

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

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

DOCKET NO. 20200006-WS
ORDER NO. PSC-2020-0222-PAA-WS
ISSUED: June 29, 2020

The following Commissioners participated in the disposition of this matter:

GARY F. CLARK, Chairman
ART GRAHAM
JULIE I. BROWN
DONALD J. POLMANN
ANDREW GILES FAY

NOTICE OF PROPOSED AGENCY ACTION
ORDER ESTABLISHING AUTHORIZED RAGE OF RETURN ON
COMMON EQUITY FOR WATER AND WASTEWATER UTILITIES

BY THE COMMISSION:

NOTICE is hereby given by the Florida Public Service Commission that the action discussed herein is preliminary in nature and will become final unless a person whose interests are substantially affected files a petition for a formal proceeding, pursuant to Rule 25-22.029, Florida Administrative Code (F.A.C.).

Background

Section 367.081(4)(f), Florida Statutes (F.S.), authorizes us to establish, not less than once each year, a leverage formula to calculate a reasonable range of returns on equity (ROE) for water and wastewater (WAW) utilities. The current leverage formula methodology was established in Order No. PSC-2001-2514-FOF-WS.¹ On October 23, 2008, we held a formal hearing in Docket No. 20080006-WS to allow interested parties to provide testimony regarding the validity of the leverage formula.² Based on the record in that proceeding, we approved the

¹ Order No. PSC-2001-2514-FOF-WS, issued December 24, 2001, in Docket No. 20010006-WS, *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.*

² At the May 20, 2008, Commission Conference, upon request of the Office of Public Counsel, we voted to set the establishment of the appropriate leverage formula directly for hearing.

2008 leverage formula in Order No. PSC-2008-0846-FOF-WS.³ In that order, we reaffirmed the methodology that was previously approved in Order No. PSC-2001-2514-FOF-WS.⁴

From 2012 through 2017, we found that the range of returns on equity derived from the annual leverage formulas were not optimal for determining the appropriate authorized ROE for WAW utilities due to Federal Reserve monetary policies that resulted in historically low interest rates. Consequently, we decided it was reasonable to continue using the range of returns on equity of 8.74 percent to 11.16 percent from the 2011 leverage formula approved by Order No. PSC-2011-0287-PAA-WS until 2018.⁵

On November 8, 2017, Commission staff held a workshop to solicit input from interested parties regarding potential changes to the current leverage formula methodology. The only parties that filed pre-workshop comments in the docket were the Office of Public Counsel (OPC) and Utilities, Inc. of Florida (UIF). OPC also filed post-workshop comments on January 31, 2018. On June 26, 2018, we approved the leverage formula by Order No. PSC-2018-0327-PAA-WS.⁶ The methodology approved in the 2018 Order was used to establish the 2019 leverage formula.⁷

Section 367.081(4)(f), F.S., authorizes us to establish a range of returns for setting the authorized ROE for WAW utilities. However, use of the leverage formula by the utilities is discretionary and a utility can file cost of equity testimony in lieu of using the leverage formula. We may set an ROE for WAW utilities based on record evidence in any proceeding. If a utility files cost of equity testimony, we will determine the appropriate ROE based on the evidentiary record in that proceeding.

We have jurisdiction pursuant to Section 367.081, F.S.

³ Order No. PSC-2008-0846-FOF-WS, issued December 31, 2008, in Docket No. 20080006-WS, *In re: Water and wastewater industry annual reestablishment of authorized range of return on common equity for water and wastewater utilities pursuant to Section 367.081(4)(f), F.S.*

⁴ Order No. PSC-2001-2514-FOF-WS, issued December 24, 2001, in Docket No. 20010006-WS, *In re: Water and wastewater industry annual reestablishment of authorized range of return on common equity for water and wastewater utilities pursuant to Section 367.081(4)(f), F.S.*

⁵ Order No. PSC-2011-0287-PAA-WS, issued July 5, 2011, in Docket No. 20110006-WS, *In re: Water and wastewater industry annual reestablishment of authorized range of return on common equity for water and wastewater utilities pursuant to Section 367.081(4)(f), F.S.*

⁶ Order No. PSC-2018-0327-PAA-WS, issued June 26, 2018, in Docket No. 20180006-WS, *In re: Water and wastewater industry annual reestablishment of authorized range of return on common equity for water and wastewater utilities pursuant to Section 367.081(4)(f), F.S.*

⁷ Order No. PSC-2019-0267-PAA-WS, issued July 1, 2019, in Docket No. 20190006-WS, *In re: Water and wastewater industry annual reestablishment of authorized range of return on common equity for water and wastewater utilities pursuant to Section 367.081(4)(f), F.S.*

Decision

The current leverage formula we approved in Order No. PSC-2019-0267-PAA-WS shall continue to be used until readdressed in 2021:

$$\text{ROE} = 6.05\% + (1.80 \div \text{Equity Ratio})$$

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

Range: 7.85 percent at 100 percent equity to 10.55 percent at 40 percent equity

The returns on common equity shall be capped at 10.55 percent for all WAW utilities with equity ratios less than 40 percent. Imposing a cap serves to discourage imprudent financial risk. This cap is consistent with the methodology in Order No. PSC-2019-0267-PAA-WS.

Pursuant to Section 367.081(4)(f), F.S., we are authorized to establish a leverage formula to calculate a reasonable range of returns on common equity for WAW utilities. We must establish this leverage formula not less than once a year. For administrative efficiency, the leverage formula is used to determine the appropriate return for an average Florida WAW utility. We find that the leverage formula is a sound, workable methodology that reduces the costs and administrative burdens in WAW rate cases by eliminating the need for cost of equity testimony. However, use of the leverage formula by utilities is discretionary and a utility can file cost of equity testimony in lieu of using the leverage formula. As is the case with other regulated companies under our jurisdiction, we have discretion in the determination of the appropriate ROE based on the evidentiary record in a proceeding. If one or more parties in a rate case or limited proceeding file testimony in lieu of using the leverage formula, we will determine the appropriate ROE based on the evidentiary record in that proceeding.

COVID-19 Impact

In light of the recessionary impact on the economy caused by the ongoing COVID-19 pandemic, the Federal Open Market Committee (Committee) voted twice in March 2020 to reduce the target range for the federal funds rate. On March 3, 2020, the Committee decided to lower the federal funds target range from 1.50 - 1.75 percent to 1.00 - 1.25 percent.⁸ On March 15, 2020, the Committee decided to lower the federal funds target range from 1.00 - 1.25 percent to 0.00 - 0.25 percent, and reasoned, “The effects of the coronavirus will weigh on economic activity in the near term and pose risks to the economic outlook.”⁹ On April 29, 2020, the Committee decided to maintain the target range for the federal funds rate of 0.00 - 0.25 percent. The Committee expects to maintain this target range until it is confident that the economy has

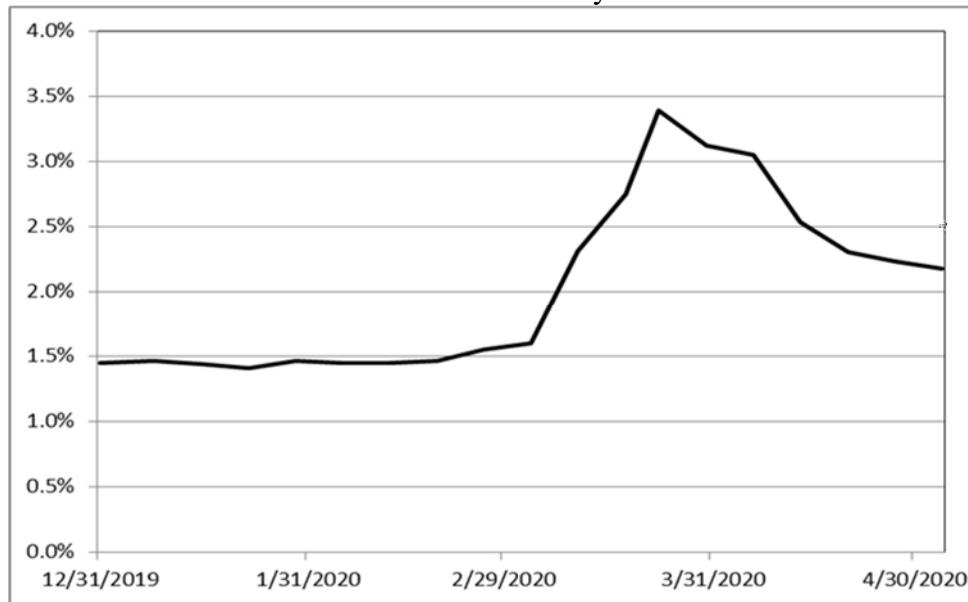
⁸See “Federal Reserve Issues FMOOC Statement” on March 03, 2020, available at <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200303a.htm>.

⁹See “Federal Reserve Issues FMOOC Statement” on March 15, 2020, available at <https://www.federalreserve.gov/newsevents/pressreleases/monetary20200315a.htm>.

weathered recent events and is on track to achieve its maximum employment and price stability goals.¹⁰

Further, due to the recent decrease in risk-free interest rates and the uncertainty in the bond market, the volatility of the spread between the Utility 25/30-year BBB Bond Yield and the U.S. 30-year Treasury Bond Yield has been much greater than usual as demonstrated in Figure 1. This extreme volatility causes weekly fluctuations in the spread. It is not reasonable to set a range of returns on equity for setting rates going forward using data that is influenced by the current catastrophic economic event. Due to this unusual and unique economic situation, we hereby find that the current 2019 leverage formula shall remain in place.

Figure 1
Spread between the 25/30-Year BBB Bond Yield
and the 30-Year U.S. Treasury Bond Yield



Source: Value Line Selection and Opinion

Updated Leverage Formula

Using the most recent financial data in the leverage formula decreases the lower end of the current allowed ROE range by 58 basis points and decreases the upper end of the range by 56 basis points. Overall, the spread between the range of returns on equity based on the updated leverage formula is 272 basis points (7.27 percent to 9.99 percent). In comparison, the range of returns on equity for the current 2019 leverage formula is 270 basis points (7.85 percent to 10.55 percent).

¹⁰See “Federal Reserve Issues FMO Statement” on April 29, 2020, available at <https://federalreserve.gov/newsevents/pressreleases/monetary20200429a.htm>.

Methodology

We applied the most recent financial data to the methodology approved in Order No. PSC-2001-2514-FOF-WS, reaffirmed in Order No. PSC-2008-0846-FOF-WS and modified in Order No. PSC-2018-0327-PAA-WS. The methodology uses ROEs derived from widely accepted financial models applied to an index of natural gas and WAW companies that have actively traded stock and forecasted financial data. To establish the proxy group, we selected five natural gas companies and seven WAW companies that derive at least 50 percent of their total revenue from regulated operations and have a Standard and Poor's credit rating. These selected companies have market power and are influenced significantly by economic regulation and have a median Standard and Poor's bond rating of "A."

Consistent with the approved methodology, a market capitalization weighted average was used for: (1) the Discounted Cash Flow (DCF) model results, (2) the Beta values in the Capital Asset Pricing Model (CAPM), and (3) the equity ratio of the proxy group.

Assumed Cost of Debt

A projected yield on Baa2 rated public utility bonds was used to estimate the bond yield of an average Florida WAW utility in the calculation of the weighted average cost of capital of the proxy group. A projected yield is used because required returns are forward looking and based on projections.

Consistent with the methodology approved in Order No. PSC-2018-0327-PAA-WS, we relied upon the projected Baa2 rated utility bond yield for the upcoming four quarters as published in the most recent Blue Chip Financial Forecast (Blue Chip). The 120-month historical average spread between the Baa and A Corporate Utility Bond was then added to the projected Baa2 rated utility bond yield to estimate a projected Baa3 rated utility bond yield of 5.46 percent.

The projected assumed Baa3 bond rate of 5.46 percent used in the updated leverage formula calculation includes a 50 basis point adjustment for small-company risk and a 50 basis point adjustment for a private placement premium and remains low relative to historic levels. In comparison, the assumed Baa3 bond rate used in the 2019 leverage formula is 6.05 percent. The lower Baa3 bond rate of 5.46 percent is the primary driver of the overall decrease in the results of the 2020 leverage formula compared to the 2019 leverage formula.

Estimated Cost of Equity

The leverage formula relies on two ROE models described below. The results of these models were adjusted to reflect differences in risk and debt cost between the proxy group and the average Florida WAW utility. The ROE models include a four percent adjustment for flotation costs. The ROE models are as follows:

- 1) A multistage Discounted Cash Flow (DCF) model applied to an index of natural gas and WAW utilities that have publicly traded stock and are followed by Value Line. This DCF

model is an annually compounded model and uses prospective dividend growth rates as published by Value Line.

- 2) A Capital Asset Pricing Model (CAPM) that relies on a market return for companies followed by Value Line, the average projected yield on the U.S. Treasury's 30-year bonds as of April 1, 2020, published by Blue Chip Financial Forecasts, and the weighted average beta for the index of natural gas and WAW utilities. The market return for the CAPM was calculated using a quarterly DCF model with stock prices as of April 15, 2020.

Consistent with Order No. PSC-2018-0327-PAA-WS, we averaged the results of the DCF and CAPM models and adjusted the result of 7.62 percent as follows:

- 1) A bond yield differential of 55 basis points was added to reflect the difference in yields between an A/A2 rated bond, which is the median bond rating for the combined utility index, and a BBB-/Baa3 rated bond. Florida WAW utilities are assumed to be comparable to companies with the lowest investment grade bond rating which is Baa3. This adjustment compensates for the difference between the credit quality of 'A' rated debt and the assumed credit quality of a typical Florida WAW utility.
- 2) A private placement premium of 50 basis points was added to reflect the difference in yields on publicly traded debt and privately placed debt, which is illiquid. Investors require a premium for the lack of liquidity of privately placed debt.
- 3) A small-utility risk premium of 50 basis points was added because the average Florida WAW utility is too small to qualify for privately placed debt and smaller companies are considered by investors to be more risky than larger companies.

After the above adjustments, the resulting cost of equity estimate of 9.17 percent is included in the weighted average capital structure of the proxy group to derive the leverage formula. The derivation resulted in an adjustment of 82 basis points to reflect an estimated required return of 9.99 percent at an equity ratio of 40 percent.

In developing the updated leverage formula, staff acknowledges that the leverage formula depends on four basic assumptions:

- 1) Business risk is similar for all WAW utilities;
- 2) The cost of equity is an exponential function of the equity ratio but a linear function of the debt to equity ratio over the relevant range;
- 3) The marginal weighted average cost of investor capital is constant over the equity ratio range of 40 percent to 100 percent; and
- 4) The debt cost rate at an assumed Moody's Baa3 bond rating, plus a 50 point private placement premium and a 50 basis point small-utility risk premium, represents the

average marginal cost of debt to an average Florida WAW utility over an equity ratio range of 40 percent to 100 percent.

For these reasons, the leverage formula is assumed to be appropriate for the average Florida WAW utility.

Conclusion

The current leverage formula range of returns on equity of 7.85 percent to 10.55 percent initially approved in 2019 is still reasonable for WAW utilities. Due to the economic volatility caused by the unique situation of the COVID-19 pandemic, we find that retaining the use of the current 2019 leverage formula until the leverage formula is addressed again in 2021 is a reasonable alternative to updating the formula using current 2020 financial information. The leverage formula is a sound, workable methodology that reduces the costs and administrative burdens in WAW rate cases by eliminating the need for cost of equity testimony. Based on the aforementioned, we hereby find that the current leverage formula we approved in Order No. PSC-2019-0267-PAA-WS shall continue to be used until the leverage formula is readdressed in 2021.

Based on the foregoing, it is

ORDERED by the Florida Public Service Commission that the leverage formula methodology approved in Order No. PSC-2019-0327-PAA-WS using a proxy group comprised of natural gas and WAW utilities and updated financial data shall be used. It is further

ORDERED that the approved leverage formula shall be used until the leverage formula is addressed again in 2021. It is further

ORDERED that the Return on Common Equity = $6.05\% + (1.80 \div \text{Equity Ratio})$. It is further

ORDERED that where the Equity Ratio = $\text{Common Equity} \div (\text{Common Equity} + \text{Preferred Equity} + \text{Long-Term and Short-Term Debt})$. It is further

ORDERED that the current range of returns on equity of 7.85 percent to 10.55 percent is approved for water and wastewater utilities as set forth in this Order. It is further

ORDERED that the returns on common equity shall be capped at 10.55 percent for all water and wastewater utilities with equity ratios less than 40 percent. It is further

ORDERED that Attachment 1 is incorporated herein by reference. It is further

ORDERED that the provisions of this Order, issued as proposed agency action, shall become final and effective upon the issuance of a Consummating Order unless an appropriate petition, in the form provided by Rule 28-106.201, Florida Administrative Code, is received by the Commission Clerk, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, by the

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close of business on the date set forth in the “Notice of Further Proceedings” attached hereto. It is further

ORDERED that this docket shall remain open to allow Commission staff to monitor changes in capital market conditions and to readdress the reasonableness of the leverage formula as conditions warrant.

By ORDER of the Florida Public Service Commission this 29th day of June, 2020.

/s/ Adam J. Teitzman

ADAM J. TEITZMAN

Commission Clerk

Florida Public Service Commission

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Copies furnished: A copy of this document is provided to the parties of record at the time of issuance and, if applicable, interested persons.

BYL

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 that is available under Section 120.57, 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 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.

The action proposed herein is preliminary in nature. Any person whose substantial interests are affected by the action proposed by this order may file a petition for a formal proceeding, in the form provided by Rule 28-106.201, Florida Administrative Code. This petition must be received by the Office of Commission Clerk, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, by the close of business on July 20, 2020.

In the absence of such a petition, this order shall become final and effective upon the issuance of a Consummating Order.

Any objection or protest filed in this/these docket(s) before the issuance date of this order is considered abandoned unless it satisfies the foregoing conditions and is renewed within the specified protest period.

SUMMARY OF RESULTS
2020 Water and Wastewater Leverage Formula

(1) DCF ROE for Combined Index	7.39%
(2) CAPM ROE for Combined Index	<u>8.97%</u>
AVERAGE	8.18%
Bond Yield Differential	0.60%
Private Placement Premium	0.50%
Small-Utility Risk Premium	0.50%
Adjustment to Reflect Required Equity	
Return at a 40% Equity Ratio	<u>0.77%</u>
Cost of Equity for Average Florida	
WAW Utility at 40% Equity Ratio	<u>10.55%</u>

Authorized Leverage Formula

Return on Common Equity = 6.05% + (1.80 ÷ Equity Ratio)

Range of Returns on Equity = 7.85% to 10.55%