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November 15, 1996

Blanca S. Bayo, Director
Division of Records & Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

HAND DELIVERY

Re: Docket No. ~~960258~~-WS
Petition of the Florida
Waterworks Association to Adopt
Rules on Margin Reserve and
Imputation of Contributions-
in-aid-of-Construction on the
Margin Reserve Calculation

Dear Ms. Bayo:

Pursuant to Order No. PSC-96-1153-PCO-WS, enclosed on behalf of the Florida Waterworks Association for filing in the above docket are an original and fifteen (15) copies of the prefiled responsive testimony of Frank Seidman, Deborah D. Swain and Arsenio Milian, together with our Certificate of Service.

Please acknowledge receipt of the foregoing by stamping the enclosed extra copy of this letter and returning same to my attention. Thank you for your assistance.

Sincerely,

Wayne L. Schiefelbein
Wayne L. Schiefelbein

- ACK _____
- AFA 1 _____
- APP 1 _____
- CAF _____
- CMU _____
- CTR _____
- EAG _____
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- SEC 1 _____
- WAS _____
- OTH _____

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Enclosures

DOCUMENT NUMBER-DATE
12174 NOV 15 96
FPSC-RECORDS/REPORTING

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition of the FLORIDA WATER-)
WORKS ASSOCIATION to Adopt Rules on)
Margin Reserve and Imputation of)
Contributions-in-Aid-of-Construction)
on the Margin Reserve Calculation)

Docket No. 960258-WS
Filed: November 15, 1996

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the prefiled responsive testimony of Arsenio Milian, Deborah D. Swain and Frank Seidman has been furnished by hand delivery to Ms. Christiana T. Moore, Esq., Office of General Counsel, Florida Public Service Commission, 2540 Shumard Oak Boulevard, Tallahassee, FLorida 32399-0850, and by U.S. Mail to Mr. Brian Armstrong, Esq. and Matthew Feil, Esq., Southern States Utilities, Inc., 1000 Color Place, Apopka, Florida 32703; to Harold McLean, Esq., Office of Public Counsel, 111 West Madison Street, Room 812, Tallahassee, Florida 32399-1400; to Richard D. Drew, Chief, Bureau of Water Facilities Regulation, Division of Water Facilities, Department of Environmental Protection, 2600 Blair Stone Road, Tallahassee, Florida 32399-2400; and to Mr. Mark F. Kramer, Manager of Regulatory Accounting, Utilities, Inc., 2335 Sanders Road, Northbrook, IL 60062-6196, on this 15th day of November, 1996.

Respectfully submitted,

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Attorneys for
FLORIDA WATERWORKS ASSOCIATION

RESPONSIVE TESTIMONY OF FRANK SEIDMAN
BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION
REGARDING THE RULES FOR MARGIN RESERVE AND
IMPUTATION OF CIAC ON MARGIN RESERVE
ON BEHALF OF
THE FLORIDA WATERWORKS ASSOCIATION
DOCKET NO. 960258-WS

Filed: November 15, 1996

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FPSC-RECORDS/REPORTING

1 **RESPONSIVE TESTIMONY OF FRANK SEIDMAN**
2 **BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION**
3 **REGARDING THE RULES FOR MARGIN RESERVE AND IMPUTATION**
4 **OF CIAC ON MARGIN RESERVE**
5 **ON BEHALF OF THE FLORIDA WATERWORKS ASSOCIATION**
6 **DOCKET NO. 960258-WS**

7
8

9 **Q. Please state your name.**

10 **A. My name is Frank Seidman.**

11

12 **Q. Have you previously filed testimony in this docket**
13 **on behalf of the Florida Waterworks Association**
14 **(FWWA)?**

15 **A. Yes, I have.**

16

17 **Q. What is the purpose of your responsive testimony?**

18 **A. The purpose is to respond to portions of the**
19 **prefiled testimony of PSC staff witness Crouch and**
20 **the comments of the Office of Public Counsel (OPC)**
21 **and the Florida Department of Environmental**
22 **Regulation (DEP.)**

23

24

25

1 RESPONSE TO WITNESS CROUCH

2 Q. On page 3 of his testimony, Mr. Crouch describes
3 what should be considered used and useful by the
4 Commission. Do you agree with his description?

5 A. Yes, I am in complete agreement with his
6 description. Unfortunately, what Mr. Crouch
7 describes does not reflect Commission policy, and
8 Mr. Crouch's recommendation for margin reserve
9 policy does not honor that description.

10

11 Q. Would you please explain your comment further?

12 A. Yes. According to Mr. Crouch:

13 "The utility's investment, prudently
14 incurred, in meeting its statutory
15 obligations shall be considered used and
16 useful. On the other hand, investment not
17 prudently incurred, and/or not required to
18 provide safe, efficient and sufficient
19 service to existing customers shall not be
20 considered used and useful."

21

22 This statement is at odds with Commission policy
23 because current Commission policy relegates
24 portions of prudently invested plant to non-used &
25 useful plant, the carrying costs of which are

1 theoretically recoverable from future customers
2 through a mechanism called AFPI or "Allowance for
3 Funds Prudently Invested."

4
5 Thus the Commission on the one hand recognizes the
6 funds are prudently invested and on the other hand
7 designates the investment as non-used and useful.

8
9 Q. How does Commission policy relegate funds
10 prudently invested to non-used plant?

11 A. By failing to recognize as used and useful through
12 the margin reserve allowance, or any other means,
13 the cost of plant that has been prudently sized to
14 take advantage of economies of scale and to comply
15 with DEP planning requirements.

16
17 Q. At page 6 of his testimony, Mr. Crouch describes
18 margin reserve as a factor that recognizes the
19 amount of plant needed to be available to connect
20 customers that will be coming on line after the
21 test year. Do you agree with that description?

22 A. No. It is incomplete. It fails to recognize that
23 other major purposes of margin reserve are to
24 provide the utility with the ability to meet
25 changes in the demands of existing customers, to

1 protect the integrity of the system for them and
2 to allow the utility to serve them in an economic
3 manner.

4
5 Q. At page 9 of his testimony, Mr. Crouch quotes a
6 portion of the DEP rules regarding the planning of
7 wastewater facilities, seemingly as support for
8 recommending a three year margin reserve for
9 wastewater plant. Do you have any comment with
10 regard to his quotation?

11 A. Yes. Mr. Crouch quotes Section 62.600.405(8)(c) of
12 the DEP rules, which indicates that a utility must
13 submit a completed construction permit application
14 if permitted capacity will be equaled or exceeded
15 within three years. But this partial quote of the
16 relevant rule is misleading in that it makes it
17 appear as if the DEP requirements for treatment
18 plant expansion begin only three years prior to
19 that expansion. If he had also quoted
20 subparagraphs (a) and (b) of Section
21 62.600.405(8), F.A.C., it would be clear that a
22 utility must begin planning and preliminary design
23 some five years prior to expansion. The prefiled
24 comments of DEP in this docket make this very
25 clear.

1 At page 9 of his testimony, Mr. Crouch
2 acknowledges that before a utility can submit a
3 construction permit application, it must invest a
4 considerable amount of time and money in design
5 and planning. Yet his recommended margin reserve
6 fails to reflect that very time period during
7 which a utility must have capacity adequate to
8 serve its certificated area.

9

10 Q. Does Mr. Crouch provide any support for his
11 recommendation that the margin reserve period for
12 water plant remain at 18 months?

13 A. No. He merely observes that the DEP has not yet
14 formulated a planning expansion rule water plants
15 similar to that for wastewater plants. But DEP
16 has made it clear through its comments at a
17 previous workshop and in this docket that the
18 position of the department with regard to capacity
19 planning for water is similar to that for
20 wastewater. The Commission should acknowledge this
21 in setting a margin reserve period for water
22 plant.

23

24

25

1 Q. Also at page 9 of his testimony, Mr. Crouch
2 discusses the differences between the PSC's margin
3 reserve and the DEP's reserve margin. Do you agree
4 with his conclusions?

5 A. No. Either Mr. Crouch does not understand the
6 function of a reserve or he is playing word games.
7 Mr. Crouch says that to DEP, reserve margin
8 represents the amount of capacity needed to
9 function properly, but to the PSC it is an
10 economic consideration for setting rates.

11
12 Whether it is called margin reserve or reserve
13 margin is of no consequence. But whether being
14 considered by DEP or PSC, the reserve indeed
15 should be the capacity needed for a utility to
16 function properly. Whatever capacity is necessary
17 to allow the utility to function properly until
18 the next increment of plant comes on line and to
19 meet its obligations to the public is the capacity
20 for which the PSC should determine the cost and
21 allow in rate base.

22
23
24
25

1 Q. What do you think of Mr. Crouch's last sentence on
2 page 9 of his testimony, "A legitimate reserve
3 capacity may in fact be a prudent, wise investment
4 by a utility, but it might not be totally included
5 in the margin reserve period covered by the PSC."
6 A. I think that sentence is illogical and sums up all
7 that is wrong with the existing and proposed
8 Commission policy on margin reserve. It clearly
9 points out that Commission policy is not
10 coordinated with DEP policy and apparently by
11 design. Mr. Crouch's statement leads one to
12 conclude that the ratemaking considerations for
13 determining allowable reserves do not, and are not
14 intended to, reflect the cost of providing
15 service. If they were intended to reflect cost of
16 providing service, they would include in rate base
17 the cost of capacity, including reserves,
18 necessary for the utility to function properly.
19 And Mr. Crouch's statement is a blatant admission
20 that the existing Commission policy, and the
21 recommended policy, do not compensate, and do not
22 intend to compensate a utility for "a prudent,
23 wise investment."
24
25

1 Q. Based on Mr. Crouch's comments regarding reserves,
2 is it a prudent, wise decision for a utility to
3 invest in reserves needed to function properly?
4 A. From the viewpoint of meeting its statutory
5 obligations, maintaining reserves adequate for the
6 utility to function properly is prudent and wise.
7 But, from an economic viewpoint, it is clearly
8 imprudent and unwise for a utility to invest in
9 plant for which it knows it will not be
10 compensated.
11
12 Q. At page 10 of his testimony, Mr. Crouch says that
13 a utility can recover the cost of reserves
14 required for a utility to function properly
15 through AFPI. Do you agree?
16 A. No. The studies prepared by Milian, Swain &
17 Associates show that this just does not happen.
18 But regardless, a reserve that has been identified
19 as necessary for the utility to function properly,
20 is a cost responsibility of current customers. The
21 Commission's responsibility is not just to keep
22 costs low, but to provide sufficient compensation
23 to a utility to allow it to attract capital at a
24 reasonable cost and to remain financially sound.
25 This won't be the case under Mr. Crouch's

1 scenario. The funds for this necessary plant must
2 come from investors or lenders. But since there is
3 no current source of earnings for them, the cost
4 of the riskiness associated with recovery through
5 AFPI will most likely result in higher debt costs.
6 It won't be met with higher equity costs because
7 the Commission's leverage formula doesn't address
8 this type of risk. And without a risk premium
9 related to speculative deferred income for used
10 and useful plant, equity infusion is not a likely
11 source of capital.

12

13 RESPONSE TO COMMENTS OF OPC

14 Q. At page 1 of its comments, OPC states that margin
15 reserve is neither used nor useful to present
16 customers. Do you agree with that statement?

17 A. No. It is wrong and I have addressed it at
18 considerable length in my prefiled direct
19 testimony. Margin reserve is necessary to protect
20 the quality of service to existing customers as
21 new customers hook up to the system. The most
22 obvious test of the OPC argument would be to build
23 a utility system with zero margin reserve and make
24 the OPC phone number available to each customer
25 for complaints. But that is not a viable option.

1 The OPC argument fails also to recognize that in
2 order to meet DEP requirements, a utility cannot
3 operate without a reserve. Specifically with
4 regard to wastewater service, a utility must
5 expand its plant before it reaches capacity.
6 Section 367.081, F.S. entitles a utility to the
7 opportunity to earn a fair return on property used
8 and useful in the public service. It doesn't say
9 on property used and useful in serving existing
10 customers or in serving future customers. It says
11 "in the public service." The ability to be ready
12 to serve is a statutory obligation and makes the
13 investment to be ready to serve an investment in
14 the public service.

15
16 A water and wastewater utility is not like a
17 service company operating on the free market. It
18 cannot choose whether to provide service; it is
19 obligated to provide service. It cannot wait for
20 expressed customer demand before it commits funds
21 to provide service; it is obliged to be ready. A
22 utility is obligated by law to be ready to serve,
23 and in turn the law gives the utility the
24 opportunity to earn on the investment necessary to
25 meets its obligations. It is a two way

1 arrangement. The OPC wants it to be a one way
2 arrangement wherein the utility must commit to the
3 investment but speculate as whether it can recover
4 costs.

5

6 **Q. How does the Commission address the recovery of**
7 **the cost of reserves and making capacity available**
8 **to serve new electric and gas customers?**

9 **A. All prudent costs associated with providing**
10 **electric or gas service, current or future, are**
11 **recovered through rates to current customers.**

12

13 **Q. On page 2 of its comments, OPC states that to**
14 **achieve a proper matching of CIAC and investment,**
15 **CIAC equivalent to the ERCs represented by margin**
16 **reserve should be imputed to rate base. Do you**
17 **agree?**

18 **A. No. Imputation does not match CIAC to investment.**
19 **As I have previously stated, if it were a match,**
20 **you would not need to impute it. Margin reserve**
21 **is an investment already made in the test year.**
22 **Imputed CIAC is a payment to be received outside**
23 **of the test year. It is, in fact, a payment to be**
24 **received 1.5 to 5 years outside of the test year,**
25 **depending on the designation of the margin reserve**

1 period. If I were to propose in a rate
2 application to include as test year costs,
3 expenses to be incurred in the 1.5 to 5 year
4 period following the test year, the Commission
5 would throw them out, and rightly so - they are
6 not matching. If it were proper to impute CIAC
7 associated with future customers over a 1.5 to 5
8 year period following the test year, then it would
9 be just as proper to impute the plant investment
10 associated with them, including investment in
11 margin reserve, and to impute the revenues,
12 expenses, depreciation and taxes associated with
13 them. Let's be honest about it; imputation is not
14 matching, it is the antithesis of matching.

15

16 **Q. At page 2 of its comments, OPC states that the**
17 **risk of serving future customers is a risk that**
18 **should be borne by stockholders and that the**
19 **utility is compensated for that risk in its**
20 **allowed return of equity. Do you agree?**

21 **A. No. And I have no idea where this theory comes**
22 **from. Clearly, as a regulated monopoly, a utility**
23 **is obligated to provide, and be ready to provide,**
24 **service within its certificated area. In return**
25 **for meeting this obligation, the utility is**

1 protected from the type of risk of which OPC
2 speaks. That is one of the factors that
3 distinguishes a regulated monopoly from a free
4 market enterprise. A free market enterprise has
5 the option of serving or not serving. It can act
6 to minimize financial risk by simply waiting for
7 demand to build up before serving it. A regulated
8 monopoly does not have that option. It must be
9 ready to serve, and as long as it makes rational
10 decisions based on the best information available
11 at the time, the investment associated with those
12 decisions is considered prudent.

13

14 **Q. OPC states that the Commission needs to adjust its**
15 **leverage formula if it does not impute CIAC on**
16 **margin reserve. Is that correct?**

17 **A. No. The Commission's Order No. PSC-95-0982-FOF-WS,**
18 **establishing the leverage formula and level of**
19 **allowable return on equity does not even mention**
20 **margin reserve or imputed CIAC. It does not allude**
21 **to any premium built in related to the risk of**
22 **future customers connecting to the system. The**
23 **risk premiums addressed by the order are those**
24 **generally related to the inability of water and**
25 **wastewater utilities to access the public debt and**

1 equity markets because of their size. There is no
2 risk premium related to future customer
3 connections in the leverage formula for which an
4 adjustment can be made.

5

6 Q. At page 3 of its comments, OPC argues that margin
7 reserve is not needed to provide a cushion for
8 changing load conditions because "averages used to
9 calculate used and useful already take plant load
10 fluctuations into consideration." Do you agree?

11 A. No. If used and useful is based on the peak
12 demand on the system, it certainly incorporates
13 the ability of the system to meet fluctuations
14 between the historic minimum and peak loads. In
15 that sense peak capacity provides the ability to
16 serve average demand. But it does not provide any
17 cushion whatsoever to meet fluctuations in the
18 peak demands of existing customers, whatever the
19 cause. All types of utilities require some margin
20 or cushion to be able to react to changes in the
21 peak demands of their existing customers. It would
22 be shortsighted and irresponsible not to have
23 capacity in reserve to meet changing peak demand.

24

25 Further, at page 3 of its comments, OPC argues

1 that since water and wastewater utilities are
2 heavily contributed, we cannot compare them to
3 electric utilities with regard to the need for a
4 reserve. Whether or not a utility finances a
5 portion of its plant through CIAC has no bearing
6 on whether reserves are necessary for a utility to
7 adequately meet its service obligations. Reserves
8 are either needed or not needed. How the costs of
9 reserves are accounted for is not a factor in
10 determining whether they are needed. However, with
11 regard to cost responsibility for necessary
12 reserves, it should be clear that the CIAC paid by
13 customers is a prorata share of the costs incurred
14 to serve them. CIAC is not a "readiness to
15 serve" charge as implied by OPC nor is any
16 customer paying a premium or paying the same costs
17 twice or paying for in rates what has already been
18 paid for through CIAC. That is why rate base
19 reflects the investment net of CIAC. OPC's
20 allegations simply detract from the issue at hand;
21 i.e. determining the extent of margin reserve
22 necessary for a utility to function properly and
23 meets its statutory obligations.

24
25

1 Q. At page 3 of its comments, OPC argues that margin
2 reserve is not used and useful and therefore
3 should be included for cost recovery in AFPI. Do
4 you agree?

5 A. Obviously not. A primary purpose of our prefiled
6 testimony is to show the consistent, historical
7 support for a reserve requirement being used and
8 useful plant. To suddenly reverse that conclusion
9 to placate OPC is uncalled for. As a matter of
10 logic, if margin reserve were truly not used and
11 useful [which is clearly not the case], then it
12 should not be built . The Commission should then
13 tell utilities outright "do not build a reserve
14 margin - it is not used and useful. If you are
15 unable to meet your obligations to serve because
16 you do not have a reserve margin, you will not be
17 penalized. It will not be considered a service
18 deficiency." At least then, everyone will know
19 where they stand. But I do not think anyone wants
20 to make such a statement and be subject to the
21 resulting consequences. The simple fact is, margin
22 reserve is necessary and it is used and useful.

23

24

25

1 RESPONSE TO COMMENTS OF DEP

2 Q. At page 4 of its comments, DEP concludes that
3 reuse facilities should be considered 100% used
4 and useful. Do you agree?

5 A. Yes. DEP substantiates that the provisions of
6 Section 403.064, F.S. require this Commission to
7 allow utilities to fully recover prudently
8 incurred costs through its rate structure. The
9 only persons to whom rates can be charged are
10 existing customers. In addition, DEP points out
11 that it is DEP that is responsible for defining
12 reuse and that the PSC should cross reference its
13 rules to those of DEP. We agree with DEP's
14 comments on this matter. The policies of the
15 agencies regulating utilities should be
16 coordinated.

17

18 Q. If the Commission does not recognize reuse
19 projects as 100% used and useful, what would be
20 the potential consequence?

21 A. If a utility cannot earn a return on a portion of
22 the project costs, then the project would no
23 longer be economically prudent for the utility to
24 initiate. The consequence would be to discourage
25 the development of reuse projects in contradiction

1 to the state objectives stated in Section
2 373.250(1), F.S. (1995).

3

4 Q. Does that conclude your responsive testimony?

5 A. Yes, it does.

6

7

8

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