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DATE: AUGUST 10, 1998

TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYD)

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

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: AUGUST 18, 1998 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: 90 DAY STATUTORY TIME LIMIT ON RULE WAIVER REQUEST WAIVED THROUGH AUGUST 18, 1998

SPECIAL INSTRUCTIONS: DEFERRED FROM JULY 21, 1998 AGENDA CONFERENCE

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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FPSC-RECORDS/REPORTING

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.

This petition was initially considered at the July 21, 1998 Agenda Conference. The Commissioners requested additional information on certain topics, including detail of UWF's return on equity for the years in question, an analysis of similar cases where return on equity was considered, the financial impact of the requested rate base adjustment standing alone, an analysis of the rationale for reducing rate base for OPEB costs which have not been recovered in rates, potential alternatives to granting all of the utility's requested relief, and background on the reasons for the adoption of Rule 25-14.012, Florida Administrative Code. The additional information requested is included in this recommendation.

Action was deferred until the August 18, 1998 Agenda Conference. The utility extended its waiver of the sixty-day statutory deadline pursuant to Section 367.081(6), Florida Statutes, and the ninety-day statutory deadline pursuant to Section 120.542(7), Florida Statutes.

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: Staff recommends denying UWF's requests for several specific reasons. Allowing the utility's request for amortization of OPEB costs incurred in 1994, 1995, 1996 and through May 31, 1997, would be a form of retroactive ratemaking, and, in staff's opinion, would result in the prescription of rates and charges that are not fair and reasonable. Granting the rate base adjustment requested by the utility would also be a form of retroactive ratemaking, and would depart from well established ratemaking concepts arising from accrual accounting. These concepts are applicable not only to accounting for OPEBs, but to other fundamental issues, such as depreciation of plant and amortization of acquisition costs.

Furthermore, the Commission has adopted Rule 25-14.012, Florida Administrative Code, which specifically addresses accounting for OPEBs for regulatory purposes in Florida. Staff believes that UWF's request for waiver of or variance from this rule does not meet the statutory requirements for granting a waiver or variance. All petitioners for a waiver or variance must demonstrate that the purposes of the statute underlying the rule will be met through alternate means. Staff believes that the rates and charges prescribed as a result of granting a waiver or variance would not be fair and reasonable as required by the underlying statute, Section 367.121, Florida Statutes, because such rates would be the result of retroactive ratemaking, or of a departure from well established regulatory practice. Even if this requirement is deemed to be met, the petitioner must meet one of two additional requirements - a "principles of fairness" requirement or a "substantial hardship" requirement. Staff does not believe that UWF has satisfied either of these requirements.

The rationale and authority used by staff in forming its opinions will be presented in detail in the subsequent sections of this recommendation.

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. Staff solicited comments from Florida public utility companies by questionnaire and held two workshops in 1991 as part of the process of drafting a proposed rule. On August 4, 1992, staff submitted an Economic Impact Statement which stated, among other things, that:

[o]ne impact of the proposed rule will be to give utilities advance notice that regulators will apply FASB Statement No. 106 for ratemaking purposes and that increased expenses are to be flowed through to income immediately. In addition, the rule puts utilities on notice that, pending the next full rate case, increases in OPB [sic] expenses are to be absorbed by the companies unless the Commission grants specific approval to defer such costs for future recovery. In so doing, the

proposed rule will assist utilities in planning the timing and need to request rate increases.

On August 6, 1992, staff submitted its recommendation that the Commission propose Rule 25-14.012. The recommendation included explanations of the rule's provisions, including:

[p]aragraph (2) of the rule allows deferral accounting for postretirement benefits only if a utility receives prior Commission approval for such accounting treatment. In the absence of such approval, utilities must charge the accrued expense to net income in the period booked. Paragraph 364 of FAS 106 allows deferral accounting consistent with FAS 71 (Accounting for Effects of Certain Types of regulation). FAS 71 allows reconciliation of the difference between Generally Accepted Accounting Principles and ratemaking treatment of regulatory decisions. Staff believes that FAS 71 would require a utility to seek Commission approval for deferral accounting for FAS 106. Deferral accounting under FAS 71 would allow a utility to create a regulatory asset consisting of the difference between its FAS 106 expense and its pay-as-you-go expense. The utility would then expect to recover the amortization of this asset (the deferred amount) in its next rate case after implementing FAS 106. (emphasis added); and,

FAS 106 requires companies to report the benefits liability as that obligation accrues, rather than at the time the money is spent. Recognition of that obligation for ratemaking purposes allows "accrual recovery" of the expense, yet it would still be reported as a liability. Therefore, since the expense would already have been recovered through rates, the accrued liability shown on the balance sheet should be used to reduce rates in some way. (emphasis added)

As applied to the current case, staff infers from the above explanations that it was never contemplated that utilities (even if unaware of the rule) would attempt to record a regulatory asset for deferred OPEB costs pursuant to SFAS 71 without seeking Commission approval. Staff also infers that it was never contemplated that utilities would fail to follow paragraph (2) of the rule, thereby creating the apparent mismatch of "recovered costs" versus the rate base reduction.

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 a hearing officer 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). During the course of this hearing, staff witnesses testified as to some the benefits of adopting the rule, including:

1. better matching of costs of providing service to customers benefitting from the service;
2. consistency and comparability over time and across companies;
3. rate stability; and,
4. reliability of measurement.

During the hearing, a utility witness suggested that the intent of paragraph (3) of the rule would be clarified by changing the word "amount" in the last sentence to "methodology."

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. In its rate case application, UWF requested recovery of the annual expense of the OPEB costs as part of its projected test year ending December 31, 1997. UWF did not reduce its rate base for any portion of the OPEB expenses that were unfunded as of the end of the test year. Staff believes that UWF was unaware of Rule 25-14.012, Florida Administrative Code, until staff identified an issue to reduce rate base for the accumulated unfunded portion of OPEBs since the effective date of SFAS 106. At that point in time, it was too late in the docket for the utility to add testimony to the record regarding the past years' expenses and the reduction to rate base for the accumulated unfunded portion. While the utility argued against application of the rule in its post-hearing brief, the Commission had only the facts of the annual OPEB amounts that would have been expensed as evidence in the record, and, accordingly, made the adjustments required by Rule 25-14.012(3), Florida Administrative Code.

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. The revenue requirement increases associated with the separate components of

UWF's request would be \$90,086 for amortizing the deferred costs and \$98,512 for adjusting the rate base reduction.

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 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 UWR and, indirectly, those of UWF. 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.

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. According to SFAS 121, the regulatory asset would have to be written off as a loss from continuing operations.

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:

[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, 259 (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.

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 (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." Southern States Utilities, Inc., Order on Remand, 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.

The Commission has consistently recognized that ratemaking is prospective and that retroactive ratemaking is prohibited. See City of Miami; Gulf Power Co. v. Cresse, 410 So.2d 492 (Fla. 1982); Meadowbrook Utility Systems, Inc. v. Florida Public Service Commission, 518 So.2d, 326 (Fla. 1987); Citizens of the State of Florida v. Florida Public Service Commission, 448 So.2d 1024 (Fla. 1982); and GTE Florida Inc. v. Clark. See also Ortega Utility Company 95 FPSC 11:247 (1995). The general principle of retroactive ratemaking is that new rates are not to be applied to past consumption. The Courts have interpreted this to mean when an attempt is made to recover either past losses (underearnings) or overearnings in prospective rates. Past losses are interpreted to be prior period costs that a utility did not recover through its rates, causing the utility to earn less than a fair rate of return. An example of this was addressed in the Ortega case, when the utility requested to reduce accumulated depreciation in a rate case for prior losses where the utility argued that it had not earned a fair rate of return. In City of Miami, the Petitioner argued that rates should have been reduced for prior period overearnings and that the excess earnings should be refunded. Both of these attempts were deemed to be retroactive ratemaking and thus were prohibited.

With respect to the utility's argument that Chapter 367 differs from Chapters 364 and 366, Florida Statutes, staff observes that the requirement under Section 367.081, Florida Statutes, to set rates which are "fair and reasonable" means that they must also be fair and reasonable to the ratepayers. Even though Section 367 does not contain the same specific language as Chapters 364 and 366, the Courts have consistently applied the same prospective requirement for ratemaking. It would not be fair, just, or reasonable to the customers to set rates based on prior consumption.

Staff does not believe that the Court decisions literally mean that retroactive ratemaking would occur when you go back to past consumption and back-bill customers for over or under collections during those periods. As previously noted, the Courts have determined that increasing future rates to make up for prior losses

(or reducing rates for prior overearnings) constitutes retroactive ratemaking. Staff believes that this is precisely what UWF is asking for the Commission to approve in its request.

Extraordinary Cost Exception to Retroactive Ratemaking

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. While staff will address these exceptions below, we believe that retroactive ratemaking is clearly prohibited in Florida. We note that these exceptions are not based on Florida statutes 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 in other jurisdictions with regard to amortization of the transition obligation, and most regulatory agencies have agreed that the exception is applicable only 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, and from the effective date of Rule 25-14.012, Florida Administrative Code, in August, 1993, 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. 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. Further, the Commission's adoption of SFAS 106 for ratemaking purposes by Rule 25-14.012, Florida Administrative Code, in 1993 was noticed to all PSC regulated utilities. Clearly, UWF had time to consider the impact of SFAS 106 and the timing of rate relief.

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 to Retroactive Ratemaking

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, which should be read narrowly to apply in situations in which a surcharge was permitted to recover costs which should have been allowed in a timely filed case. UWF did not request recovery or deferral of the OPEB costs in question prior to incurring the costs.

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." As an example of the application of this principle, if the Commission were to allow recovery of \$5 million test year OPEB expense in a rate case, the rate base reduction in the next rate case would be based on actual accumulated unfunded OPEBs, not on the specific amount of \$5 million per year.

Staff believes that the concept of rate base reduction for unfunded OPEB liability is analogous to the common situation in which a utility adds plant between rate cases. The utility does not earn a return on that plant or recover depreciation expense on that plant until it comes in for its next rate case. Nonetheless, the utility is required to reduce rate base for accumulated

depreciation on the plant from the date it was placed in service. Similarly, in UWF's last rate case, the utility had not amortized positive acquisition adjustments booked several years prior to the rate case. The Commission found that UWF should have been amortizing the acquisition adjustments and reduced rate base for the full amount of accumulated amortization, even though the utility had not recovered the amortization expense in rates for those prior periods. In staff's opinion, a decision not to apply the comparable provision for unfunded OPEB liability prescribed by the rule would be inconsistent.

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 to SFAS 106. Management bears the burden of determining the timing of requests for rate relief so that total recovered OPEB costs will approximate cumulative OPEB liability (the unfunded portion of which is subtracted from rate base). 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 an order issued on August 12, 1994, the Commission stated that Rule 25-14.012, Florida Administrative Code, requires reduction of rate base, adjusted OPEB expense to include accrual of life insurance expense, and ordered a reduction in working capital of \$13,089. In Re: Florida Public Utilities Co., Order No. PSC-94-0983-FOF-EI, issued August 12, 1994, in Docket No. 930720-EI.

Moreover, the Commission ordered a rate base reduction pursuant to Rule 25-14.012(3), Florida Administrative Code, despite objections from Poinciana Utilities, Inc. (Poinciana). Poinciana presented two witnesses who stated that the rate base reduction should not be applied because SFAS 106 costs had not yet been recovered in rates. This argument was repeated in Poinciana's brief. Nonetheless, the Commission affirmed the applicability of the rule, stating:

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. (emphasis added)

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The Commission then ordered a rate base reduction of \$30,000 for the total accrued unfunded OPEB amounts. In Re: Poinciana Utilities, Inc., Order No. PSC-94-1168-FOF-WS, issued September 26, 1994, in Docket No. 930912-WS.

In a final order involving Florida Cities Water Company (North Ft. Myers Division), the Commission stated the applicability of Rule 25-14.012(3), Florida Administrative Code, allocated a portion of total company OPEB liability to the division, and ordered a rate base reduction of \$81,855. In Re: Florida Cities Water Co., Lee County Division, Order No. PSC-96-1133-FOF-SU, issued September 10, 1996, in Docket No. 950387-SU. (This order was appealed, but not on the issue of OPEBs).

Similarly, in a proceeding involving Florida Cities Water Company (Barefoot Bay Division), the Commission applied Rule 25-14.012(3), Florida Administrative Code, and reduced rate base by \$152,048 to reflect the division's allocated portion of the total unfunded OPEB liability. 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 a rate case involving Southern States Utilities, Inc. (SSU), the Commission noted that SSU had appropriately reduced its rate base by the total amount of unfunded OPEB liability, consistent with Rule 25-14.012(3), Florida Administrative Code. In Re: Southern States Utilities, Inc., Order No. PSC-96-1320-FOF-WS, issued October 30, 1996, in Docket No. 950495-WS.

In the present case, staff believes that UWF's interpretation of the limitation of rate base reduction to allowed OPEB costs is incorrect. Staff also 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, staff believes that 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.

Conclusion Concerning Retroactive Ratemaking

Based upon the preceding analysis, staff strongly believes that allowing a rate increase to reflect amortization of OPEB costs deferred from 1994 through May 1997 or to reflect an adjustment of the rate base reduction ordered in the utility's last rate case would be a form of retroactive ratemaking. Even if the two exceptions were permissible to consider, UWF has not shown that its circumstances fall within either the "extraordinary cost" exception or the "fairness and equity" exception. The requirements in Rule 25-14.012(2) and (3), Florida Administrative Code, for prior Commission approval of deferral of OPEB costs and for reduction of rate base for unfunded OPEB liabilities are consistent with upholding this concept. Accordingly, staff believes that the utility's requests cannot be granted without violating the prohibition of retroactive ratemaking. If the Commission disagrees with staff's assertion that granting the requests would be retroactive ratemaking, then the only way these requests can be granted is through a variance from or waiver of Rule 25-14.012(2) and (3), Florida Administrative Code. The utility's petition for variance from or waiver of this rule is discussed later in this recommendation.

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:

[v]ariances 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. We do not believe it is 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. Further, had UWF requested rate relief in a timely manner, the question of rate base reduction for the unfunded liability would be moot. Staff believes that rates are established to allow utilities the opportunity to recover their prudently incurred expenses and earn a fair return on their investments, not a guarantee that they will do so. Further, granting UWF's request would create an "accounting nightmare." Maintaining the records necessary to reflect the adjustments in future rate proceedings would be time consuming and expensive for both the utility and the Commission.

It is clearly the burden of the utility's management to seek rate relief on a timely basis. Indeed, as stated previously in this recommendation, staff believes that granting the requested relief would be a form of impermissible retroactive ratemaking. 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. Because all petitioners for waiver or variance must meet the underlying statute requirement, staff believes that any discussion of the other requirements is superfluous; however, should the Commission wish to explore the issue further, staff has included the following analysis.

Principles of Fairness Requirement

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 it says were decided before the effective date of the rule. In the first case cited, Florida Cities Water Company (Florida Cities) requested deferral of OPEB expense from January 1, 1993 until its next rate case. The annual amount of OPEB expense was reported as \$251,626, and Florida Cities asserted that its earnings would be adversely affected without the deferral. The Commission calculated the effect of denying the deferral on Florida Cities' return on equity (ROE) based on Florida Cities' 1992 Annual Report as 104 basis points. The Commission denied the request, stating that it considered other factors, as follow:

some OPEB expenses were already included in a filed rate case and removal of these would reduce the ROE effect to 98 basis points;

the effect of rate increases from recent filings was not reflected;

information from the annual report was unaudited and did not reflect Commission adjustments from recent rate cases;

Florida Cities knew the estimated amount of FAS 106 costs as early as February, 1992, and could have requested recovery prior to the implementation date; and

SFAS 106 has a non-cash flow effect on the financial statements, so that denial would not affect Florida Cities' financing ability from a cash flow point of view.

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 the same order, the Commission denied deferral of OPEB costs requested by Poinciana Utilities, Inc. (Poinciana). The amount of annual OPEB expense claimed by Poinciana was \$32,445. The Commission calculated the effect of the denial on ROE as 72 basis points. The Commission stated that, in reaching its decision, it also considered Poinciana's withdrawal of a recent rate case which included OPEB costs. 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.

Southern States Utilities, Inc. (SSU) requested deferral of OPEB costs from January 1, 1993, until the date final rates were approved in pending rate cases. The amounts involved totaled \$299,276. SSU provided a calculation of the ROE effect on the total company of 39 basis points. The Commission recalculated the effect, based solely on PSC regulated systems, as 23 basis points. As in the other cases cited by UWF, in this case the Commission mentioned other factors considered in its decision, including that:

the effect of the deferral on SSU's financing capability was not determinable because final rates from pending rate cases had not been implemented; and,

by SSU's own admission, many factors other than OPEBs were currently having a major effect on the financing ability of the total company.

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.

The fourth case cited by UWF in its second memorandum of law was a rate case discussed earlier in this recommendation involving Poinciana Utilities, Inc. This case 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 Commission order mentioned the deferral request discussed above and the calculated ROE effect from that case, but did not use the ROE concept in reaching its decision in the cited case. 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.

In the present case, UWF 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. The circumstances of those cases differ in that the ROE analysis was done for the primary purpose of estimating the prospective effect of deferring costs not yet incurred. The majority of the costs requested by the utilities were costs to be incurred from the effective date of SFAS 106 until the utilities' next rate case. Additionally, staff's analysis of the cases cited reveals that effect on ROE is only one of the factors considered by the Commission in reaching its decisions.

Pursuant to a Commissioner request at the July 21, 1998 agenda conference, UWF submitted a calculation of the effect on ROE which would have resulted had the deferred OPEB costs been expensed each year. The utility computed Achieved ROE for each year from 1994 through 1997, and then calculated what it calls "adjusted ROE" for each year after subtracting each year's OPEB expense from net income. UWF contends that the appropriate measurement of ROE effect is to compare the so-called "adjusted ROE" with its approved ROE, which the utility states was 11.57%. This is the mid-point of the ROE authorized in the last rate case (the Final Order and the Reconsideration Order). Using this method, UWF calculates the ROE effects as follows:

Variance of Achieved ROE, Adjusted for OPEB Expense, Measured From Authorized ROE (UWF Calculation)

Year	Authorized ROE	Achieved ROE, Adjusted	Basis Point Effect
1994	11.57%	9.0894%	-248
1995	11.57%	8.8233%	-275
1996	11.57%	9.6307%	-194
1997	11.57%	8.8155%	-275

UWF also states that the one time write-off of \$1,100,098 would cause a basis point reduction in excess of 300 if applied to 1997.

Staff differs from the utility as to the method of determining the appropriate measure of ROE effect. During the years at issue, UWF was already achieving a ROE below the authorized rate, without consideration of the effect of OPEBs. The following is an analysis of the achieved ROE compared with the authorized ROE:

**Variance of Achieved ROE, Without OPEB Adjustment
 From Authorized ROE (UWF Calculation)**

Year	Authorized ROE	Achieved ROE	Difference
1994	11.57%	9.2797%	-229 Basis Pts
1995	11.57%	9.9017%	-167 Basis Pts
1996	11.57%	10.6887%	-88 Basis Pts
1997	11.57%	9.5591%	-201 Basis Pts

Staff believes that a more appropriate measurement is the difference between the achieved ROE and the achieved ROE adjusted for deduction of OPEB costs. This method will isolate the actual effect of expensing the OPEB costs, without the inclusion of other factors which may have been causing the utility to earn below its authorized rate of return. Staff also believes that, in calculating the achieved ROE adjusted for deduction of OPEB costs, the rate base reduction prescribed by Rule 25-14.012(3), Florida Administrative Code, should be used. Additionally, staff believes that the effect of the one-time write-off should be computed net of income taxes, as are the annual amounts. Recalculating the ROE effects using staff's method yields the following results:

**Variance of Achieved ROE, Adjusted for OPEB Costs
 From Achieved ROE (Staff Calculation)**

Year	Achieved ROE	Achieved ROE, Adjusted	Difference
1994	9.2797%	9.1010%	-18 Basis Pts
1995	9.9017%	8.8790%	-102 Basis Pts
1996	10.6887%	9.7353%	-95 Basis Pts
1997 (Annual)	9.5591%	8.9402%	-62 Basis Pts
1997 (One-time)	9.5591%	7.6468%	-191 Basis Pts

Using the method that staff believes to be logical and consistent, the effect of expensing OPEB costs would have produced a decrease in ROE of more than 100 basis points in only one of the four years analyzed. Additionally, the effect of the one-time non-cash flow write-off would be fewer than 200 basis points.

Staff reiterates that the detailed analysis of the ROE issue should not overlook the fact that the Commission has consistently considered not only the potential financial effect of denying or granting deferral requests, but also other factors, such as the opportunity of the utilities to recover the costs without the need for deferral.

In the course of our 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.

Substantial Hardship Requirement

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. The Commission does not regulate the parent, UWW, or the grandparent, 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, such as impact on the parents' ability to obtain financing or attract capital.

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. As noted by staff in the preceding discussion of the "principles of fairness" test, the Commission has not applied the 100 basis point threshold as an automatic sole determinant of economic effect, but has used this test in conjunction with other factors.

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 UWR'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 UWR's area by \$700,000 per year. The same memo includes charts which purport to show how UWR 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.

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. 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."

Staff has considered whether there are any viable alternatives to granting all of the relief requested by UWF, including the utility's proposal at the July 21, 1998 Agenda Conference that a longer amortization period be approved for the deferred OPEB costs. Staff believes that any amortization of the deferred costs or adjustment to the rate base reduction for unfunded OPEB liability would be inappropriate and would constitute retroactive ratemaking. In addition, staff believes that allowing UWF's request for adjustment of the rate base reduction would be discriminatory and unfair in view of the Commission's previous consistent treatment of this issue. Staff believes that granting either request would result in prescription of rates which would not be fair or reasonable.

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: AUGUST 10, 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.