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Florida Cities Water Company

Litigation Expense Recovery

971663-WS

Testimony of John D. McClellan

Q. Please state your name and business address.

A. My name is John D. McClellan, and my business address is 555 12th Street, N.W., Suite 500, Washington, D.C. 20004.

Q. What is your current professional position?

A. I am a self employed regulatory consultant engaged in assisting clients of the firm of Deloitte & Touche LLP (D&T) in utility accounting and regulatory issues.

Q. Were you an active partner of D&T?

A. Yes. Up until June of 1992, I was a partner of the firm. I retired as a partner at that time, but have continued to serve the firm and its clients as a consultant on utility accounting and regulatory issues.

Q. What was your responsibility as a partner of the firm?

A. My primary responsibility was that of a regulated utility industry specialist. In conjunction with that position, I served as the firm's National Regulatory Practices Partner, having primary responsibility for the regulatory activities of the firm. I continue to function as a regulatory specialist on behalf of the firm, but in the capacity of an individual contractor.

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FPSC RECORDS/ALPORTING

1 Q. How long were you with Deloitte & Touche?

2 A. I joined the predecessor firm of Haskins & Sells in
3 1969.

4 Q. With whom were you affiliated prior to 1969?

5 A. I was on the staff of the Florida Public Service
6 Commission from 1957 to 1969, and was Director of the
7 Accounting Department at the time I left the
8 Commission to join D&T.

9 Q. Are you licensed as a certified public accountant?

10 A. Yes. I currently hold an active license in Florida,
11 and have been licensed in a number of numerous other
12 states.

13 Q. Have you previously testified as an expert witness in
14 Florida?

15 A. Yes, on numerous occasions.

16 Q. Have you prepared an outline of your background and
17 experience?

18 A. Yes. The outline is attached as Appendix A.

19 Q. What is the purpose of your testimony in this
20 proceeding?

21 A. Florida Cities Water Company ("FCWC" or the "Company")
22 requested that I submit testimony in this proceeding
23 addressing (1) the Company's requested recovery of
24 a portion of approximately \$3.8 million of litigation
25 expenses incurred in defending against the charges by

1 the United States Environmental Protection Agency
2 (EPA) claiming that provisions of the Clean Water Act
3 (the "CWA") had been violated; (2) the propriety of
4 such recovery under regulatory principles; (3) whether
5 the recovery of the litigation expense is appropriate
6 by a per customer surcharge; (4) the financial
7 prudence of the Company's pursuit of a defense against
8 the EPA charges; and (5) the propriety of recovery of
9 certain rate case expenses that are now being incurred
10 in seeking recovery of the litigation expenses.

11 **BACKGROUND**

12 Q. Are you familiar with the events leading to that
13 litigation, the development of the proceedings and the
14 decisions rendered in the process?

15 A. Yes.

16 Q. How did you become familiar with these events?

17 A. I reviewed various documents, had a number of
18 discussions of the events with Company officials, and
19 reviewed the testimony of the Company witnesses who
20 have submitted testimony in this proceeding.

21 Q. Would you briefly describe these events and the nature
22 of the charges brought by the EPA?

23 A. Yes. The particular conditions leading to the
24 litigation process, the resulting developments and the
25 ultimate decision rendered by the court system will be

1 described in more detail by other witnesses. As a
2 brief summary, however, the problem began in 1986
3 when the EPA denied FCWC's application for renewal of
4 its National Pollution Discharge Elimination System
5 (NPDES) permit for the Waterway Estates Wastewater
6 Plant. The conditions that caused FCWC to start
7 incurring the costs sought to be recovered in this
8 proceeding began to develop in 1991 when the EPA
9 concluded that the Company had failed to meet
10 scheduled responses to an administrative order
11 resulting from a show cause hearing held in Atlanta in
12 1991. The problem began to accelerate in October of
13 1993 when the U.S. Department of Justice (DOJ) filed
14 on behalf of the EPA a complaint in Federal District
15 Court against FCWC alleging violations of the CWA at
16 the Waterway Estates Wastewater Treatment Plant. In
17 March, 1995 DOJ filed an amended complaint which
18 added alleged violations of the CWA at the Barefoot
19 Bay and Carrollwood Wastewater Treatment plants.

20 Q. Did the complaints seek assessment of a civil penalty
21 against FCWC?

22 A. Yes. The legal proceedings initiated by the DOJ
23 attempted to impose very large penalties on the FCWC
24 system. The original complaint sought a civil penalty
25 in the total amount of \$32,375,000. The amended

1 complaint increased the amount of the requested
2 penalties to \$104,325,000.

3 Q. Were efforts made to settle this controversy?

4 A. Yes. The attempt to settle this controversy is
5 described by Mr. Gerald Allen and Mr. Gary H. Baise,
6 FCWC witnesses in this case. However, it is my
7 understanding that in an attempt to reach a reasonable
8 settlement, FCWC discussed and negotiated with DOJ and
9 EPA on several occasions both before and after the
10 litigation was started. In December of 1992, before
11 the initial complaint was filed, DOJ offered a
12 settlement proposal that would have required a payment
13 by FCWC of a penalty of \$5 million. FCWC did not
14 accept this settlement, but, as explained by Mr.
15 Allen, did respond with a counter offer to settle with
16 a payment of \$250,000 in December 1992. That offer
17 was increased to \$500,000 in January 1993. These FCWC
18 offers were rejected by EPA and DOJ. On October 1,
19 1993, the DOJ filed the complaint in federal court.
20 Thereafter, it is my understanding that the attorneys
21 for DOJ and FCWC had further settlement discussions.

22 Q. What was the amount of the penalty ultimately
23 assessed against FCWC by the Court?

24 A. After lengthy legal proceedings, the assessments were
25 set at a total of \$309,710. These amounts were

1 based upon assessments of \$5,610 at Barefoot Bay,
2 \$14,675 at Carrollwood and \$289,425 at Waterway
3 Estates. Mr. Allen and Mr. Baise further explain the
4 court's ruling.

5 **THE COMPANY'S REQUESTED RECOVERY**

6 Q. Is the Company requesting recovery of the \$309,710
7 penalty assessment made by the federal court?

8 A. No. The recovery request of the costs incurred in the
9 litigation process is limited to a portion of amounts
10 expended in defending against the attempted \$104
11 million penalty assessment and recovery of the
12 estimated \$250,000 of rate case expenses to be
13 incurred in this proceeding undertaken to obtain
14 litigation expense recovery approval.

15 Q. What were the total litigation expenses incurred in
16 opposing the DOJ Amended Complaint seeking \$104
17 million of penalties.

18 A. The costs incurred in the legal defense undertaken to
19 avoid the \$104 million of penalties sought by the
20 EPA/DOJ amounted to approximately \$3.8 million.

21 Q. Is the Company seeking recovery of a substantial
22 portion of these costs?

23 A. Yes. As explained by Mr. Allen, FCWC is seeking to
24 recover \$3,589,368 of the \$3,826,210 of the litigation
25 expenses.

1 Q. What is your opinion of the method used by Mr. Allen
2 in arriving at the \$3,589,368.

3 A. Mr. Allen's approach recognizes that some costs would
4 have been absorbed by FCWC had an early settlement
5 been successful and the litigation process avoided.
6 In assessing FCWC's responsibility for a portion of
7 these costs, he correlated the DOJ's original offer of
8 settlement in the amount of \$5,000,000 with the
9 Court's final determination of a civil penalty of
10 \$309,710. In this process, he applied the
11 penalty/settlement offer ratio to the expenses
12 incurred in pursuing the litigation defense. The
13 resulting ratio of 6.19% as applied to the \$3.8
14 million of costs produced an unrecoverable amount of
15 \$236,842 which was deducted from the total litigation
16 expenses of \$3,826,210 resulting in \$3,589,368 of
17 recoverable litigation expenses.

18 Q. Was that the only measure applied by Mr. Allen in
19 evaluating a cost responsibility to be absorbed by
20 FCWC?

21 A. No. He also established a second recovery amount
22 using a different measure. In this measure, the
23 litigation expenses of \$3.8 million were reduced by
24 the difference between the \$500,000 settlement offer
25 that presumably would have settled the issue and the

1 final judgement of \$309,710 imposed by the court. The
2 \$309,710 penalty is being absorbed by the Company.
3 If the \$190,290 difference (\$500,000 - \$390,710) is
4 also absorbed by subtraction from the litigation
5 expenses incurred, the Company would be entitled to a
6 recovery of slightly more than the \$3.6 million
7 requested using the penalty/settlement ratio measure
8 that has been applied. Recovery of the lesser of the
9 two amounts is requested.

10 Q. Of the total \$3.6 million of recoverable litigation
11 expenses, how much is being requested from customers
12 subject to this Commission's jurisdiction?

13 A. The request in this filing is that the Commission
14 approve the recovery of \$2,265,833 from customers
15 being served in counties subject to the Commission's
16 jurisdiction. As explained by Mr. Murphy, FCWC will
17 seek approval to recover the balance of the expenses
18 from rate regulatory authorities in the counties not
19 subject to the Commission's jurisdiction. The manner
20 in which this portion of the recoverable litigation
21 expenses has been determined is presented in the
22 testimony of Mr. Murphy.

23 Q. Did the Company incur carrying charges on the funds
24 required to pay the litigation expenses over the last
25 five years?

1 A. Yes.

2 Q. Have the related carrying costs been recorded?

3 A. No.

4 Q. What is the approximate level of such costs?

5 A. Assuming a capital cost of 10%, the funding of the
6 litigation efforts for which cost recovery is being
7 requested would have resulted in costs accumulating
8 to over \$4.5 million by the end of this year. This
9 accumulated cost measure reflects the current revenue
10 recovery that would be necessary to make FCWC whole
11 for the costs of the litigation incurred since this
12 struggle began.

13 Q. Is FCWC requesting recovery of these total accumulated
14 costs that have actually been incurred?

15 A. No. Recovery of the prior period costs is being
16 requested for only the direct portion of the costs.
17 No request is being made for recovery of the related
18 prior years' carrying costs.

19 **PROPRIETY OF RECOVERY**

20 Q. Have you reviewed the Company's rationale for the
21 recovery of these costs and the proposed methods of
22 establishing tariff provisions that will achieve this
23 objective?

24 A Yes. As is discussed in Mr. Murphy's testimony and
25 reflected in his exhibits, the litigation expenses

1 were incurred to protect the system from severe
2 financial damages. The Company was convinced that
3 a direct challenge to the claimed damages was
4 necessary to preserve the system and to maintain the
5 services to which the customers are entitled.

6 Q. Would serious financial penalties have been assumed if
7 the suit filed by the DOJ had no been challenged?

8 A. Yes. Although there is no way to identify the
9 specific amount of penalty that may have been
10 assessed, given the penalty levels sought the amount
11 would have been substantial. It is very clear that
12 any attempt to satisfy financial obligations at the
13 levels sought by the DOJ in the litigatory process
14 would have left the Company with monetary demands that
15 would have to be diverted from the normal conduct of
16 operations of both the water services and the
17 wastewater services provided to the system levels,
18 assuming that such service could have been maintained
19 at all. Accordingly, the incurrance of litigation
20 expenses was unavoidable in the defense of the systems
21 against the penalties sought by the DOJ. These
22 actions preserved the system from calamitous financial
23 burdens and clearly benefitted all customers on the
24 system, whether water, wastewater or both.
25 Consequently, all customers should share in the cost

1 reimbursement.

2 Q. Do observations made by the court support your
3 conclusion that the penalties sought would have been
4 financially calamitous?

5 A. Yes. There are observations contained in the
6 judgement that clearly recognize the inability of the
7 Company to pay the judgements sought, and that
8 adequate funds were not available or accessible. As
9 observed at page 20 of the Court's judgement, it is
10 found that FCWC did "...not have the ability to pay
11 the statutory maximum penalty. . . ." and that
12 planned capital expenditures would "...exhaust the
13 available lines of credit."

14 **PROPRIETY OF SURCHARGE**

15 Q. Is the proposed use of a surcharge to recover the
16 litigation expenses an appropriate vehicle to achieve
17 the targeted cost recovery?

18 A. Yes. Although there are alternative ways in which the
19 costs may be assessed, the use of a surcharge has the
20 clear advantage of providing for the recovery of a
21 specific level of costs since the recovery process
22 will terminate when the identified costs have been
23 recovered.

24 Q. Is the application of a surcharge per customer an
25 appropriate method of recovering the litigation

1 costs?

2 A. Yes. The recovery of the litigation expenses on a
3 customer surcharge basis appears to be the most
4 appropriate of the available methods. All of the
5 system's water and wastewater customers benefited from
6 the Company's battle to avoid the crippling penalties
7 sought in the Complaint, and all customers should
8 share in the costs of the battle. While not directly
9 proportional to consumption, the benefits from the
10 litigation efforts do vary with customer size. For
11 example, large customers, both water and wastewater,
12 received a greater relative benefit simply because
13 they depend on higher levels of service being
14 maintained. Accordingly, a customer based charge is
15 proposed, but it is weighted by meter size to
16 recognize the relative levels of benefits between
17 customer classes. As is discussed by Mr. Murphy,
18 levels of wastewater services correlate with levels of
19 water usage and the application of a surcharge level
20 that relates to meter size recognizes this condition.
21 As applied, the monthly charges will be equal for all
22 customers with similar sized meters. The monthly
23 charges are scheduled over a 10 year period, but will
24 continue only until the identified costs are
25 recovered. At that point the charges will be

1 terminated. If customer growth occurs as expected,
2 the recovery period will be somewhat shorter than 10
3 years.

4 Q. Is it appropriate to spread the recovery over future
5 periods?

6 A. Most certainly. The spreading of the cost burden is
7 not only appropriate, but it is the only practical way
8 to assess the costs. It has been a long and
9 frequently used regulatory procedure, both here in
10 Florida and elsewhere, to spread significant short
11 period costs over longer periods to achieve a
12 balancing of customer and utility interests. The
13 targeted balance of interests (1) minimizes the rate
14 impact on customers while (2) providing cost recovery
15 without undue delay. In this instance, the recovery
16 period of 10 years introduces such a balance. There
17 is no specific period that is "right" or "wrong".
18 While a different period could be used, 10 years is a
19 long period and any change should be toward a shorter
20 period.

21 Q. Is it appropriate to recover from the system as a
22 whole those costs incurred from defending against
23 charges directed at specific parts of the system?

24 A. I do not believe that there is any doubt as to this
25 approach. It is the most appropriate manner in which

1 the costs incurred may be correlated with the benefits
2 received in the Company's successful efforts in
3 defending the financial viability of the water and
4 wastewater systems. Even though the charges were
5 directed to individual facilities, the assessed
6 penalties would have become the burden of the entire
7 system. As observed earlier, the attempt to pay the
8 assessments would have financially crippled the system
9 and would have seriously disrupted the service across
10 the full customer base. The legal defense taken was
11 necessary to preserve the total system and the service
12 to all customers. The litigation expenses were truly
13 beneficial to the entire system and it is appropriate
14 to spread and recover the costs accordingly.

15 Q. How is the cost recovery being applied under the
16 Company's filing?

17 A. The costs are being assigned on a weighted customer
18 basis. It is recognized that the cost benefits have
19 no direct relationship to customer consumption levels
20 and that usage volumes is not an appropriate basis for
21 recovery. Accordingly, the recovery approach assigns
22 a fixed monthly charge per customer, but with a
23 customer meter size weighting to recognize customer
24 size.

25 Q. Have you addressed the propriety of weighting the

1 customer by meter size in assessing the monthly charge
2 per customer?

3 A. Yes. As previously stated, customers provide the
4 general allocation base. However, the size of a
5 customer also reflects the degree of benefit realized
6 by pursuing the litigation. Accordingly, meter size
7 is factored into the recovery provision to reflect the
8 level of benefits received. In addition, this
9 approach is consistent with existing tariff structures
10 that provide for recovery of fixed costs through a
11 monthly charge weighted by meter size.

12 Q. Does the requested surcharge include provisions for
13 future delays in cost recovery?

14 A. No. The request is that the \$3.6 million of costs
15 directly incurred in the litigation process be
16 recovered in equal annual amounts per customer over
17 the next 10 years. Additional carrying costs will be
18 incurred during this recovery period, and if there are
19 any rate filings during that period, any unamortized
20 costs should be recognized as a rate base component.

21 **RECOVERY OF RATE CASE EXPENSE**

22 Q. In your opinion, should FCWC recover its expenses for
23 this proceeding?

24 A. Yes. This rate case process is a necessary adjunct
25 to the recovery of the litigation expenses, a role

1 that justifies recovery of the costs incurred in
2 processing this case, and which endorses the
3 spreading of the costs to customers in a manner
4 consistent with the assignment of the related
5 litigation expenses.

6 Q. Are the litigation expenses and the rate case
7 expenses to be recovered over the same period?

8 A. Yes, the intent is to recover both over the next 10
9 years.

10 Q. Does that complete your testimony?

11 A. Yes.

Resume of **JOHN D. MCCLELLAN**
Position **Consultant (Retired Partner)**
 Deloitte & Touche LLP
 Washington, D.C.

Utility Experience Mr. McClellan is a former partner of Deloitte & Touche LLP. Since his retirement from D&T in 1992, he has functioned under a contractual arrangement in which he provides utility accounting and ratemaking services to the firm's public utility industry clientele. Prior to retirement, he functioned as the National Regulatory Practices Partner with primary responsibility for the firm's public utility regulatory services.

As a public utility industry specialist, he has been continuously involved in public utility accounting and regulatory policies and proceedings, problem analyses, special studies, and training programs. In assisting clients in various aspects of the ratemaking process, he has served as an expert witness in a wide variety of issues. He has addressed numerous state regulatory commissions, legislative committees, special agencies, city councils, state and federal courts, the Federal Energy Regulatory Commission, the Canadian National Energy Board and the Ontario Energy Board.

Prior to joining D&T, Mr. McClellan served as the Chief Accountant of the Florida Public Service Commission. As a Commission staff member from 1957 to 1969, he participated in the areas of development of accounting procedures, audits, rate base, test period operating results, rate of return and capital cost evaluations, cost allocations, rate design criteria, automatic adjustment clauses, and a variety of special study projects.

Utility Clients Served

Mr. McClellan has served clients throughout the industry. These include operating utilities, regulators and parties being served by utilities. Some of these clients, grouped according to the client role in the engagement, are identified in the following lists.

Operating Utilities:

Florida Power & Light Co.
Tampa Electric Company
Southern Bell Telephone Co.
(in Fla. Ga., S.C., N.C. and La.)
Atlanta Gas Light Co.
Duke Power Company
Virginia Power Company

Florida Progress
Gulf Power Company
General Telephone
Peoples Gas
Carolina P&L.
South Carolina Electric & Gas Co
American Electric Power

Texas Utilities Company
Southern Union Gas Co.
Tucson Electric Power Co.
Nevada Power Co.
Entergy Corporation
Kansas City Power & Light Co.
Delmarva Power & Light Co.

Houston Lighting & Power Co.
Lone Star Gas Co.
Arizona Public Service Co.
San Diego Gas & Electric
Transcanada Pipelines
Citizens Utilities
Alltel, Inc.

Regulators:

Canadian National Energy Board
Ontario Energy Board
Texas Public Utility Commission
Illinois Commerce Commission

Canadian Transport Comm
New York PSC
Missouri PSC
Vermont PSC

Consumers:

Delaware Industrial Group
Virginia Committee for Fair Rates
City of Martinsville, Va.
Group of Texas Electric Cooperatives
Attorney General of Virginia
Ghanian Aluminum Smelter

Virginia Industrial Group
Connecticut Industrial User
Southern Union Gas
Group of Texas Municipal
Public Counsel of Vermont
Canadian Industrial Gas User

**Publications
and Speaking**

Mr. McClellan has lectured at numerous public utility seminars, including presentations to the FERC staff and to the Florida, New York, Missouri, Texas, Arkansas and Illinois State Commission staffs, various professional and educational groups, and a Pan American seminar for the Servicio Nacional de Electricidad in San Jose, Costa Rica. He has conducted various training courses, including the D&T sponsored *Tax Aspects of Regulation* and is a co-author of the D&T Public Utility Manual. He is also a contributing author to *Accounting For Public Utilities*.

Education

Mr. McClellan graduated from Florida State University in 1957 with a B.S degree in Business Administration, and a major in accounting. He has attended numerous industry training courses since beginning his career as a public utility regulatory specialist.

Professional

Mr. McClellan is a Certified Public Accountant and is a member of the American Institute of Certified Public Accountants. In his role as a specialist in the public utility industry, he has served on various AICPA, NARUC, and industry committees addressing public utility accounting and ratemaking principles.