

State of Florida

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# Public Service Commission

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TALLAHASSEE, FLORIDA 32399-0850

## -M-E-M-O-R-A-N-D-U-M-

**DATE:** JULY 9, 1998

**TO:** DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYÓ)

**FROM:** DIVISION OF WATER AND WASTEWATER (KYLE, MERCHANT) *JK*  
DIVISION OF LEGAL SERVICES (GERVASI) *RS*

**RE:** DOCKET NO. 971596-WS - PETITION FOR LIMITED PROCEEDING REGARDING OTHER POSTRETIREMENT EMPLOYEE BENEFITS AND PETITION FOR VARIANCE FROM OR WAIVER OF RULE 25-14.012, F.A.C., BY UNITED WATER FLORIDA INC. COUNTIES: DUVAL, NASSAU, ST. JOHNS

**AGENDA:** JULY 21, 1998 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

**CRITICAL DATES:** 90 DAY STATUTORY TIME LIMIT ON RULE WAIVER REQUEST WAIVED

**SPECIAL INSTRUCTIONS:** NONE

**FILE NAME AND LOCATION:** I:\PSC\WAW\WP\971596WS.RCM

### CASE BACKGROUND

United Water Florida, Inc. (UWF or utility) is a Class A utility providing water and wastewater service to approximately 29,000 customers in Duval, Nassau, and St. Johns Counties. According to its 1996 annual report, the utility's operating revenues were \$7,274,333 for its water service and \$14,584,266 for its wastewater service. UWF is located in a critical use area as designated by the St. Johns River Water Management District. Prior to May 1995, UWF was known as Jacksonville Suburban Utilities Corporation, a wholly-owned subsidiary of General Waterworks Corporation (GWC), now known as United Waterworks, Inc. (UWW). Subsequent to a merger in April 1994, UWW became a wholly-owned subsidiary of United Water Resources, Inc. (UWR), a publicly traded corporation listed on the New York Stock Exchange.

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By Order No. PSC-97-0618-FOF-WS, issued May 30, 1997, in Docket No. 960451-WS, the utility's last full rate case proceeding, the Commission approved the utility's current rate structure. Included in that structure were test year expenses of \$524,825 for Other Postretirement Employee Benefits (OPEB), and a rate base reduction of \$1,153,000 for unfunded accumulated OPEB liability. On June 16, 1997, UWF timely filed a Motion for Reconsideration of the Commission's Final Order. OPC filed a timely response to that motion on June 25, 1997. By Order No. PSC-97-1146-FOF-WS, issued September 30, 1997, in Docket No. 960451-WS, the Commission denied the utility's motion for reconsideration on the issue of OPEB. On October 30, 1997, UWF filed a Notice of Administrative Appeal of both the Final Order and the Order on Reconsideration. However, UWF voluntarily dismissed the appeal. On November 21, 1997, a copy of the order dismissing the appeal from the First District Court of Appeal was filed with the Commission.

On December 8, 1997, UWF filed this Petition for Limited Proceeding Regarding Other Postretirement Employee Benefits and Petition for Variance from or Waiver of Rule 25-14.012, Florida Administrative Code. The utility has indicated in its filing that, pursuant to Statement of Financial Accounting Standards No. 106 (SFAS 106), it recorded deferred OPEB costs during 1994, 1995, 1996 and through May 1997 amounting to \$1,100,098, and that it made Voluntary Employee Beneficiary Association (VEBA) contributions amounting to \$247,022 for the same period. As a result, the utility asserts that its unfunded OPEB costs as of May 1997 amounted to \$854,230.

In its petition, the utility requests that the Commission approve recovery of its unrecovered OPEB costs over a fifteen-year period at \$73,340 per year (\$26,402 for water and \$46,938 for wastewater), use as the unfunded OPEB cost reduction to UWF's rate base the amount of \$305,985, and increase UWF's rates to recognize the above adjustments. The utility calculates that this would result in revenue increases of 0.7033% and 0.6715% for water and wastewater, respectively.

UWF also requests that, if the Commission cannot fully grant the above request without granting a variance from or waiver of Rule 25-14.012 (2 & 3), Florida Administrative Code, such variance or waiver be granted with respect to the unrecovered OPEB Costs and the unfunded portion of the unrecovered OPEB costs.

Pursuant to Section 120.542(6), Florida Statutes, on December 18, 1997, the Commission provided notice to the Department of State, which published notice of the waiver request in the Florida Administrative Weekly. The Commission did not receive any comments regarding the utility's petition. By letter dated January 13,

1998, the utility waived the sixty-day limitation for the Commission's withholding of consent to the operation of any rate increase contained in Section 367.081(6), Florida Statutes, and the ninety-day requirement for the Commission's granting or denial of a petition for variance or waiver of a rule contained in Section 120.542(7), Florida Statutes, to enable the Commission to rule upon the utility's requests together.

Informal meetings to discuss the utility's petitions were held on January 16, 1998, and May 5, 1998, at the offices of the Commission. Representatives of the utility and Commission staff were present at both meetings. Subsequent to the first meeting, the utility provided additional information requested by staff and submitted a Memorandum of Law containing additional support for its requests. Subsequent to the second meeting, an additional Memorandum of Law was submitted by UWF.

#### **DISCUSSION OF ISSUES**

**ISSUE 1:** Should the utility's Petitions for Limited Proceeding regarding OPEBs and for Variance from or Waiver of Rule 25-14.012, Florida Administrative Code, be approved?

**RECOMMENDATION:** No. UWF's Petitions for Limited Proceeding regarding OPEBs and for Variance from or Waiver of Rule 25-14.012, Florida Administrative Code, should be denied. (KYLE, MERCHANT, GERVASI)

#### **STAFF ANALYSIS:**

##### **History of SFAS 106**

In December 1990, the Financial Accounting Standards Board (FASB) issued Statement of Financial Accounting Standards No. 106 (SFAS 106). SFAS 106 provides that effective for financial statements for fiscal years beginning after December 15, 1992, employers must recognize postretirement benefits obligations other than pensions (OPEBs) and related costs during the period employees provide the services that entitle them to future benefits.

Essentially, under SFAS 106, companies which have material OPEBs are required to change their form of accounting for OPEBS

from pay-as-you-go or cash basis to an accrual method of accounting. In addition to requiring the accrual of current period OPEBs expense, SFAS 106 requires recognition of a "transition obligation," consisting of the difference between the estimated present value of the accumulated OPEB costs not previously charged to expense, and the net fair value of qualifying plan assets when SFAS 106 was implemented. SFAS 106 permits two treatments of the transition obligation: (1) it may be charged to expense in one year; or (2) it may be amortized on a straight-line basis over a period of up to 20 years.

Since the inception of SFAS 106, its applicability to utility regulation has been widely debated and a wide variety of treatments has been adopted by state and federal regulatory agencies. The following is a brief summary of the history of this Commission's actions. Prior to the effective date mandated by SFAS 106, several large utilities requested Commission approval to adopt SFAS 106 for rate making purposes. On a case by case basis, the Commission approved the requests and the basic concept of accruing OPEBs, reserving to itself the authority to determine whether specific OPEB costs were accurately calculated and prudently incurred. On September 3, 1992, the Commission filed notice of its intent to adopt proposed rule 25-14.012 in the Florida Administrative Weekly. A challenge by OPC on behalf of the Citizens of the State of Florida was heard by the Division of Administrative Hearings on November 9, 1992, and was dismissed on March 26, 1993. Citizens of the State of Florida v. Public Service Commission, 15 FALR 1790, Case No. 92-5717RP (Rule Approval Decision). By Order No. PSC-93-1040-FOF-PU, in Docket No. 910840-PU, issued July 16, 1993, the Commission adopted Rule 25-14.012, Florida Administrative Code, with an effective date of August 4, 1993.

The text of Rule 25-14.012 as adopted is:

25-14.012 Accounting for Postretirement Benefits Other Than Pensions.

(1) "Postretirement benefits other than pensions" shall mean all forms of benefits, other than retirement income, provided by an employer to retirees, as defined by the Financial Accounting Standards Board in its Statement of Financial Accounting Standards No. 106 (Employers' Accounting for Postretirement Benefits Other Than Pensions, December 1990, which is hereby incorporated by reference). Those benefits may be defined in terms of specified benefits, such as health care, tuition assistance, or legal services, that are provided to retirees as the need for those benefits arises, or they may be defined in terms of monetary amounts that become

payable on the occurrence of a specified event, such as life insurance benefits.

(2) Each utility that offers postretirement benefits other than pensions shall account for the costs of such benefits in the manner required by Statement of Financial Accounting Standards No. 106 (December 1990). Deferral accounting under Statement of Financial Accounting Standards No. 71 (Accounting for the Effects of Certain Types of Regulation, December 1982) shall not be used to account for the costs of post retirement [sic] benefits other than pensions without prior Commission approval.

(3) Each utility's unfunded accumulated postretirement benefit obligation shall be treated as a reduction to rate base in rate proceedings. The amount that reduces rate base is limited to that portion of the liability associated with the cost methodology for post retirement [sic] benefits other than pensions.

Specific Authority: 364.01, 366.05, 367.011, Florida Statutes

Law Implemented: 364.17, 366.04, 367.121, Florida Statutes

History: New 8/4/93.

#### **History of UWF's Request for Recovery of OPEBs**

UWF requested recovery of OPEBs pursuant to SFAS 106 for the first time in its rate case filed on September 3, 1996 in Docket No. 960451-WS. Based on a projected test year ending December 31, 1997, the Commission approved rates calculated to recover annual OPEBs expense of \$524,825 (\$188,937 allocated to water and \$335,888 to wastewater). This amount was based on the test year expense as calculated by the utility, with a Commission adjustment for a reduced number of test year employees. In addition, pursuant to Rule 25-14.012(3), Florida Administrative Code, the Commission reduced UWF's rate base by \$1,153,000 (\$415,080 for water and \$737,920 for wastewater) to reflect the utility's unfunded OPEB liability as of December 31, 1997. This amount consisted of the accumulated OPEB expense of \$1,454,187 incurred from 1994 through 1997, less \$301,187 of contributions to a Voluntary Employees' Beneficiary Association (VEBA) trust. A VEBA is a tax exempt trust used by employers to provide certain types of benefits for employees. The above amounts were approved by Order No. PSC-97-0618-FOF-WS, issued May 30, 1997 (Final Order).

In its post-hearing brief, the utility requested approval to include in its rates the OPEB expenses incurred prior to the test year, amortized over a 15-year period. UWF also argued that its rate base should be reduced only by the allowed unfunded test period expense and the unfunded portion of the requested amortized expense. Amortization of the prior year expense was rejected by

the Commission as not supported by the record. The Commission also found that Rule 25-14.012(3), Florida Administrative Code, requires that rate base be reduced by the entire unfunded accumulated OPEB obligation.

On June 16, 1997, UWF filed a Motion for Reconsideration of the above order, pursuant to Rule 25-22.060(1)(a), Florida Administrative Code. Among the issues for which reconsideration was requested was the Commission's handling of the OPEB issues. UWF reiterated its request to amortize the prior years' expenses and unfunded liability amounts over a fifteen-year period. By Order No. PSC-97-1146-FOF-WS, in Docket No. 960451-WS, issued September 30, 1997 (the Reconsideration Order), the Commission denied the utility's request for reconsideration on these issues, upon finding that it had made no error of fact or law in determining that the evidence of record did not support such recovery. In the Motion for Reconsideration, UWF asserted that the intent of Rule 25-14.012(3), Florida Administrative Code, was to reduce rate base only for unfunded OPEB expenses which had been recovered from ratepayers. The Commission disagreed, stating that its decision in the original case was consistent with the language of the rule and evidence available from the record of the proceeding.

#### Petition for Limited Proceeding

The petition now before the Commission is a formal request to increase the utility's revenue requirement by \$188,597 (\$67,895 for water and \$120,702 for wastewater) over the rates approved in the Final Order. This would represent percentage increases of 0.7033% and 0.6715% for water and wastewater, respectively. The increase in revenue requirement would result from an increase in operating expense consisting of \$73,340 annual amortization of OPEB costs deferred in 1994, 1995, 1996 and through May 30, 1997 (the effective date of the Final Order), a revenue requirement adjustment of \$80,199 resulting from proposed adjustments to rate base for unrecovered OPEB costs, and associated adjustments of \$25,483 for income tax expense, \$8,487 for regulatory assessment fees and \$1,089 for uncollectible accounts.

UWF states in its petition that under accounting rules in effect prior to SFAS 106, its compensation structure did not result in the recognition of a significant level of OPEB costs. In response to a staff data request, the utility stated that its former ultimate parent, GWC, believed that UWF's OPEB costs were not material, and were therefore not subject to recording pursuant to SFAS 106. After GWC merged with UWR in April 1994, the management of UWR determined that it was necessary to perform an actuarial evaluation to quantify its subsidiaries' OPEB costs. The evaluation determined the costs were material, and they were

10. Rate actions of a regulator can reduce or eliminate the value of an asset. If a regulator excludes all or part of a cost from allowable costs and it is not probable that the cost will be included as an allowable cost in a future period, the cost cannot be expected to result in future revenue through the rate-making process. Accordingly, the carrying amount of any related asset shall be reduced to the extent that the asset has been impaired. Whether the asset has been impaired shall be judged the same as for enterprises in general.

UWF requests that the Commission allow a rate increase that would provide for recovery of the OPEB costs incurred from 1994 through May 1997 over a fifteen year period, i.e., \$73,340 per year. The utility believes, and staff concurs, that denial of this request, in conjunction with denial in the Final Order and the Reconsideration Order, would constitute a regulatory action which would cause an impairment of the previously recorded regulatory asset. SFAS 121 states, in part:

13. An impairment loss for assets to be held and used shall be reported as a component of income from continuing operations before income taxes for entities presenting an income statement . . .

14. An entity that recognizes an impairment loss shall disclose all of the following in the financial statements that include the period of the impairment write-down:

- a. A description of the impaired assets and the facts and circumstances leading to the impairment
- b. The amount of the impairment loss and how fair value was determined
- c. The caption in the income statement . . . in which the impairment loss is aggregated if that loss has not been presented as a separate caption or reported parenthetically on the face of the statement
- d. If applicable, the business segment(s) affected.

UWF has advanced a number of arguments in support of its request to defer and amortize these costs. The first argument is that SFAS 106 changed only the timing of recognition of OPEB costs, not the total amount to be recognized. The utility states that, absent the implementation of SFAS 106, all of its OPEB costs would be recognized on a pay-as-you-go basis and recovered in its rates. If the Commission does not allow deferral and amortization of the costs, as calculated under SFAS 106, incurred prior to the date of the Final Order, these costs will never be recovered. In its petition, UWF cites as authority for its request Section 367.081(2)(a), Florida Statutes, which provides in part, that:

recorded on UWF's books for the first time at December 31, 1994. In addition, the transition amount was calculated as of April 22, 1994, the date of the merger. The utility states that at the time Rule 25-14.012, Florida Administrative Code, was issued, it was unaware that it had a material OPEB liability, and that it was not aware that it was required to obtain prior Commission approval for deferring OPEB costs until the 1996 rate case was in process.

In this petition, UWF states that its deferred OPEB costs consist of the following:

1994	\$ 67,735
1995	398,303
1996	465,242
1997	<u>168,818</u>
Total	<u>\$1,100,098</u>

The amount for 1997 represents the OPEB cost for the first five months of the rate case test year, which UWF asserts was not "recovered" because the effective date of the Final Order was May 30, 1997. UWF states in its petition that if the Commission does not permit recovery of the above amounts in its rates, the utility will be required to charge \$1,100,098 entirely to income. Inquiry by staff has elicited the clarification that, while UWF does not itself issue public financial statements, its financial information is included in the audited financial statements of UWW and, indirectly, those of UWR. Subsequent to the 1994 merger, those statements have reflected a balance sheet item called "Regulatory Assets," which includes "Deferred Employee Benefits." These assets were recorded pursuant to SFAS 71, which states in pertinent part:

9. Rate actions of a regulator can provide reasonable assurance of the existence of an asset. An enterprise shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:

a. It is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes.

b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent clearly be to permit recovery of the previously incurred cost.



[t]he commission shall, either upon request or upon its own motion, fix rates which are just, reasonable, compensatory, and not unfairly discriminatory. In every such proceeding, the commission shall consider the . . . cost of providing the service, which shall include, but not be limited to . . . operating expenses . . . ; and a fair return on the investment of the utility in property used and useful in the public service.

The utility also cites, as authority to consider this matter in a limited proceeding, Section 367.0822, Florida Statutes, which provides in part, that:

[u]pon petition or by its own motion, the commission may conduct limited proceedings to consider, and act upon, any matter within its jurisdiction, including any matter the resolution of which requires a utility to adjust its rates.

#### **Retroactive Ratemaking Concern**

In response to staff's concern that approval of the requested deferral and amortization of OPEB costs would constitute retroactive ratemaking, UWF provided an extensive argument in its first Memorandum of Law, filed February 27, 1998. The utility asserts that the principal case in Florida on the establishment of a limitation against retroactive ratemaking is City of Miami v. Florida Public Service Commission, 208 So. 2d 249 (Fla. 1968). In City of Miami, the Florida Supreme Court noted that the Florida Legislature had limited the Commission's ratemaking authority by virtue of specific language in Chapters 364 and 366, Florida Statutes, requiring rates "to be thereafter observed in force," "to be thereafter installed, observed and used," "to be thereafter charged," and "to be imposed, observed, furnished, or followed in the future." Id. at 259. UWF asserts that Chapter 367, Florida Statutes, does not contain the same statutory limitations discussed in City of Miami, and that the legislature gave the Commission the power "[t]o prescribe fair and reasonable rates and charges," by Section 367.121(1)(a), Florida Statutes, and to "fix rates which are just, reasonable, compensatory, and not unfairly discriminatory," by Section 367.081(2)(a), Florida Statutes.

With respect to this argument, staff observes that the requirement to set rates which are "fair and reasonable" means that they must also be fair and reasonable to the ratepayers. In addition, staff notes language in Section 367.081(3), Florida Statutes, which implies a legislative intent that ratemaking for entities subject to Chapter 367 be prospective:

The commission, in fixing rates, may determine the prudent cost of providing service during the period of time the rates will be in effect following the entry of a final order relating to the rate request of the utility and may use such costs to determine the revenue requirements that will allow the utility to earn a fair rate of return on its rate base. (emphasis added)

In its first Memorandum of Law, the utility states that retroactive ratemaking occurs "where a new rate is requested and then applied retroactively," citing GTE Florida Inc. v. Clark, 668 So. 2d 971, 973 (Fla. 1996). UWF also cites to a definition of retroactive ratemaking formulated by the Commission that "retroactive ratemaking occurs when new rates are applied to prior consumption." Order No. PSC-95-1292-FOF-WS, issued October 19, 1995, in Docket No. 920199-WS. UWF argues that the deferral and amortization requested would not be retroactive ratemaking because new rates would not be established and applied retroactively to past consumption, but would be applied to future consumption. In informal discussions, management also stated that there is not a large amount of growth or turnover of customers in its service area; therefore, the impact of shifting rate recovery of the OPEB costs in question to current and future customers would not be extreme.

#### Extraordinary Cost Exception

The utility argues that, even if the Commission determines that the requested deferral and amortization constitute retroactive ratemaking, there are two major exceptions to the limitation against retroactive ratemaking. These exceptions are characterized as the "extraordinary cost" exception and the "fairness and equity" exception. Staff notes that these exceptions are not based on Florida Public Service Commission or Florida court decisions.

UWF's First memorandum of law states that an exception to the prohibition against retroactive ratemaking occurs when an extraordinary cost is incurred that does not arise from company mismanagement or imperfect forecasts in the ratemaking process. The utility cites a number of cases in support of its contention that the requested action falls within this exception, including MCI Telecommunications Corp. v. Public Service Commission of Utah, 840 P.2d 765 (Utah 1992); Philadelphia Electric Co. v. Pennsylvania Public Utility Comm., 502 A.2d 722 (Pa. Cmwlth. 1985); Town of Norwood, Massachusetts v. Federal Energy Regulatory Commission, 53 F.3d 377, 381, 383 (D.C. Cir. 1985); and Popowsky v. Pennsylvania

Public Utility Commission, 164 Pa. Cmwlth 600, 643 A.2d 1146 (Pa. Cmwlth 1994).

The utility's position is that the change in accounting treatment of OPEBs from traditional cash method to the accrual method prescribed by SFAS 106 was an extraordinary and unpredictable event, beyond the control of management. This concept has been argued extensively with regard to amortization of the transition obligation, and most regulatory agencies have agreed that the exception is applicable to the transition obligation. The rates already approved by the Commission for UWF include an annual amount for amortization of the transition obligation.

Staff believes that UWF's attempt to equate the transition obligation with OPEB costs incurred subsequent to the effective date of SFAS 106 is erroneous. A substantial amount of time passed from the issuance of SFAS 106 in December 1990 until the filing of UWF's rate case in July 1996. Management has stated that it did not believe that it had a material OPEB liability until after the merger of GWC and UWR in 1994. While "mismanagement" may be an excessively harsh term, the fact remains that management did not perform the calculations prescribed by SFAS 106 to determine the amount of the OPEB liability prior to 1994, even though SFAS 106 had been widely published, and even though the Commission had formally adopted SFAS 106 for ratemaking purposes in Florida by the promulgation of Rule 25-14.012, Florida Administrative Code, in 1993.

Even assuming that there was no material OPEB liability prior to 1994, UWF could have secured recovery of a substantial portion of the 1994, 1995 and 1996 costs by initiating a rate case or limited proceeding earlier than mid-1996. The Commission made a similar observation in denying deferral of OPEB costs by Florida Cities Water Company and Poinciana Utilities, Inc.:

In reaching our decision herein we also considered the fact that the utility knew the estimated amount of SFAS 106 costs as early as February, 1992. We find that the utility could have requested recovery of these expenses in rate case proceedings since it was known well in advance that SFAS 106 would be implemented in January, 1993. In Re: Florida Cities Water Co., Docket No. 921158-WS, and Poinciana Utilities, Inc., Docket No. 921159-WS, Order No. PSC-93-1328-FOF-WS, issued September 9, 1993.

**Fairness and Equity Exception**

UWF also believes that the circumstances of this case fall under the "fairness and equity" exception to the prohibition against retroactive ratemaking. The utility cites to GTE Florida, Inc. v. Clark, 668 So. 2d 971, 972 (Fla. 1996), wherein the Florida Supreme Court states that, "[W]e view utility ratemaking as a matter of fairness. Equity requires that both ratepayers and utilities be treated in a similar manner."

By this case, the Court reversed the Commission's order implementing a remand imposed by GTE Florida, Inc. v. Deason, 642 So. 2d 545 (Fla. 1994), which resulted from the Commission's disallowance of certain costs which had been included by GTE Florida, Inc. in a prospective test year in rate case proceedings. In GTE Florida, Inc. v. Deason, the Florida Supreme Court ruled that the Commission erred in disallowing the costs. GTE sought to impose a surcharge to recover the erroneously disallowed costs from the effective date of the original Commission order. The Commission denied the surcharge, characterizing it as retroactive ratemaking, but was reversed by the Court in GTE Florida, Inc. v. Clark, in which the Court held:

We ... reject the contention that GTE's requested surcharge constitutes retroactive ratemaking. This is not a case where a new rate is requested and then applied retroactively. The surcharge we sanction is implemented to allow GTE to recover costs already expended that should have been lawfully recoverable in the PSC's first order.

Id. at 973.

Staff believes that the facts in the present case are clearly distinguishable from those in GTE Florida, Inc. v. Clark, in which a surcharge was permitted to recover costs which should have been allowed in a timely filed rate case. UWF did not request recovery or deferral of the OPEB costs in question prior to incurring the costs.

**Conclusion Concerning Retroactive Ratemaking**

Based upon the preceding analysis, staff believes that allowing a rate increase to reflect amortization of OPEB costs deferred from 1994 through May 1997 would be a form of retroactive ratemaking, and that UWF has not shown that its circumstances fall within either the "extraordinary cost" exception or the "fairness and equity" exception to the prohibition against retroactive

ratemaking. The requirement in Rule 25-14.012(2), Florida Administrative Code, for prior Commission approval of deferral of OPEB costs is consistent with upholding this concept. Accordingly, staff does not believe the utility's request can be granted without a variance from or waiver of Rule 25-14.012(2), Florida Administrative Code. The utility's petition for variance from or waiver of this rule is discussed later in this recommendation.

### **Rate Base Reduction for Unfunded OPEB Liability**

The second major request presented in the utility's petition for limited proceeding is that an adjustment be made to the rate base reduction for unfunded OPEB liability which was included in the Final Order. (As a matter of clarification, it should be noted that the petition states that the amount of this reduction was \$1,143,920; the actual amount of reduction stated in the Final Order, after all other adjustments were taken into consideration, was \$1,153,000). UWF objects to having its rate base reduced for the total amount of the unfunded liability, and proposes an adjustment which would have the effect of creating an initial rate base reduction of \$305,895, which it says would consist of the unfunded portion of the 1997 OPEB cost recovered from June through December of 1997 plus the unfunded portion of the first year's amortization of deferred costs requested above. The rate base reduction would then be adjusted annually to include the unfunded portion of each subsequent year's amortization.

The utility's contention is that the intent of Rule 25-14.012(3) is to reduce rate base only for unfunded portions of allowed OPEB costs. In support of this position, the utility states that the Commission has not yet allowed the 1994, 1995 and 1996 OPEB costs (or allowed recovery for the 1997 OPEB costs through May 1997), but still reduced its rate base for the unfunded portion of the costs for those years. The utility cites the Rule Approval Decision, 15 FALR at 1783, which it interprets as providing that the rate base reduction is to be for unfunded portions of allowed OPEB costs. "Just as depreciation expenses result in a write-down of the value of the depreciated asset, so that the utility earns a rate of return only on the depreciated asset value, any unfunded accumulated postretirement benefit expense allowed by the Commission reduces the utility's rate base so no return is earned on that amount." (emphasis added)

Staff disagrees with UWF's interpretation of the rule's intent. The same paragraph of the Rule Approval Decision quoted above closes as follows:

If a specific OPEB expense for retirees is disallowed by the Commission (e.g., dental coverage for retirees) the utility does not recover that expense in its rate base. Concomitantly, the disallowed expense does not become a reduction to rate base.

Staff also notes that, while the original version of Rule 25-14.012(3) stated that the rate base reduction "is limited to that portion of the liability associated with cost allowance for postretirement benefits other than pensions," the final version of the rule adopted by the Commission changed the word "allowance" to "methodology." Order No. PSC-93-1040-FOF-PU, issued July 16, 1993, in Docket No. 910840-PU, In Re: Adoption of Rule 25-14.012, Florida Administrative Code, Employer's Accounting for Postretirement Benefits Other Than Pensions. As stated in the staff recommendation for adoption of the rule, "The change from cost allowance to cost methodology was proposed by staff to indicate that it was not referring to a specific dollar amount allowed in the utility's last rate case but rather the methodology used to calculate the reduction to rate base produced by OPEBs."

The Commission did not disallow any specific OPEB expense properly requested in the utility's last rate case, nor did it disallow any OPEB expense as a result of UWF's methodology of calculating the expense pursuant of SFAS 106. Furthermore, the Commission has consistently applied Rule 25-14.012(3), Florida Administrative Code, in rate cases where recovery of OPEB costs has been at issue. In Re: Florida Public Utilities Co., Order No. PSC-94-0983-FOF-EI, issued August 12, 1994, in Docket No. 930720-EI; In Re: Poinciana Utilities, Inc., Order No. PSC-94-1168-FOF-WS, issued September 26, 1994, in Docket No. 930912-WS; In Re: Florida Cities Water Co., Lee County Division, Order No. PSC-95-1360-FOF-SU, issued November 2, 1995, in Docket No. 950387-SU; In Re: Florida Cities Water Co., Barefoot Bay Division, Order No. PSC-96-1147-FOF-WS, issued September 12, 1996, in Docket No. 951258-WS; In Re: Southern States Utilities, Inc., Order No. PSC-96-1320-FOF-WS, issued October 30, 1996, in Docket No. 950495-WS. Therefore, staff believes that the utility's interpretation of the limitation of rate base reduction to allowed OPEB costs is incorrect.

Staff believes that the Commission has properly applied both the letter and the spirit of Rule 25-14.012(3), Florida Administrative Code, in determining the rate base reduction in the Final Order and in denying reconsideration in the Reconsideration Order. Unlike some jurisdictions, such as Pennsylvania, Florida does not require utilities to set up dedicated trust funds to accumulate OPEB costs as they are recovered in rates. Rule

Approval Decision, 15 FALR at 1783. See Pennsylvania Public Utility Commission opinion and order issued May 20, 1993, in Docket No. M-00930415, Re: Policy Statement for Implementation of SFAS 106. Accordingly, the rate base reduction mechanism incorporated in Rule 25-14.012(3), Florida Administrative Code, achieves a fair and reasonable result.

The utility asserts in its petition that when it makes the payments to fund the liability for costs incurred prior to the Final Order, it will not recover such payments in its rates, even though the policy of the Commission is for customers to pay the OPEB costs in their rates. This argument fails to recognize that the rate base reduction is only for unfunded OPEB liabilities. To the extent that funding actually occurs, the unfunded portion of the liability will decrease, as will the rate base reduction adjustment.

In summary, staff does not believe that UWF has shown that the rate base reduction determined in the Final Order should be adjusted, absent a waiver of or variance from Rule 25-14.012(3), Florida Administrative Code.

#### **Petition for Variance from or Waiver of Rule 25-14.012**

The final segment of UWF's petition is the Petition for Variance from or Waiver of Rule 25-14.012, Florida Administrative Code. The utility filed this petition in the event that the Commission determines that it cannot fully grant the relief sought as to UWF's rates or rate base without granting a variance from or waiver of Rule 25-14.012(2) & (3), Florida Administrative Code.

#### **Statutory Requirements**

Section 120.542(2), Florida Statutes, in pertinent parts, provides that "variances and waivers shall be granted when the person subject to the rule demonstrates that the purpose of the underlying statute will be or has been achieved by other means by the person and that application of the rule would create a substantial hardship or would violate principles of fairness. For purposes of this section, 'substantial hardship' means a demonstrated economic, technological, legal, or other type of hardship to the person requesting the variance or waiver. For purposes of this section, 'principles of fairness' are violated when the literal application of a rule affects a particular person in a manner significantly different from the way it affects other similarly situated persons who are subject to the rule." (emphasis added)

**The Underlying Statute**

The underlying statute pertaining to the rule in this instance is Section 367.121, Florida Statutes, which provides that the Commission shall have the power to prescribe fair and reasonable rates and charges, classifications, standards of quality and measurements, and to prescribe service rules to be observed by each utility. This statute does not explicitly address the issue of recovery of OPEB costs. However, Rule 25-14.012(2), Florida Administrative Code, provides that "[d]eferral accounting under Statement of Financial Accounting Standards No. 71 (Accounting for the Effects of Certain Types of Regulation, December 1982) shall not be used to account for the costs of post retirement benefits other than pensions without prior Commission approval," and Rule 25-14.012(3) provides that "[e]ach utility's unfunded accumulated postretirement benefit obligation shall be treated as a reduction to rate base in rate proceedings."

In its petition, UWF properly specifies the rule from which the variance or waiver is requested. It also specifies the type of action requested:

United Water Florida seeks the variance from or waiver of the requirements of Rule 25-14.012 (2 & 3), Florida Administrative Code, to the extent necessary that seven-twelfths of the current year (1997) unfunded SFAS 106 costs and one fifteenth of the unfunded portion of the Unrecovered OPEB Costs be treated as a reduction to rate base and that it recover its OPEB costs for such period in its rates. United Water Florida requests that only one fifteenth of the unfunded portion of the Unrecovered OPEB Costs be treated as a reduction to rate base simultaneously with the recognition of the one fifteenth of the Unrecovered OPEB Costs in United Water Florida's rates.

The specific facts that would justify a waiver or variance are presented by the utility as follows:

The strict application of the rule to United Water Florida for the Unrecovered OPEB Costs and the unfunded portion of the Unrecovered OPEB Costs will impose a substantial hardship, violate the principles of fairness, and lead to unreasonable, unfair and unintended results.

- a. United Water Florida incurred such costs and liabilities and such costs and liabilities were prudent and necessary.
- b. "The utility rate payers pay the cost of the OPEBs and other expenses in their utility rates." Rule Approval Decision, 15 FALR at 1782. Utility companies are to



recover OPEB costs in their rates. Because United Water Florida is not recovering its Unrecovered OPEB Costs in its rates, its customers are not paying for such OPEB costs and, therefore, the utility company's shareholders are paying for such OPEB costs.

c. If not for the rule and SFAS 106, United Water Florida would recover its OPEB costs in the year of payment.

d. The effect of imposing the rule will be the following: (i) reduce the rate base of United Water Florida by \$1,143,920 [sic] even though United Water Florida will not collect the related OPEB costs in its rates; (ii) not recognize payments to the VEBA in 1995 and 1996 by United Water Florida in the amount of \$247,022; (iii) not recognize future payments to be made to the VEBA from the currently unfunded portion of \$854,230; (iv) prevent United Water Florida from recovering its OPEB costs in its rates; and (v) reduce United Water Florida's current earnings by \$1,100,098; (vi) reduce United Water Florida's net operating income by 13.75 percent; and (vii) reduce United Water Florida's overall rate of return by more than 130 basis points.

UWF's petition addresses the statutory requirement that granting the variance or waiver will achieve the purpose of the underlying statute by stating:

Section 367.121, Florida Statutes (1995), the underlying statute for Rule 25-14.012, Florida Administrative Code, provides in part that "the Commission shall have power . . . [t]o prescribe fair and reasonable rates." Section 367.121 (1)(a), Florida Statutes (1995). Approving the requests of United Water Florida in the Petition will result in fair and reasonable rates. It is fair and reasonable for the company to recover its OPEB costs. It would be unfair and unreasonable to require United Water Florida to suffer a 13.75 percent loss in its net operating income and more than 130 basis point loss in its overall rate of return because of a timing change in accounting rules. Furthermore, United Water Florida already is following SFAS 106 and in compliance with the Commission's policy decision "that accrual accounting under FAS 106 is the most appropriate method to account for OPEB Expenses." Rule Approval Decision, 15 FALR at 1783. Granting the variance or waiver will result in United Water Florida not being penalized for following SFAS 106, which promotes the Commission's adoption of "a uniform system and classification of accounts for all utilities, which rules, among other things, shall establish adequate, fair, and reasonable depreciation rates and charges." See Section 367.121(1)(b), Florida

Statutes (1995). The variance or waiver will achieve the purpose of the underlying statute, Section 367.121, Florida Statutes (1995).

Staff reiterates at this point that the rates set pursuant to Section 367.121, Florida Statutes, should be "fair and reasonable" with respect to both the utility and the ratepayers. It does not appear to be fair and reasonable for current and future ratepayers to pay for costs of providing service in 1994, 1995 and 1996, when those costs could reasonably have been recovered from ratepayers during that time period, had UWF's management acted in a prudent and timely manner to request such recovery. Therefore, staff does not believe that UWF has met its burden of showing that the purpose of Section 367.121, Florida Statutes, will be achieved if the variance or waiver is granted.

The utility does not state in its petition that "principles of fairness," as specifically defined in Section 120.542(2), Florida Statutes, are violated by application of the rule to UWF. This issue is addressed in UWF's second Memorandum of Law, filed May 26, 1998. The utility asserts that companies such as Ford and General Motors can recover OPEB costs through setting prices in the competitive market place. Staff notes that regulated utilities are monopolies and that regulation takes the place of the competitive market. Moreover, the comparison is not relevant to the "fairness" issue in this context, because those companies are not subject to Rule 25-14.012. By definition, the only entities subject to the rule are utilities regulated by the Commission and which have material OPEBs. UWF, in its second Memorandum of Law, cites four cases involving requests for deferral of OPEB costs that were decided before the effective date of the rule: In Re: Petition for Certain Accounting and Ratemaking Authority Associated With Implementation of Statement of Final Accounting Standards No. 106 in Brevard, Collier and Lee Counties by FLORIDA CITIES WATER COMPANY, Order No. PSC-93-1328-FOF-WS, issued September 9, 1993, in Docket No. 921158-WS; In Re: Petition for Certain Accounting and Ratemaking Authority Associated With Implementation of Statement of Financial Accounting Standards No. 106 in Osceola and Polk Counties by POINCIANA UTILITIES, INC., Order No. PSC-93-1328-FOF-WS, issued September 9, 1993, in Docket No. 921159-WS; In Re: Petition for Authority to Defer SFAS No. 106 Costs by SOUTHERN STATES UTILITIES, INC., in Bradford, Brevard, Citrus, Clay, Collier, Duval, Hernando, Highlands, Lake, Lee/Charlotte, Marion, Martin, Nassau, Orange, Osceola, Pasco, Seminole, Volusia, and Washington Counties, and by LEHIGH UTILITIES, INC. in Lee County, Order No. PSC-93-1377-FOF-WS, issued September 20, 1993, in Docket No. 921301-WS; and In Re: Application for a Rate Increase in Osceola/Polk Counties by Poinciana Utilities, Inc., Order No. PSC-94-1168-FOF-WS, issued September 26, 1994, in Docket No. 930912-WS. (Note: the fourth of these examples actually was decided after the rule was in effect,

and dealt with the issue of rate base reduction, not with deferral of OPEB costs). The utility suggests that the rule (if not waived) will affect UWF differently from the other entities because the Commission used a 100 basis point threshold test in denying the other requests for deferral. UWF's argument is predicated upon the assumption that the 100 basis point test should be applied at the subsidiary level, rather than at the level of the parent corporation. This issue is discussed further in the next section. The utility's second Memorandum of Law fails to note that the 100 basis point test was not the only criterion used in denying the other utilities' requests. In Dockets Nos. 921158-WS and 921159-WS, the Commission stated:

In reaching our decision herein we also considered the fact that the utility knew the estimated amount of SFAS 106 costs as early as February, 1992. We find that the utility could have requested recovery of these expenses in rate case proceedings since it was known well in advance that SFAS 106 would be implemented in January, 1993.

In its decision in Docket No. 921301, part of the Commission's reason for denying deferral was that other cases cited by Southern States Utilities, Inc. in support of its request involved deferrals requested prior to the effective date of SFAS 106. Additionally, although the order noted that the effect of denying deferral would be limited to 39 basis points, the Commission also stated, "by the utility's own admission, many factors other than unrecovered OPEB costs currently are having a major effect on the financing ability of the total company."

Likewise, in its decision in Docket No. 930912-WS, the Commission considered the basis point reduction claimed by the utility, but also stated:

FAS 106 was adopted as an accounting standard in December 1990. It became effective for Poinciana for the 1993 fiscal year. Poinciana could have timed its rate case so that its implementation of FAS 106 would have matched the effective date of rates approved in a rate case. In any event, the rule does not tie the reduction of rate base due to the unfunded liability to the recovery of FAS 106 expense through rates.

Clearly, the Commission has consistently considered not only the potential financial effect of denying or granting deferral requests, but also the opportunity of the utilities to recover the costs without the need for deferral. In the course of its extensive review of the above cases and other cases decided after

the promulgation of the rule, staff has found no examples where application of the rule would have a different effect on UWF than on other affected entities. Therefore, staff concludes that UWF has not shown that "principles of fairness" are violated by the literal application of the rule.

With respect to the alternative statutory requirement that the petitioner demonstrate that application of the rule would create a "substantial hardship," UWF's petition makes reference to the probability that the Commission's refusal to grant the requested variance or waiver would result in a financial statement adjustment of \$1,100,098, which would reduce UWF's operating income by 13.75 percent and its overall rate of return by more than 130 basis points. The effects on net operating income and rate of return are stated in terms of the operating income and rate of return projected in the Final Order, and the percentages relate to the operations of UWF as opposed to those of the parent corporation (UWW) or the grandparent (UWR). The Commission does not regulate UWW or UWR, but staff believes that it is appropriate to consider the relationship of the entities in determining the effect of the Commission's actions on UWF.

Assuming that the above conditions will be the result of the Commission's refusal to grant the requested variance or waiver, whether the conditions rise to the level of "substantial hardship" as defined in Section 120.542(2), Florida Statutes, is a question of fact for the Commission to determine. In its two memoranda of law, the utility states that the Commission has previously used a materiality threshold of 100 basis points to determine the financial impact of "the nondeferral of OPEB costs," and suggests that the 130 basis point effect calculated by UWF meets that test.

UWF itself does not issue public financial statements. Its results of operations and balance sheet are included in consolidated financial statements issued by UWW, and, through UWW, in consolidated statements issued by UWR. UWR is a publicly traded corporation listed on the New York Stock Exchange. According to a press release issued by UWR on March 12, 1998, UWR is the nation's second largest investor owned water services company, and it has paid continuous cash dividends on its common stock since 1886. According to UWR's Fourth Quarter Report for 1997, the average number of common shares outstanding during 1997 exceeded 35 million.

In its second memorandum of law, UWF includes a memo generated internally by UWR which discusses the hypothetical effect of a reduction of UWW's Standard and Poor's credit rating from its current "A" level to "BBB," concluding that such a reduction would increase interest costs on planned capital spending in UWF's area by \$700,000 per year. The same memo includes charts which purport

to show how UWW would be rated based on actual performance from 1994 through 1997. Staff reviewed these charts and recalculated the financial ratios, using the 1996 financial statements (the latest audited statements available). Staff's calculations indicate that, for 1996, ratios based on actual operations would result in an overall rating of "A." In addition, staff calculated Pretax Interest Coverage and Total Debt/Total Capital, both of which would indicate a probable rating of "A."

Of the ratios presented, only Funds From Operations/Total Debt and Funds From Operations Interest Coverage are affected by a change in net income as opposed to cash flow. Both of these ratios were recalculated assuming a net income decrease of \$1,100,098 (the presumed effect of the Commission's denying the rule waiver). In neither case would the ratio change enough to change the hypothetical rating.

In a previous case, United Telephone Company of Florida contended that a Commission decision would create a disincentive to invest in its stock. The Commission disagreed, stating that "no one can directly invest in United; rather one must purchase Sprint stock which conveys only an indirect interest in United." In Re: United Telephone Company of Florida, Order No. PSC-92-1277-FOF-TL, issued November 9, 1992, in Docket No. 910980-TL. This line of reasoning suggests that the appropriate level at which to measure the impact of the application of Rule 25-14.012, Florida Administrative Code, is the level at which investment and financing decisions are made by potential or existing investors and lenders. Staff analysis of the audited financial statements of UWW for 1996 (the most recent made available by the utility) revealed that bond financing for UWF is obtained by UWW. This was confirmed by discussion with the utility's representatives. The one-time write-off of \$1,100,098 would appear on the financial statements of UWW if determined to be material by management and the external auditors. The 1996 Statement of Consolidated Income for UWW showed "Operating Income" of \$41,697,000 and "Net Income Applicable to Common Stock" of \$20,693,000. Assuming materiality, the write-off would reduce these amounts by 2.64 percent and 5.32 percent respectively. The UWW financial statements do not reflect "Rate Base" directly; however, "Common Stock and Retained Earnings" at December 31, 1996 were \$259,181,000. The write-off, before tax effect, represents 0.42 percent of this amount, i.e., 42 basis points.

The consolidated financial statements of UWR for 1997 show "Operating Income" of \$95,644,000 and "Net Income Applicable to Common Stock" of \$29,331,000. If deemed material at this level, the write-off would reduce these amounts by 1.15 percent and 3.75 percent, respectively. Earnings per Common Share were \$0.83 for 1997. The write-off would reduce earnings per share by

approximately \$0.03. The write-off, as a percentage of "Common Stock and Retained Earnings" for UWR at December 31, 1997 of \$418,601,000, would be 0.26 percent, i.e., 26 basis points.

In another case involving deferral of OPEB costs, the Commission stated that "[s]ince SFAS 106 has a non-cash flow effect on the financial statements, we also find that the denial of the deferral of the OPEB expenses will not affect the utility's financing ability from a cash flow point of view." In Re: Florida Cities Water Co., Order No. PSC-93-1328-FOF-WS, issued September 9, 1993, in Docket No. 921158-WS; and Poinciana Utilities, Inc., Order No. PSC-93-1328-FOF-WS, issued September 9, 1993, in Docket No. 921159-WS.

In response to staff queries as to the specific effects on UWF of disallowance of the utility's current request, management expressed the opinion that, notwithstanding the fact that UWF's stock is not publicly traded, it has shareholders consisting of UWW and, indirectly, UWR. Management also stated that a deterioration in financial performance by UWF might result in decisions by the parent and/or grandparent corporations to reduce spending on capital improvements in UWF's service area, thereby potentially derogating service to UWF's customers. Staff believes these comments have some plausibility; however, when all of the known factors are taken into consideration, staff does not believe that the impact to UWF of literal application of Rule 25-14.012, Florida Administrative Code, rises to the level of "substantial hardship."

Granting a variance from or waiver of the rule requires that the petitioner meet the requirement of achieving the purpose of the underlying statute and either the "principles of fairness" test or the "substantial hardship" test. Staff does not believe that any of these statutory requirements have been met. Accordingly, staff recommends that the Commission deny the utility's request for variance from or waiver of Rule 25-14.012(2) and (3), Florida Administrative Code.

DOCKET NO. 971596-wS  
DATE: JULY 9, 1998

**ISSUE 2:** Should this docket be closed?

**RECOMMENDATION:** Yes. This docket should be closed if no person whose interests are substantially affected by the proposed action files a protest within the 21-day protest period. (GERVASI)

**STAFF ANALYSIS:** This docket should be closed if no person whose interests are substantially affected by the proposed action files a protest within the 21-day protest period.