of no more than 50 words, set off with asterisks, shall be included in that statement. If a party's position has not changed since the issuance of the prehearing order, the post-hearing statement may simply restate the prehearing position; however, if the prehearing position is longer than 50 words, it must be reduced to no more than 50 words. If a party fails to file a post-hearing statement, that party shall have waived all issues and may be dismissed from the proceeding.

Pursuant to Rule 28-106.215, Florida Administrative Code, a party's proposed findings of fact and conclusions of law, if any, statement of issues and positions, and brief, shall together total no more than 40 pages, and shall be filed at the same time.

VI. PREFILED TESTIMONY AND EXHIBITS; WITNESSES

Testimony of all witnesses to be sponsored by the parties and Staff has been prefiled. All testimony which has been prefiled in this case will be inserted into the record as though read after the witness has taken the stand and affirmed the correctness of the testimony and associated exhibits. All testimony remains subject to appropriate objections. Each witness will have the opportunity to orally summarize his or her testimony at the time he or she takes the stand. Summaries of testimony shall be limited to five minutes. Upon insertion of a witness' testimony, exhibits appended thereto may be marked for identification. After all parties and Staff have had the opportunity to object and cross-examine, the exhibit may be moved into the record. All other exhibits may be similarly identified and entered into the record at the appropriate time during the hearing.

Witnesses are reminded that, on cross-examination, responses to questions calling for a simple yes or no answer shall be so answered first, after which the witness may explain his or her answer.

The Commission frequently administers the testimonial oath to more than one witness at a time. Therefore, when a witness takes the stand to testify, the attorney calling the witness is directed to ask the witness to affirm whether he or she has been sworn.

VII. ORDER OF WITNESSES

<u>Witness</u>	<u>Proffered By</u>	<u>Issues #</u>
<u>Direct</u>		
Dr. Roger A. Morin	FWA	1, 2, 3, 4
Mark A. Cicchetti	OPC	1, 2, 3, 4
Pete Lester	STAFF	1, 2, 3, 4

<u>Rebuttal</u>		
Dr. Roger A. Morin	FWA	1, 2, 3, 4
Mark A. Cicchetti	OPC	1, 2, 3, 4

VIII. BASIC POSITIONS

FWA: This docket was opened as a result of FWA's petition challenging the Commission's Proposed Agency Action Order No. PSC-01-1226-PAA-WS (the "PAA Order") issued June 1, 2001. The PAA Order proposes a continuation (with only a minor correction and a minor modification) of the existing leverage formula methodology used for calculating a reasonable range of returns on equity for water and wastewater utilities. The current leverage formula methodology has essentially been followed by the Commission for several years without any significant

modifications to reflect changes in the industry. FWA contends that the proposed regulatory treatment embodied in the existing leverage formula methodology does not appropriately reflect the risks and issues facing the industry. FWA also contends that the financial models utilized by the Commission in the PAA Order result in rates of return that are significantly lower than the rates of return on equity authorized for other Commission regulated utilities. The rates of return that result from the selected financial models also result in rates of return that are significantly lower than returns authorized for water and wastewater utilities in other states.

The FWA contends that the Commission should not simply continue the current leverage formula methodology for water and wastewater utilities as proposed in the PAA Order. The range of returns on equity calculated under the PAA Order are not fair and reasonable. A more thorough and objective analysis results in a range of return between 10% to 13.4% with a mid point of 11.7% for a typical Florida water and wastewater utility.

OPC: The leverage formula described in Order No. PSC-01-1226-PAA-WS results in liberal equity returns that equal or exceed the "range of returns on common equity for an average water and wastewater utility," as required by Section 367.081(4)(f), Florida Statutes.

STAFF: Staff's positions are preliminary and based on materials filed by the parties and on discovery. The preliminary positions are offered to assist the parties in preparing for the hearing. Staff's final positions will be based upon all the evidence in the record and may differ from the preliminary positions. The following 2001 Leverage Formula should be approved:

Return on Common Equity = $8.95\% + 0.738/\text{Equity Ratio}$

Where the Equity Ratio = $\text{Common Equity} / (\text{Common Equity} + \text{Preferred Equity} + \text{Long-Term and Short-Term Debt})$

Range: 9.69% @ 100% equity to 10.80% @ 40% equity

IX. ISSUES AND POSITIONS

A. Issue of Fact

ISSUE 1: What is the most appropriate model or method to estimate a fair and reasonable return on a water and wastewater utility's common equity capital?

POSITIONS

FWA: No individual model or approach provides the necessary level of accuracy. Several different approaches should be utilized to cross-check results. The PAA Order is based upon a sample of utilities that is not reflective of Commission regulated water and wastewater utilities. The sample is too small in size and utilizes a disproportionate number of utilities located out-of-state who operate in markets and circumstances which do not reflect the water and wastewater industry in Florida. Furthermore, the current leverage formula utilizes an index of out-of-state water utilities that have publically traded stock. This sample does not accurately reflect a typical Florida water and wastewater company. A more diversified and focused use of financial models produces a significantly higher range of returns than contained in the PAA Order. Strict adherence to the Commission's models has resulted in rates of return that are significantly lower than the returns on equity authorized for water and wastewater utilities in other states. Consequently, investment in Florida water and wastewater utilities is comparatively becoming less and less attractive. Florida water and wastewater utilities will not be able to attract the capital funds needed to meet their service demands and to maintain financial integrity with the range of returns calculated using the current methodology.

An independent, diversified analysis of the fair and reasonable range of return on equity upon which the Commission should base its leverage formula methodologies for water and wastewater utilities in the State of

Florida results in a range of returns significantly higher than contained in the PAA Order. (Morin)

OPC: The most appropriate model is that which is used in the PAA. With occasional modifications, this model has been used for many years and clearly has proven to result in ROEs that attract capital investment to the industry. (Cicchetti)

STAFF: With its four modifications to the existing leverage formula methodology, staff believes that its position in Issue 4 sets forth the appropriate range of returns on common equity. However, staff's final position will be dependent upon the record developed at the hearing. (Lester)

B. Mixed Issue of Law and Policy

ISSUE 2: Should the Commission, as a matter of law or policy, establish a leverage formula that systematically results in an allowed equity return that is either higher or lower than the actual measured cost of equity for an average water or wastewater utility at the corresponding equity ratio?

POSITIONS

FWA: FWA objects to this issue as framed on the grounds that it is unnecessarily argumentative and is subsumed in Issues 1, 3 and 4. As discussed in FWA'S positions with respect to those issues, there is no single method for measuring the cost of equity. Each model has its own strengths and weaknesses. Section 367.081(4)(f), Florida Statutes, does not limit the Commission to consideration of any single model for determining the cost of equity. As a matter of policy, the Commission should consider and evaluate the testimony and evidence regarding various approaches for estimating the cost of equity in determining the appropriate range of returns for water and wastewater utilities. (Morin)

OPC: No. Sound public policy as well as Section 367.081(4)(f), F.S., contemplates the establishment of authorized equity returns that equal -- not systematically exceed -- the actual cost of equity. (Cicchetti)

STAFF: Pursuant to Section 367.081(4)(f), Florida Statutes, the Commission must establish a leverage formula that reasonably reflects the range of returns on common equity for an average water or wastewater utility. With its four modifications to the existing leverage formula methodology, staff believes that its position in Issue 4 sets forth the appropriate range of returns on common equity. However, staff's final position will be dependent upon the record developed at the hearing. (Lester)

C. Issue of Policy

ISSUE 3: Is there justification for utilizing a leverage formula methodology that yields a lower return on equity for water and wastewater utilities as compared to other rate-based regulated industries in Florida and elsewhere?

POSITIONS

FWA: The current leverage formula methodology for water and wastewater utilities produces returns on equity that are significantly less than the composite authorized rate of return for Commission regulated electric and gas utilities. There is no reasonable or justified basis for this difference.

The proposed regulatory treatment embodied in the PAA Order does not appropriately reflect the risks and issues facing the water and wastewater industry. This industry is a rising cost industry facing uncertain and continually changing environmental regulations and conditions. Thus, water and wastewater utilities must assume greater business risks than in the past. The Commission's proposed continuation of the current formula fails to adequately recognize these risks and thereby jeopardizes the financial viability of the utilities and

potentially compromises their ability to provide adequate, safe and reliable service. (Morin)

OPC: The formula should reflect the actual cost of equity for an average water/wastewater utility, not ROE's stipulated in some other industry. If risk factors associated with another industry are different (e.g., threat of restructuring, absence of pass-throughs or indexing), the ROEs should reflect that difference. (Cicchetti)

STAFF: While other industries may be used as a reference, the particular risk associated with an average water and wastewater utility in Florida is what must be used to calculate the appropriate return on common equity. Again, with its four modifications to the existing leverage formula methodology, staff believes that its position in Issue 4 sets forth the appropriate range of returns on common equity. However, staff's final position will be dependent upon the record developed at the hearing. (Lester)

D. Mixed Issues of Fact, Law and Policy

ISSUE 4: What is the appropriate range of returns on common equity for water and wastewater utilities pursuant to Section 367.081(4)(f), Florida Statutes?

POSITIONS

FWA: A just and reasonable range of return on common equity to be used as part of the leverage formula methodology for ratemaking purposes on a company's common equity capital should be 10% to 13.4% with the mid-point of 11.7% for a typical Florida water and wastewater utility with an average capital structure. Individual rates of return on equity can be determined within that range in accordance with the leverage adjustment based upon the common equity ratio of each company. The range of return set forth in the PAA Order is too low. The proposed continuation of the current leverage formula methodology for water and wastewater utilities produces returns on equity that are significantly less than the composite authorized rate of return for competing investments of similar risks. There

is no reasonable or justified basis for this difference. The range of returns calculated in accordance with the PAA Order would place Florida water and wastewater utilities at a competitive disadvantage in the capital markets.

A formal comprehensive review of the leverage formula should be undertaken so that individual ranges of return on equity can be more fairly and accurately calculated. (Morin)

OPC: 9.14% ROE @ 100% equity ratio to 10.24% ROE @ 40% (or lower) Equity ratio, based on the formula: Return on Common Equity = 8.41% + 0.731/Equity Ratio. (Cicchetti)

STAFF: The Commission should make four modifications to the existing leverage formula methodology, updated with current financial data. The four modifications or adjustments are: (1) add 10 basis points to the CAPM results to allow for flotation costs; (2) add 10 basis points to the market return in the CAPM model to allow for quarterly compounding of dividends; (3) use an index of natural gas distribution companies along with an index of water companies with both the DCF and CAPM models; and (4) add 50 basis points as the appropriate small-utility risk premium. Based on these four modifications, staff recommends the following leverage formula:

Return on Common Equity = 8.95% + 0.738/Equity Ratio

Where the Equity Ratio = Common Equity / (Common Equity + Preferred Equity + Long-Term and Short-Term Debt)

Range: 9.69% @ 100% equity to 10.80% @ 40% equity (Lester)

ISSUE 5: Should this docket be closed?

POSITIONS

FWA: Agrees with staff.

ORDER NO. PSC-01-2139-PHO-WS
DOCKET NO. 010006-WS
PAGE 12

OPC: Agrees with staff.

STAFF: This docket should remain open to allow staff to monitor the movement in capital costs and to readdress the reasonableness of the leverage formula as conditions warrant. (Lester)

X. EXHIBIT LIST

<u>Witness</u>	<u>Proffered By</u>	<u>I.D. No.</u>	<u>Description</u>
			<u>Direct</u>
Dr. Roger A. Morin	FWA	RAM Appendix A	Flotation Cost Allowance
		RAM-1	Resume
		RAM-2	Annual long-term risk premium analysis-- Moody's electric utility common stocks over long-term treasury bonds
		RAM-3	Annual long-term risk premium analysis-- Moody's natural gas distribution common stocks over long-term treasury bonds

<u>Witness</u>	<u>Proffered By</u>	<u>I.D. No.</u>	<u>Description</u>
Dr. Roger A. Morin	FWA	RAM-4	Value line water utilities DCF analysis: analysts' growth forecasts
		RAM-5	Moody's generation divestiture utilities DCF analysis: analysts' growth forecasts
		RAM-6	Natural gas distribution utilities DCF analysis: analysts' growth forecasts
		RAM-7	Composite analysis of allowed risk premium 1987- 2000
Mark A. Cicchetti	OPC	MAC-1	Qualifications and experience
		MAC-2	Water Company Index Investment Character- istics
		MAC-3	Discounted Cash Flow Model

<u>Witness</u>	<u>Proffered By</u>	<u>I.D. No.</u>	<u>Description</u>
Mark A. Cicchetti	OPC	MAC-4	Risk Premium Analysis
		MAC-5	Risk Premium Analysis Results
		MAC-6	Summary of Results
Pete Lester	Staff	PL-1	Index of Exhibits
		PL-2	Water and Wastewater Leverage Formula Equation
		PL-3	Calculation of Recommended Leverage Formula
		PL-4	Comparison of Allowed Returns of Equity (ROEs)
		PL-5	Breakdown of Water and Wastewater Systems by Revenue
		PL-6	Florida Electric Utilities Revenue & Earnings for 2000

ORDER NO. PSC-01-2139-PHO-WS
DOCKET NO. 010006-WS
PAGE 15

<u>Witness</u>	<u>Proffered By</u>	<u>I.D. No.</u>	<u>Description</u>
Pete Lester	Staff	PL-7	Florida Gas Utilities Revenue & Earnings
		PL-8	Comparison of 2000 Revenue for Gas Companies and WAW Systems
		PL-9	Distribution by Revenue of the Nine Water Systems with Revenue Over \$1 Million
		PL-10	Distribution by Revenue of the Nine Wastewater Systems with Revenue Over \$1 Million
		PL-11	Comparison of Achieved ROEs for Water Systems
		PL-12	Comparison of Achieved ROEs for Wastewater Systems
		PL-13	Water Index Statistics for the Four Water Utilities followed by Value Line

<u>Witness</u>	<u>Proffered By</u>	<u>I.D. No.</u>	<u>Description</u>
Pete Lester	Staff	PL-14	Gas Index Statistics of Eleven Gas Utilities Followed by Value Line
		PL-15	Basic DCF Equation
		PL-16	Two Stage Annually Compounded DCF Model
		PL-17	Inputs and Results of DCF Analysis
		PL-18	Equation for CAPM Model
		PL-19	Bond Yield Differentials
		PL-20	Spread Between BBB and BB+ Bond Yields
		PL-21	Leverage Formula Calculation and Comparison
		PL-22	Status Quo Leverage Formula

Parties and Staff reserve the right to identify additional exhibits for the purpose of cross-examination.

XI. PROPOSED STIPULATIONS

1. This docket should remain open to allow staff to monitor the movement in capital costs and to readdress the reasonableness of the leverage formula as conditions warrant.

2. The depositions taken on October 23, 2001 and November 1, 2001, of Dr. Roger A. Morin, and all exhibits thereto, shall be admitted as an exhibit at the hearing and shall be in lieu of cross-examination of that witness by the parties.*

3. The direct and rebuttal testimony of Dr. Roger A. Morin shall be inserted into the record as though read at the appropriate time, and the exhibits attached to that testimony shall be admitted into the record at the hearing.*

4. Dr. Roger A. Morin shall be allowed to attend the hearing by telephone, and he shall be excused if the Commission determines that there are no cross-examination questions for him.*

*Proposed stipulations 2, 3, and 4 above were agreed to by the parties and staff subsequent to the Prehearing Conference on October 22, 2001.

XII. PENDING MOTIONS

There are no pending motions at this time.

XIII. RULINGS

FWA objected to Issue 2 as framed on the grounds that it was unnecessarily argumentative and was subsumed in Issues 1, 3, and 4. This objection was overruled and the Issue was allowed.

Based on the foregoing, it is

ORDERED by Commissioner Michael A. Palecki, as Prehearing Officer, that this Prehearing Order shall govern the conduct of these proceedings as set forth above unless modified by the Commission.

ORDER NO. PSC-01-2139-PHO-WS
DOCKET NO. 010006-WS
PAGE 18

By ORDER of Commissioner Michael A. Palecki, as Prehearing Officer, this 2nd day of November, 2001.



MICHAEL A. PALECKI
Commissioner and Prehearing Officer

(S E A L)

RRJ

NOTICE OF FURTHER PROCEEDINGS OR JUDICIAL REVIEW

The Florida Public Service Commission is required by Section 120.569(1), Florida Statutes, to notify parties of any administrative hearing or judicial review of Commission orders that is available under Sections 120.57 or 120.68, Florida Statutes, as well as the procedures and time limits that apply. This notice should not be construed to mean all requests for an administrative hearing or judicial review will be granted or result in the relief sought.

Mediation may be available on a case-by-case basis. If mediation is conducted, it does not affect a substantially interested person's right to a hearing.

Any party adversely affected by this order, which is preliminary, procedural or intermediate in nature, may request: (1) reconsideration within 10 days pursuant to Rule 25-22.0376, Florida Administrative Code, if issued by a Prehearing Officer; (2) reconsideration within 15 days pursuant to Rule 25-22.060, Florida Administrative Code, if issued by the Commission; or (3) judicial review by the Florida Supreme Court, in the case of an electric, gas or telephone utility, or the First District Court of Appeal, in the case of a water or wastewater utility. A motion for

ORDER NO. PSC-01-2139-PHO-WS

DOCKET NO. 010006-WS

PAGE 19

reconsideration shall be filed with the Director, Division of the Commission Clerk and Administrative Services, in the form prescribed by Rule 25-22.060, Florida Administrative Code. Judicial review of a preliminary, procedural or intermediate ruling or order is available if review of the final action will not provide an adequate remedy. Such review may be requested from the appropriate court, as described above, pursuant to Rule 9.100, Florida Rules of Appellate Procedure.