ORIGINAL

FLORIDA CITIES WATER COMPANY
RATE APPLICATION FOR RECOVERY OF LEGAL EXPENSES
REBUTTAL TESTIMONY OF JOHN D. MCCLELLAN
TO DIRECT TESTIMONY OF
HUGH LARKIN, JR. AND PATRICIA W. MERCHANT
DOCKET NO. 971663-WS

Q. PLEASE STATE YOUR NAME AND ADDRESS.

A. John D. McClellan, Deloitte & Touche LLP, 555 12th Street N.W., Washington D.C., 20004.

Q. ARE YOU THE SAME JOHN D. MCCLELLAN THAT FILED DIRECT TESTIMONY IN THIS CASE?

A. Yes.

Q. WHAT IS THE PURPOSE OF THIS REBUTTAL TESTIMONY?

A. Florida Cities Water Company ("FCWC" or the "Company") requested that I review and respond to the direct testimony filed by Mr. Hugh Larkin, Jr., who is appearing as a witness for the Florida Office of Public Counsel ("OPC").

Q. HAVE YOU REVIEWED MR. LARKIN'S TESTIMONY AND ARE YOU PREPARED TO RESPOND TO THE OBSERVATIONS CONTAINED THEREIN?

A. Yes.

Q. PLEASE PROCEED WITH YOUR RESPONSES.

A. As indicated on page two of Mr. Larkin's testimony, he is recommending that the Company

be denied recovery of any portion of the $3.8 million of costs incurred in defending itself against the litigation resulting from claims filed and penalties sought by the Department of Justice (DOJ). He states that his recommendation is based upon the following assumptions:

- Recovery of the costs would reflect retroactive ratemaking
- The owners and creditors of the Company were the primary beneficiaries of the significant results achieved in the defense efforts and should therefore bear the costs
- The allowance by the Commission of the recovery of these costs would result in putting ratepayers in the position of "guaranteeing...[the costs of] any and all litigation undertaken by regulated public utilities..." in Florida.

Each of these assumptions upon which Mr. Larkin has based his recommendation is erroneous.

Q. WHAT IS THE BASIC CHARACTER OF RETROACTIVE RATEMAKING?

A. Retroactive ratemaking generally refers to the

application of current rates to recover from current ratepayers (or return to current ratepayers) revenues that should have been recovered (or not recovered) in rates of prior periods to cover costs of ordinary events effects were limited to those periods. For example, if it is determined that 1997 rates did not produce an adequate level of earnings (i.e., the cost of equity capital in 1997) and 1999 rates are adjusted to recover the 1997 rate shortfall (or excess), this could give rise to a legitimate claim of retroactive ratemaking. At the same time, regulators commonly allow the recovery in current or future periods of explicitly identified non recurring or extraordinary costs incurred in prior periods.

Q. IS RECOVERY OF NON-RECURRING OR EXTRAORDINARY COSTS OF PRIOR PERIODS CONSIDERED TO BE RETROACTIVE RATEMAKING?

A. No. Regulators have long practiced the spreading of costs incurred in one period over subsequent periods and do not consider the practice to embrace retroactive ratemaking. Generally, the spreading of costs is applied either to avoid the dramatic rate impact that

would result if rates were adjusted to recover the costs currently or to recognize the longer term benefits of the costs (or both). This spreading of cost recovery is precisely what FCWC is seeking. Along with avoiding complications in anticipating and providing for costs that were being incurred each year that the litigation continued, delaying recovery and spreading the litigation costs over future periods avoids any dramatic rate impact and gives credence to the fact that there are ongoing benefits to avoiding the penalties sought by the DOJ. The recovery of the litigation expenses as proposed by FCWC in this proceeding does not constitute retractive ratemaking.

Q. MR. LARKIN OBSERVES ON PAGE THREE OF HIS TESTIMONY THAT THERE IS NO ACCOUNTING ORDER THAT PROVIDED FOR DEFERRING THE EXPENSES AS INCURRED. BASED ON THIS CONDITION, HE CONCLUDES THAT RECOVERY CANNOT BE PERMITTED. WOULD YOU RESPOND?

A. Extraordinary cost conditions are often recognized as the costs are being incurred and cost deferral is approved as the expenditures are made. In such instances, the future regulatory treatment of the

cost accumulations is reserved for determination at the next rate proceeding. In other instances the extent, impact and timing of the costs are not subject to determination, and accounting cost deferral may not be or can not be obtained in advance. In these instances, the request for deferral and recovery will not arise until a rate filing occurs. In either case, cost recovery provisions will not be determined in the absence of a rate proceeding. The advance accounting approval does not assure ultimate rate recovery. Neither does the absence of such advance approval prohibit ultimate rate recovery.

Q. WHAT WERE THE CONDITIONS RELATING TO COST DETERMINATION AND ULTIMATE OUTCOME THAT CONFRONTED FCWC IN THE LITIGATION PROCESS?

A. First, costs were incurred over a number of years. During this period FCWC did not know how long the process would continue. Second, FCWC simply did not know how much cost would be incurred in the process. There was no way to estimate these costs in advance. Finally, there was no way for FCWC to accurately predict the ultimate outcome of the litigation process.

Q. WHY DID FCWC NOT GO BEFORE THE COMMISSION AND

REQUEST, IN ADVANCE, AN ACCOUNTING ORDER?

A. For the reasons stated above FCWC simply did not have sufficient data and information to go before the Commission until the litigation process was completed.

Q. DOES REGULATORY APPROVAL TO DEFER THE RECORDING OF AN INCURRED COST CONCURRENTLY ESTABLISH APPROVAL OF THE RATEMAKING TREATMENT OF THAT COST?

A. No. In many instances the accounting order will explicitly state that the approval is limited to accounting measures and that the ratemaking treatment of the costs will be established in subsequent rate proceedings. Where not explicitly stated, this condition is normally implied. Accordingly, approval of a delay in reporting costs does not establish the subsequent ratemaking treatment.

Q. DO GENERALLY ACCEPTED ACCOUNTING PRINCIPLES ("GAAP") REQUIRE THAT AN ACCOUNTING ORDER EXIST FOR A REGULATED UTILITY TO DEFER A CURRENT COST ASSUMED TO BE RECOVERABLE IN FUTURE RATES?

A. No. GAAP directives for regulated systems are expressed in Financial Accounting Standards Board Statement No. 71 : Accounting for the Effects of

Certain Types of Regulation ("FASB 71") issued in 1982. As stated at Paragraph 9 of FASB 71, for accounting purposes a regulated utility shall capitalize (i.e., defer) an incurred cost that would otherwise be charged to expenses 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, and

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.

This provision provides that costs normally expensed under GAAP standards shall be deferred if "it is probable" (i.e., can reasonably be expected or believed on the basis of available evidence or

logic) that future revenues will be produced through rates provided to recover the costs. Otherwise, the costs must be expensed for financial reporting purposes. The deferral conditions address recoverability issues and accounting orders are not even mentioned.

Q. DOES THE ISSUANCE OF AN ACCOUNTING ORDER BY A REGULATOR SATISFY THE GAAP REQUIREMENTS FOR COST DEFERRAL?

A. No. As observed, the issue is cost recoverability. As expressed at Paragraph 4 of the Introduction to FASB 71, accounting orders may be imposed by regulators that do not conform with GAAP. Under these conditions, the issuance of the order does not provide a basis for capitalizing and amortizing the cost. This situation will arise when an accounting order is not accompanied by cost recovery probability, and in such instances the utility is not permitted to defer the costs for financial reporting purposes. Paragraph 4 of FASB 71 includes the following language:

> "...a regulatory authority may order an enterprise to capitalize and amortize a cost that would be charged to income currently by

an unregulated enterprise. Unless capitalization of that cost is appropriate under this Statement, generally accepted accounting principles require the regulated enterprise to charge the cost to income currently."

Q. IS AN ACCOUNTING ORDER NECESSARY FOR THE SUBSEQUENT RECOVERY OF A PRUDENTLY INCURRED PRIOR PERIOD COST?

A. No. An accounting order may be useful in supporting the conclusion that rate recovery can reasonably be expected, i.e., that it is "probable". However, as previously observed and clearly evidenced by regulatory decisions, the existence of an accounting order does not establish prospective cost recovery, and the absence of an accounting order does not prohibit prospective cost recovery.

Q. IF FCWC OBTAINS A RATEMAKING ORDER THAT PROVIDES FOR THE RECOVERY OF LITIGATION COSTS, WILL FCWC BE ABLE TO CURRENTLY RECORD THOSE COSTS INCURRED IN PRIOR YEARS?

A. Yes.

Q. DID THE OWNERS AND/OR CREDITORS OF THE COMPANY BENEFIT FROM THE LITIGATION EFFORTS?

A. Yes. Had the claimed penalties of tens of millions of dollars been applied, the owners certainly would have been adversely affected. The creditors may or may not have been.

Q. DID THE RATEPAYERS ALSO BENEFIT FROM THOSE EFFORTS?

A. Yes. As has been expressed in the Company's direct testimony, the financial pressures that would have been produced by the levels of penalties sought by the DOJ would have created severe problems. The financial impact of these problems is not quantifiable, but it follows that a financially healthy company can perform more efficiently and at less costs than can a financially crippled system. Any losses in efficiency and increases in costs that result from financial crises will necessarily impact customer rates or service, or both.

Q. IS THE RELATIVE DEGREE TO WHICH THE COMPANY OR ITS RATEPAYERS MAY HAVE BENEFITED A LEGITIMATE ISSUE IN DETERMINING THE PROPRIETY OF COST RECOVERY?

A. No. The issue is the right of recovery of costs prudently incurred in operating and maintaining the system. Under the Cost of Service standard, a regulated utility is entitled to an opportunity

to recover all costs prudently and legitimately incurred in providing efficient and reliable service, and in maintaining a financially healthy system. There does not appear to be any reasonable challenge to the position that had the Company not mounted a defense against the DOJ claims that (1) the financial consequences would have been extremely serious, (2) a financially healthy system would not have emerged and (3) rates and/or services could have been negatively impacted. Accordingly, it is appropriate to conclude that the litigation costs were necessarily and prudently incurred. Consequently, it is appropriate that cost recovery be permitted.

Q. IS THERE ANY MERIT TO MR. LARKIN'S CLAIM THAT THE COMMISSION'S ALLOWING THE COMPANY TO RECOVER THESE COSTS WILL PROVIDE A "GUARANTEE" THAT FLORIDA UTILITIES WILL RECOVER "ANY AND ALL LITIGATION" COSTS IN THE FUTURE?

A. No. There simply is no basis for such a claim.

Q. AT PAGE 4, MR. LARKIN OBSERVES THAT RATEPAYERS ARE NOT GENERALLY RESPONSIBLE FOR FINES, PENALTIES OR COSTS RELATED THERETO. HAS THE COMPANY REQUEST ELIMINATED BOTH THE PENALTY AND THE RELATED LITIGATION COSTS?

A. Yes. As has been observed elsewhere, the Company is not requesting recovery of the penalty imposed by the decision of the court and is not requesting the full amount of litigation costs incurred. The request for recovery of litigation costs is at a level that relieves ratepayers of the portion of the costs that may be associated with the penalty. In the request, the litigation costs have been reduced by the ratio of the $5 million penalty that would have been absorbed, had a settlement been made, to the $309,000 penalty imposed by the court. The result is consistent with the position advocated by Mr. Larkin

Q. BEGINNING AT PAGE 7, LINE 18, MR. LARKIN DISCUSSES TWO CASES ADDRESSING LEGAL FEES. WOULD YOU COMMENT ON THE DECISIONS RENDERED IN THESE CASES?

A. Yes. In the first instance it is noted that the OPC had taken the position that legal expenses "...should be reduced by the amount allocated for defense of fines."(Larkin testimony page 8, line 6) The Commission concluded that it would be appropriate to allow recovery of legal expenses relating to permitting and compliance and "Accordingly, no adjustment to legal expenses has been made." (Larkin testimony page 8, line 18)

This clearly shows that the OPC position relating to the disallowance of legal expenses "...allocated for defense of DER and Environmental Protection Agency (EPA) fines" was rejected. That decision fully supports the allowance of the litigation costs in this proceeding.

In the second case referenced (Larkin testimony page 9, line 11), the Commission again issued a decision that supports the Company request in this case. Specifically, the Commission concluded that although the fines imposed due to violations of DEP and EPA requirements should be borne by the shareholders, that it was "...reasonable for UWF to recover the costs of defending such fines." Mr. Larkin then rejects the Commission's adopted principle on the grounds that the amounts were insignificant. It is of note that the finding addressed the principle. It did not in any way condition the recognition of legal fees on the significance of the fees in question.

Q. IN THE ANSWER AT PAGE 15, LINE 2, MR. LARKIN OBSERVES THAT THE COMPANY PERCEIVES THE DOJ CLAIMS TO HAVE BEEN UNREASONABLE, RESULTING IN SIGNIFICANT LEGAL FEES, AND THAT THERE IS NO BASIS

ON WHICH THE COMMISSION MAY CONCUR WITH THIS COMPANY VIEW. WOULD YOU COMMENT?

A. I disagree. The DOJ was seeking damages exceeding $100,000,000. Ultimately, the court established damages at less than $310, 000, or about 0.3% of the penalty sought by the DOJ. Even if compared to the DOJ's early settlement offer of $5.0 million, the court imposed only about 6.0% of the DOJ amount. This appears to fully support the perception that the DOJ action was unreasonable.

Q. MR. LARKIN FURTHER OBSERVES AT THAT POINT THAT THE COMMISSION IS PUT IN THE POSITION OF JUDGING THE QUALITY AND MOTIVE OF THE DOJ AND THAT SUCH IS NOT THE COMMISSION'S ROLE. WOULD YOU COMMENT?

A. I agree that such judgement is not a responsibility of the Commission and would observe that no such judgement is needed. The court has already judged both the quality and the motive of the DOJ. It is abundantly clear that the court's decision imposing a $300,000 fine in a case claiming $100 million of amounts due from the Company has already judged the quality of the DOJ position as being grossly excessive. The Court clearly indicated its opinion as to DOJ's motive by saying, "[T]he United States contends that

since a judgement was returned in its favor on its claims against the Defendant Florida Cities, [that] Florida Cities is hereby precluded from being a Sec. 2412(a) `prevailing party'. The Court agrees with Plaintiff's analysis and, grudgingly (emphasis added), with its conclusion." See page 11, Exhibit ____ (GHB-101).

Q. IN RESPONSE TO A QUESTION AT PAGE 16, LINE 23, MR. LARKIN OBSERVES THAT HE DOES NOT BELIEVE THAT BANKRUPTCY WOULD HAVE AFFECTED THE SERVICE TO RATEPAYERS. WOULD YOU COMMENT?

A. Mr. Larkin's view of the impact of bankruptcy is quite interesting. He argues that service would not be affected and then observes that FCWC would have emerged from the bankruptcy with debts discharged and stockholder interests extinguished. He concludes with the observation that under these conditions that "...utility rates might have seen a significant lessening." From these comments, it could be rationally concluded that the bankruptcy actually would have been the best of all worlds for the ratepayers.

I have a problem with this conclusion. To me, it stretches the credulity of finance and economic theory to conclude that a utility that

goes through a bankruptcy proceeding will be able to maintain the same quality of service, and at lower rate levels, than was maintained by the utility operating from a healthy financial position. I am convinced that such conditions would result in undesirable consequences to ratepayers.

Q. IS BANKRUPTCY, OR THE POTENTIAL THEREOF, THE REAL ISSUE IN THIS PROCEEDING?

A. No. The issue is the ability to recover reasonable costs that were prudently incurred in defending against the proposed imposition of large penalties by the DOJ; penalties that subsequently were found by the court to be inappropriate.

Q. EVEN IF SERVICE LEVELS AND RATES WOULD NOT HAVE BEEN ADVERSELY AFFECTED BY A LARGE PENALTY, IS THAT JUSTIFICATION FOR DENYING RECOVERY OF THE COSTS INCURRED IN AVOIDING THE PENALTY?

A. No. As has been observed, the Company surely has a right, if not an obligation, to defend itself against claims that appear to be unwarranted or excessive. In doing so costs will be incurred, and to the extent that such costs are reasonable and the Company actions are prudent, the costs should be recoverable in the application of cost

of service ratemaking principles.

Q. AT PAGE 23 MR. LARKIN RECOMMENDS DISALLOWANCE OF A RETURN TO MEASURE THE IMPACT OF DELAYED RECOVERY OF THE LITIGATION COSTS. WOULD YOU COMMENT?

A. Yes. Mr. Larkin has avidly argued against recovery of the costs in any form or manner. At this point, he appears to be building a fall-back position that will gain a partial victory in the event that cost recovery is found to be appropriate. As I have stated, both in my direct testimony and in this rebuttal testimony, I believe that accepted cost recovery principles fully support the recovery of these costs. If these costs have been legitimately incurred in maintaining the system (and no one has challenged that), cost recovery opportunity clearly should be provided. Since a part of the total cost of litigation is the cost of recovery delay, the costs associated with the delay should also be recovered.

To spread recovery out over a ten year period results in adding time value costs to the amounts initially expended. Accordingly, assuming that cost recovery is found to be appropriate, the rate base inclusion is unavoidable if full cost

recovery is to be made possible.

Q. DOES THAT COMPLETE YOUR REBUTTAL TESTIMONY?

A. Yes.