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RECORDS AND
REPORTING

March 8, 1999

Ms. Blanca S. Bayó, Director
Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0870

RE: Docket No. 990006-WS

Dear Ms. Bayó:

Enclosed are an original and fifteen copies of Citizen's Comments in the above-referenced docket.

Also enclosed is a 3.5 inch diskette containing the Citizen's Comments in WordPerfect for Windows 6.1. Please indicate receipt of filing by date-stamping the attached copy of this letter and returning it to this office. Thank you for your assistance in this matter.

Sincerely,

Stephen C. Burgess
Deputy Public Counsel

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DOCUMENT NUMBER-DATE

02982 MAR-89

FPSC-RECORDS/REPORTING

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Annual Reestablishment of)
Authorized Range of Returns on Common)
Equity for Water and Wastewater Utilities,)
Pursuant to Section 367.081(4)(f), Florida)
Statutes.)
_____)

DOCKET NO. 990006-WS
FILED: March 8, 1999

CITIZEN'S COMMENTS

The Citizens of the State of Florida, through their attorney, the Public Counsel, file the following comments in response to the issues identified in the "Notice of Second Workshop" issued in this Docket on February 2, 1999.

1. Florida water and wastewater utilities may be unique with respect to other utilities across the nation.

a. What risk factors are unique to the water and wastewater industry?

- Generally, less risky than other regulated industries
- No substitute for water which is an essential resource
- High degree of operating leverage
- Relatively smaller firms

b. What risk factors are unique to the Florida water and wastewater utilities?

- Many small firms
- Relatively high percentage of contributed property
- Favorable regulation
- Automatic cost adjustments for inflation
- Allowance for funds prudently invested
- Allowance for funds used during construction (AFUDC)
- Staff assisted rate cases
- Reuse facilities are considered used and useful

c. How should the Commission quantify this risk?

The current method is reasonable.

2. The return on equity (ROE) and cost of borrowing are related. ROE should exceed the cost of borrowing.

DOCUMENT NUMBER-DATE

02982 MAR-89

FPSC-RECORDS/REPORTING

- a. What are the sources of loans for water and wastewater companies - banks, individuals, etc.?

Sources of loans for water and wastewater companies include banks, individuals, affiliates, private placements, and industrial development bonds.

- b. What are the qualitative factors that determine the price and availability of debt?
- c. Can water and wastewater companies borrow independently or do they need backing from parent companies or individuals?

Water and wastewater companies can borrow independently if they are properly capitalized, are not closely held, and meet standard credit criteria. Many closely held or undercapitalized companies must provide personal guarantees or guarantees by affiliated companies to help assure the lender that the borrower has a substantial interest in the repayment of the loan. The management of a company that is not closely held has a fiduciary responsibility to the shareholders of the company to ensure the company is financially well-managed.

- d. What are the typical terms of a loan to water and wastewater utilities, such as time to maturity and type of collateral?

Typical terms range from short-term loans of 30 days to 1 year, secured by assets or guarantees, at rates commensurate with current market rates that reflect the risk of the loan to 30-year bonds, at market rates, secured by the assets, revenues, and receipts of the company. Typical bank loans are for intermediate terms, secured by assets or guarantees, with rates ranging from prime to prime plus a risk premium based on the risk of the loan.

- e. What interest rates are typical for loans to water and wastewater utilities?

Interest rates for water and wastewater utilities vary based on market conditions and the credit worthiness of the borrower.

3. The current leverage formula, established by Order No. PSC-98-0903-FOF-WS, issued July 6, 1998, is based on the financial theory that the lower the equity ratio (percentage of common equity to total debt and equity), the higher the demanded return on equity (ROE) and vice versa. However, to discourage imprudent financial risk, the Commission does not allow for returns greater than the level indicated at a 40% equity ratio. Should the Commission's formula be modified or changed? Please explain what changes would lead to a more reasonable approach.

The Commission's approach should not be changed. The Commission should not provide an incentive (a higher return to shareholders) for inadequately capitalizing a company. Inadequate capitalization can result in poor service, high capital costs, and abandonment.

4. The Commission employs an average of three financial models to estimate ROE for the water and wastewater industry, a discounted cash flow (DCF) model, capital asset pricing model (CAPM) and a risk premium analysis. The present input into these models is readily available historical and prospective market information.

A. Are there other financial models that would more reasonably reflect the average ROE for the Florida water and wastewater industry? Please explain.

The models relied on by the Commission are reasonable.

B. Would other financial models rely on historical market information or prospective information?

All models used to estimate ROE should use prospective information.

5. The current financial models use quarterly compounding. Should ROE models use annual or quarterly compounding? Please explain.

If quarterly compounding is used, the resulting rate, the effective rate, should be adjusted to the nominal rate to reflect the reinvestment associated with dividends paid and earnings retained and should also be adjusted to be consistent with the equity ratio construct (13-month average, etc.) used to determine revenue requirements.

6. The current DCF model employed in the derivation of the leverage formula is applied to an index of large, publicly traded water utilities. Most of these companies have no operating systems in Florida. Is this a reasonable approach? If not, provide details as to a more reasonable index of companies which reflect the ROE for an average water or wastewater utility and where to readily obtain such information.

Generally, the current approach is reasonable. However, a DCF model using historical information should not be used.

7. The current risk premium analysis employed in the derivation of the leverage formula is applied to an index of natural gas distribution utilities. Is this a reasonable approach? If not, provide details as to a more reasonable index of companies and where to readily obtain such information.

The current approach is reasonable.

8. In the development of the leverage formula, the Commission assumes a Moody's Baa bond rating for all Florida water and wastewater utilities. There is a bond yield differential adjustment to reflect the difference in size between the index companies and typically small Florida utilities.

A. Is an assumed bond rating of Baa3 reasonable for all Florida utilities? Please explain.

For purposes of establishing the cost of debt for use in a single leverage formula that is to be used for the purposes the leverage formula has been used by the Commission, an assumed bond rating of Baa3 is reasonable. An assumed Baa3 bond rating reflects the fact most water and wastewater utilities in Florida are small and have somewhat greater relevant risk than the comparison companies used in the indices to determine ROE. Use of a bond rating below Baa3 would assume that the ability of the companies to pay interest and repay principal is speculative and such a conclusion is illogical for a regulated utility under the jurisdiction of a commission viewed as favorably as the FPSC.

B. If not, what bond rating should the Commission use? Please explain.

Not applicable.

C. Does the bond yield adjustment accurately reflect the difference in size between the index companies and Florida utilities? Why or why not?

There is no definitive way to accurately quantify the difference in risk between the index companies and Florida utilities. The method employed by the Commission represents a reasonable approach to quantifying such difference.

D. Should the Commission recognize the difference in size of utilities within the Florida industry? Why or Why not?

Yes. The formula, as prescribed by the Commission, addresses the relevant risk of small utilities in Florida. If a firm is meaningfully larger, and therefore less risky (all other things being equal), than the profile reflected in the formula, the larger firm should be allowed a lower ROE.

E. What alternatives to a bond yield differential should the Commission employ to recognize the difference in risk between Florida utilities and the companies in the indices? Please explain.

The bond yield differential is a reasonable method of recognizing the difference in risk between Florida utilities and the companies in the indices.

9. Other than higher ROE's, what regulatory policies would enhance the opportunities of water and wastewater utilities to earn a reasonable rate of return?

In the long run, all parties are better served by utilities that have compensatory rates that are not excessive and that have adequate capitalization.

10. What regulatory policies would improve the financial viability of Florida water and wastewater utilities?

Regulatory policies that allow companies to have compensatory rates that are not excessive, such as a financial integrity test and a minimum equity ratio.

Potential Issues to be Added

Is it appropriate to weight historical DCF results by market capitalization?

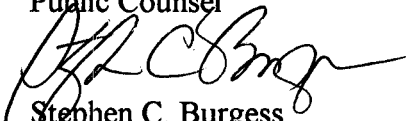
To what extent do Commission policies, such as the automatic adjustment to costs for inflation, reduce the risk of water and wastewater utilities?

Are the personal guaranties required for closely held firms a function of relevant risk or simply a function of the firm being closely held?

Is the CAPM an appropriate model to use to determine the ROE for water and wastewater utilities in Florida?

Respectfully submitted,

Jack Shreve
Public Counsel



Stephen C. Burgess
Deputy Public Counsel

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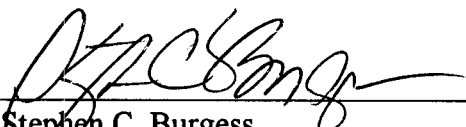
I HEREBY CERTIFY that a true and correct copy of Citizen's Comments has been furnished to the following parties by hand-delivery(*) or U.S. Mail this 8th day of March, 1999:

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