

ORIGINAL

DOCKET NO.: 971663-WS - Florida Cities Water Company

WITNESS: Direct Testimony of Patricia W. Merchant,
Appearing on Behalf of Staff

DATE FILED: JUNE 19, 1998

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APAC-RECORDS/REPORTING

1 DIRECT PREFILED TESTIMONY OF PATRICIA W. MERCHANT

2 Q. Please state your name and professional address.

3 A. My name is Patricia W. Merchant and my business address is 2540 Shumard
4 Oak Boulevard, Tallahassee, Florida 32399-0850.

5 Q. By whom are you employed and in what capacity?

6 A. I am employed by the Florida Public Service Commission as a Public
7 Utilities Supervisor in the Division of Water and Wastewater.

8 Q. How long have you been employed by the Commission?

9 A. I started working at the Commission in September 1981.

10 Q. Would you state your educational background and experience?

11 A. I received a Bachelor of Science degree with a major in accounting from
12 Florida State University in August 1981. Upon graduation, I was employed by
13 the Commission as a Public Utilities Auditor in what is now the Division of
14 Auditing and Financial Analysis. My primary responsibility in that capacity
15 was to perform audits on the books and records of electric, gas, telephone,
16 water and wastewater public utilities. In August 1983, I joined what is now
17 the Division of Water and Wastewater as a Regulatory Analyst in the Bureau of
18 Accounting. In May 1989, I became a Regulatory Analyst Supervisor in what is
19 now the Accounting Section of the Bureau of Economic Regulation, in which
20 capacity I am currently employed. I have attended various regulatory seminars
21 and Commission in-house training and professional development meetings
22 concerning regulatory matters.

23 Q. Are you a Certified Public Accountant?

24 A. Yes, I am. In September 1983, I received a certificate and a license
25 to practice in the State of Florida by the Florida Board of Accountancy.

1 Q. Are you a member of any professional associations?

2 A. Yes. I am a member in good standing of the American Institute of
3 Certified Public Accountants and the Florida Institute of Certified Public
4 Accountants (FICPA). I am a former member of the Board of Governors of the
5 FICPA and was the President of the Tallahassee Chapter of the FICPA for the
6 year ended June 30, 1994. I currently am the Vice Chair of the Florida State
7 University Accounting Conference Committee of the FICPA.

8 Q. Have you ever testified before the Florida Public Service Commission?

9 A. Yes, in Docket No. 840047-WS, Application of Poinciana Utilities, Inc.
10 for increased water and wastewater rates; in Docket No. 850031-WS, Application
11 of Orange/Osceola Utilities, Inc. for increased water and wastewater rates;
12 in Docket No. 850151-WS, Application of Marco Island Utilities for increased
13 water and wastewater rates; in Docket No. 881030-WU, Investigation of Sunshine
14 Utilities rates for possible over earnings; in Docket No. 940847-WS,
15 Application of Ortega Utility Company for increased water and wastewater
16 rates; and in Docket No. 911082-WS, Water and Wastewater Rule Revisions to
17 Chapter 25-30, Florida Administrative Code.

18 Q. Were you accepted as an expert in regulatory accounting?

19 A. Yes, I was.

20 Q. Have you ever testified before any other tribunals as an expert in
21 regulatory accounting?

22 A. Yes. I testified before the Division of Administrative Hearings, Case
23 No. 97-2485RU, Aloha Utilities, Inc., and Florida Waterworks Association,
24 Inc., Petitioners, vs. Public Service Commission, Respondent, and Citizens of
25 the State of Florida, Office of Public Counsel, Intervenors.

1 Q. Would you explain what your general responsibilities are as a Public
2 Utilities Supervisor in the Accounting Section of the Bureau of Economic
3 Regulation?

4 A. I am responsible for the supervision of five professional accountants
5 in the accounting section. This section is responsible for the financial,
6 accounting and rates review and evaluation of complex formal rate proceedings
7 before the Commission. This specifically includes the analysis of file and
8 suspend rate cases, overearnings investigations and limited proceedings of
9 Class A and B water and wastewater utilities under the jurisdiction of the
10 Florida Public Service Commission. The accounting section is also responsible
11 for the review of smaller filings of Class A and B utilities, such as
12 allowance for funds used during construction (AFUDC), allowance for funds
13 prudently invested (AFPI), service availability applications, and tariff
14 filings. This section coordinates, prepares and presents staff
15 recommendations before the Commission on the above type cases. This section
16 is also responsible for preparing testimony, testifying and writing cross-
17 examination questions for hearings involving complex accounting and financial
18 issues.

19 Q. Can you summarize the issues to which you are providing testimony?

20 A. I am testifying about Florida Cities Water Company's (FCWC) requested
21 method of allocating litigation fees incurred to all FCWC water and wastewater
22 customers. I am also providing opinion testimony regarding when or if
23 environmental legal fees should be recovered by a utility's customers.
24 Further, I address the accounting classification of any revenues which may be
25 collected from the customers.

1 Q. Please explain your testimony regarding the allocation to all FCWC
2 customers.

3 A. FCWC has requested that all of its water and wastewater customers
4 reimburse the company for litigation expenses incurred in FCWC's defense
5 against the U.S. Department of Justice (DOJ) and the U.S. Environmental
6 Protection Agency (EPA). FCWC claims that the DOJ proposed penalties were of
7 such magnitude, that any payment of these penalties would have severely
8 damaged the financial integrity of FCWC. According to FCWC, by litigating
9 these actions, FCWC preserved all systems from such calamity, thus benefitting
10 all FCWC customers.

11 Q. Was FCWC ultimately required to pay the maximum penalty sought by the
12 DOJ?

13 A. No. FCWC was fined a total of \$309,710 for violations of the Clean
14 Water Act (CWA). This was made up of \$289,425 for the Waterway Estates
15 Wastewater Treatment Plant (North Ft. Myers), \$14,675 for the Carrollwood
16 Wastewater Treatment Plant (Hillsborough County), and \$5,610 for the Barefoot
17 Bay Wastewater Treatment Plant (Brevard County). The utility incurred a total
18 of \$3,826,210 for legal fees in defense of its violations of the CWA.

19 Q. How did the utility account for these legal fees on its books?

20 A. During the early years the utility capitalized some portion of these
21 costs for the expansion of the North Ft. Myers wastewater treatment plant.
22 During 1994, FCWC began expensing these legal fees below the line for rate
23 setting purposes. FCWC had written off all of these costs prior to 1997.

24 Q. Did the write-off of the penalties and legal fees cause any severe
25 financial damages to FCWC?

1 | A. No, in my opinion, they did not. FCWC has not filed bankruptcy or
2 | documented any direct financial harm caused by the write-off of these costs.

3 | Q. In your opinion, should the threat of severe financial harm to FCWC
4 | resulting from the DOJ proposed penalties be considered the burden of all
5 | FCWC's water and wastewater customers?

6 | A. No, it should not. These costs were incurred because of violations at
7 | specific wastewater facilities of FCWC. As Commission witness Moniz
8 | testifies, FCWC's rates for all but two systems have been set on a system-
9 | specific basis and are not uniform. The only facilities that have uniform
10 | rates are the North and South Ft. Myers water systems. To assume that the
11 | legal fees incurred for three wastewater systems found in violation of the CWA
12 | are the shared burden of all water and non-involved wastewater customers is
13 | inappropriate. These legal fees are not a cost of providing water service,
14 | nor are they a cost of wastewater service to any of the other FCWC wastewater
15 | facilities not penalized.

16 | Q. Do you have an opinion regarding when or if environmental legal fees
17 | should be recovered by a utility's customers?

18 | A. Yes. In general, legal costs prudently incurred by a utility for
19 | maintaining environmental compliance or bringing a utility into compliance
20 | with new environmental regulations should be considered a normal cost of doing
21 | business. If a utility can show that legal fees incurred for environmental
22 | compliance were prudent and sufficiently documented, then those costs should
23 | be recovered from the ratepayers. In a circumstance when an environmental
24 | agency claims that a utility is in non-compliance with environmental standards
25 | and a utility disputes this and ultimately is found to be in compliance, then

1 the Commission should look at the specifics in each case to decide whether the
2 utility prudently incurred legal fees in its defense of these claims. It is
3 also common for utilities to incur legal fees in conjunction with a penalty
4 or a consent order. I do not believe that just because penalties were
5 incurred that the associated legal fees should always be disallowed. If a
6 utility can show that the legal fees in such a case minimized or avoided
7 increased plant or operational costs to provide service, then such costs could
8 be considered beneficial to the customers and this should be considered on a
9 case by case basis. As long as the utility sufficiently justifies that the
10 legal fees incurred were prudent and not excessive, then the legal fees,
11 exclusive of the penalty, should be recovered through rates.

12 Q. What are some circumstances when environmental legal fees should not be
13 recovered by the customers?

14 A. First, if a utility fails to provide sufficient documentation supporting
15 its requested expenses or the amounts are deemed excessive or imprudent, then
16 those costs should be disallowed. It is the utility's burden to show that its
17 requested expenses are prudent and reasonable. Further, if the utility fails
18 to show that it acted prudently to maintain compliance with environmental
19 requirements, or that its defense mitigated other costs that might have
20 otherwise been incurred in connection with violations, then the associated
21 legal fees should be borne by the shareholders. The mere fact that a utility
22 incurs legal fees associated with a penalty does not automatically require
23 that those fees should be borne by the customers.

24 Q. Has the Commission addressed some of these issues in prior cases?

25 A. Yes. In Order No. PSC-97-1547-FOF-WS, (issued December 12, 1997, in

1 Docket No. 970521-WS, Betmar Utilities, Inc.), the Commission denied \$1,245
2 in legal fees associated with contesting allegations of a Florida Department
3 of Environmental Protection (DEP) consent order. The utility stated that the
4 legal fees incurred were legitimate utility expenses in connection with a DEP
5 consent order and as such, should be recovered. The Commission found that
6 even if the legal fees were found to be prudent, the utility failed to meet
7 its burden by its failure to provide supporting documentation to support its
8 legal fees. In Order No. PSC-93-0423-FOF-WS (issued March 22, 1993, in Docket
9 No. 920199-WS, Southern States Utilities, Inc.), the Commission allowed legal
10 fees associated with environmental fines because the evidence supported that
11 the ratepayers benefitted from the utility's defending itself in regulatory
12 proceedings. If the utility succeeds, rate base or other expenses may be
13 lower. In Order No. PSC-93-1070-FOF-WS (issued July 23, 1993, in Docket No.
14 920655-WS, Southern States Utilities, Inc. - Marco Island), the Commission
15 found that the suggestion that legal fees be disallowed because they were
16 incurred to defend the utility against alleged violations presupposes that the
17 utility should acquiesce in all cases, whether or not fault exists.
18 Litigation may be appropriate even when imposition of a fine is a possibility,
19 when compliance with a disputed regulation will create adverse economic
20 consequences. On other occasions, payment of a fine pursuant to a consent
21 order, even when "guilt" is not admitted, may result in avoidance of further
22 litigation costs that would be detrimental to a utility's financial condition.
23 The Commission found that an absolute prohibition against recovery of legal
24 fees in any proceeding where a fine may be imposed would be impractical. In
25 that docket, the Commission was addressing test year legal fees of \$20,738.

1 | not all of which related to contesting environmental compliance with the EPA
2 | and DEP.

3 | Q. How was this issue addressed by the Commission for other industries?

4 | A. In Order No. PSC-97-1047-FOF-EI (issued September 5, 1997, in Docket No.
5 | 970007-EI, Investor-Owned Electric Utilities), the Commission accepted a
6 | stipulation that legal expenses directly associated with environmental
7 | compliance activities approved by the Commission incurred in order to comply
8 | with environmental laws or regulations should be recovered. However, the
9 | Commission stated that those costs will continue to be examined on a case-by-
10 | case basis in order to determine the prudence of its recovery. In Order No.
11 | 20162 (issued October 13, 1988, in Docket No. 880069-TL, Southern Bell), the
12 | Commission denied recovery of expenses incurred in the settlement of antitrust
13 | cases. The Commission found that Southern Bell had not shown that the
14 | expenses were reasonable or to the benefit of Florida ratepayers.

15 | Q. Are you testifying to the issue of whether or not any costs should be
16 | recovered by the FCWC customers?

17 | A. No, I am not recommending specifically as to whether or not any costs
18 | incurred by FCWC should be recovered through customer rates. If the
19 | Commission finds that FCWC has shown that the legal fees were reasonable and
20 | prudent and were incurred to maintain compliance, or to minimize or avoid
21 | other increased plant or operational costs to provide service, then it may be
22 | appropriate for some amount of legal fees associated with this litigation to
23 | be recovered by FCWC's customers. I am not testifying as to whether FCWC has
24 | met this burden in this case, or what amount, if any, should be considered
25 | prudent or reasonable.

1 Q. If the Commission does allow some costs to be recovered by the
2 customers, how should they be allocated?

3 A. Any allowed costs should only be recovered from the North Ft. Myers,
4 Barefoot Bay and Carrollwood wastewater customers. The fees should be
5 allocated between these customers based on the evidence in the record that
6 shows what costs were incurred to maintain compliance or how FCWC minimized
7 or avoided other increased plant or operational costs.

8 Q. Please describe the accounting treatment for any amounts collected from
9 the customers associated with these legal fees.

10 A. Any amounts collected from the customers to reimburse the utility for
11 litigation costs incurred would be considered utility operating revenues and
12 as such regulatory assessment fees are required to be collected on those
13 amounts. These revenues should be recorded in Account No. 536, Other
14 Wastewater Revenues. According to Section 367.145, Florida Statutes,
15 regulatory assessment fees are based on 4.5 percent of gross revenues of the
16 utility derived from intrastate business. The only exemption in the statute
17 is for sales for resale made to a regulated company.

18 Q. Does this conclude your testimony?

19 A. Yes, it does.

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