



Public Service Commission

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DATE: APRIL 19, 2001

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

FROM: DIVISION OF ECONOMIC REGULATION (KYLE, MERCHANT) *J.M.C.*
DIVISION OF LEGAL SERVICES (CIBULA)

RE: DOCKET NO. 001514-WS - PETITION FOR APPROVAL OF REGULATORY ACCOUNTING TREATMENT IN DUVAL, NASSAU, AND ST. JOHNS COUNTIES BY UNITED WATER FLORIDA INC., HOLDER OF CERTIFICATES NOS. 236-W AND 179-S, AND REQUEST FOR RELIEF. COUNTIES: DUVAL, NASSAU, ST. JOHNS

AGENDA: 05/01/01 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\ECR\WP\001514.RCM

CASE BACKGROUND

United Water Florida Inc. (UWF or utility), is a Class A utility providing service to approximately 31,000 water customers and 24,000 wastewater customers in Duval, Nassau, and St. Johns Counties. According to its 1999 annual report, the utility's operating revenues were \$11,515,168 for its water service and \$18,126,745 for its wastewater service. The utility's current rates were approved pursuant to Order No. PSC-99-1070-FOF-WS, issued May 25, 1999, in Docket No. 980214-WS. In that order, the Commission approved a rate of return of 8.22 percent, with a range of 7.78 percent to 8.66 percent.

On September 18, 2000, UWF filed a petition for approval of regulatory accounting treatment for costs associated with implementation of a voluntary early retirement (ER) program in 1999. The utility seeks to defer these costs to create a

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regulatory asset, and to have the costs considered in its next rate case, with amortization to begin after the Commission's action in the next rate case. This recommendation addresses UWF's request. The Commission has jurisdiction pursuant to Sections 367.091, 367.101 and 367.121, Florida Statutes, to consider this petition.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission approve UWF's request for regulatory accounting treatment for costs incurred to implement an early retirement program?

RECOMMENDATION: No. The utility's request should be denied because the impact of utilizing standard accounting methods is not sufficiently material to create an extraordinary circumstance. (KYLE)

STAFF ANALYSIS: In its petition, UWF stated that, in 1999, the utility offered a voluntary early retirement program (ER program). The ER program was available to all UWF employees with 15 or more years of service who were 54 years of age on December 31, 1999. Additionally, this offer was made to employees with 10 or more years of service who were 62 or older on December 31, 1999. According to the petition, the ER Program was designed to capture efficiencies through work force reductions. UWF anticipated that several of the employees with longer service terms and higher salaries and benefits would elect to take advantage of the ER Program. UWF expected to utilize the result of the early retirements to restructure its staff and employ lower cost employees to replace the former higher cost employees. As a result, the utility anticipated developing a staff whose members would have longer remaining years of service and who were subject to reduced future turnover while reducing the overall cost of salaries and benefits for such a staff. Such benefits would act to reduce expenses in UWF's next rate case.

The utility stated that 12 UWF employees elected early retirement under the ER program, and that the actuarially determined cost to UWF of the program was \$1,055,418. UWF stated that it intends to accrue the cost in deferred accounts, which it states would create a regulatory asset. The utility further requests that the reasonableness and prudence of these costs be

considered by the Commission in the utility's next rate case, and that amortization of the regulatory asset not begin until after the Commission's action in such rate case. UWF also stated that its accounting for the cost of the ER program was in accordance with Statement of Financial Accounting Standards (SFAS) No. 87, Employers' Accounting for Pensions, as prescribed by Rule 25-30.117, Florida Administrative Code. Further, the utility stated that its proposed treatment of the cost as a regulatory asset was in accordance with SFAS No. 71, Accounting for the Effects of Certain Types of Regulation.

Staff has several concerns with the utility's request. First, staff believes that the Commission's practice has been to approve deferral accounting in very limited circumstances. Second, staff believes that treating the ER program costs as a regulatory asset pursuant to SFAS No. 71 is inappropriate because the criterion of reasonable assurance of favorable Commission action has not been met. Further, staff is concerned that UWF's request addresses only deferral of the costs incurred in implementing the ER program, but not the resulting savings. These concerns are addressed in more detail in the following sections.

Deferral Accounting

The Commission approves or requires deferral of costs or losses in certain circumstances. These include amortization of rate case expense pursuant to Chapter 367.0816, Florida Statutes, and amortization of non-recurring items in a rate proceeding. See Rule 25-30.433(8), Florida Administrative Code. The Commission has also denied deferral of previously incurred costs. See Order No. PSC-98-1583-FOF-WS, issued November 25, 1998, in Docket No. 971663-WS in which the Commission stated:

(t)he utility argues that the Commission has allowed recovery of other out of test year litigation expenses on the basis that these expenses are extraordinary and non-recurring. As noted above, FCWC cites to Order No. 6094, issued April 5, 1974, in Docket No. 74061-EU, and Order No. 5044, issued February 4, 1971, in Docket No. 70214-W, as support for its position. However, we note that the expenses approved in those dockets were requested in rate cases, and not for costs incurred prior to the date the application was filed, as is the case here. As courts have made clear, there is no reasonable claim for costs incurred prior to the date the application was filed or for cost categories discovered after the rate case is approved. We find that the prohibition against

retroactive ratemaking protects the public by ensuring that present consumers will not be required to pay for past deficits of the company in their future payments. This practice is fair to the public utility, for it can act as speedily as it sees fit to move for a modification of inadequate rates. It is also fair to the consumers, as they are safeguarded from surprise surcharges related to past accounting periods.

In its petition, UWF states that the ER program and its results are unusual and extraordinary because of the magnitude of the costs, and because this is the first time such a program has been offered on a company-wide basis. Staff, however, believes that the decision to implement such a program is an ordinary part of doing business, and, unlike events such as natural disasters, management had control over the choice of implementing the program and its timing. In Order No. PSC-92-1197-FOF-EI, issued October 22, 1992, in Docket No. 910890-EI, the Commission denied a request by Florida Power Corporation (FPC) to create and amortize a regulatory asset related to pension expense, stating:

We believe the regulatory asset and its amortization should be disallowed for ratemaking purposes. First, in order to record an asset or a liability under FAS No. 71, there must be an indication from us that the asset or liability will be recoverable. In this case, there was no such indication. It was inappropriate for FPC to use FAS No. 71 without our prior approval.

Second, we do not believe pension expense should be "tracked." Pension expense will be run through earnings and will fluctuate. Earnings should be reviewed in aggregate with no true-up provision for certain expenses. If a true-up is allowed for one expense, it can easily be argued that all the expenses should be trued-up. Other expenses also change, but the change itself does not justify deferring the expenses. Utilities are given an opportunity to recover their costs, not a guarantee. If costs change, the entire cost to serve must be reevaluated. Individual changes in costs should not be deferred for future recovery in another rate case.

Further, in Order No. PSC-98-0329-FOF-GU, issued February 24, 1998, in Docket No. 971310-GU, the Commission denied a request for deferral accounting for environmental costs by Peoples Gas System, Inc., stating:

The Company has been deferring all environmental costs since September 30, 1994, instead of expensing them. According to Peoples Gas, its position since that time, supporting deferral accounting, is that environmental costs are outside the Company's control in both magnitude and timing and are so unpredictable and erratic from year to year that deferral accounting is the only appropriate accounting method with which to account for them. Peoples Gas also believes that its accounting for these costs is correct and consistent with the method used in its last rate case.

We find that the Company should be expensing these costs because it was allowed \$1,248,000 in expenses in its last rate case and does not have our specific authority to defer these costs. A review of prior orders addressing Peoples Gas' environmental costs shows that the Commission has not authorized Peoples Gas to utilize deferral accounting on an ongoing basis.

Staff notes that the Commission has recently denied two requests for deferral by this utility. See Order No. PSC-98-1243-FOF-WS, issued September 21, 1998, in Docket No. 971596-WS, (finding 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); see also PAA Order No. PSC-01-0857-PAA-WS, issued April 2, 2001, in Docket No. 000610-WS, wherein the Commission proposed that treating the administrative costs incurred in connection with an application for service availability charges as a regulatory asset would not meet the "reasonable assurance" criterion required by SFAS No. 71. The protest period for Order No. PSC-01-0857-PAA-WS, expires April 23, 2001, and the order will become final and effective upon the issuance of consummating order, if no timely protests are received.

Qualification as a Regulatory Asset Pursuant to SFAS No. 71

Staff does not believe that it is appropriate to permit an indefinite deferral of recognition of the costs until the next full rate case. Such treatment would not meet the criteria for establishing a regulatory asset pursuant to SFAS No. 71, which states in relevant 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 which

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. (Emphasis added)

Staff's interpretation of SFAS 71 is that in order to defer any cost that otherwise would have been expensed, the utility has to have approval from the Commission to recover the cost in future rates. By not addressing the prudence of the ER program or specific amounts in this case, the utility is not reasonably assured of future revenue recovery. Thus, staff believes that deferring unadjudicated amounts would be in violation of SFAS No. 71. This is consistent with the Commission's proposed action in Order No. PSC-01-0857-PAA-WS (the denial of the deferral of regulatory commission expenses related to the service availability application of UWF).

Deferral of Costs versus Deferral of Savings

In its petition, UWF has requested deferral of the cost of implementing the ER program, but it did not consider the impact of the savings that would result immediately after implementation. In order to gain an understanding of the possible financial impact of the ER program, staff requested supplemental data from UWF. In its response, UWF provided additional documentation, including copies of the actuarial reports, details of specific employees electing early retirement, estimates of the effect on return on equity of expensing the entire cost in 1999 versus amortizing the cost over a three-year period, and explanations of discrepancies between the 1999 Annual Report and prior Commission decisions. In its response to staff's second data request, the utility provided a breakdown of projected savings by specific employee, including benefits, as well as estimates of the salaries and benefits of replacement employees, where applicable.

In its response to staff's second data request, the utility provided a calculation of net operating income and rate base which incorporated amounts reported in its 1999 Annual Report with certain adjustments. Total reported rate base was \$97,977,080, and net operating income was reported as \$7,153,718 (exclusive of any portion of the cost of the ER program). Using these figures, the achieved rate of return for 1999 was 7.30 percent. The utility's calculation of the after tax effect of the ER program cost is \$664,913, if the entire amount was expensed in 1999, or \$221,637 for each of three years, if amortized. As shown in Attachment 1, the effect of the ER program cost without consideration of benefits would be to decrease the rate of return to 6.62 percent, if the entire amount was written off in 1999, and to 7.07 percent, if amortized over a three year period.

In its petition, the utility states that, as a result of the ER program, the next rate case will reflect reduced payroll costs. Staff notes, however, that the utility will benefit from these reduced costs from the inception of the program. As shown in Attachment 2, staff has calculated the annual net savings of implementing the ER program to be \$210,869. When this amount is offset against the cost of the program, the achieved rate of return would be 6.84 percent, if the entire ER cost was written off in one year, or 7.29 percent, if amortized. Staff believes that, if a deferral were permitted, an appropriate amortization period for the ER program costs would be three years or more. As shown in Attachment 1, the projected savings would materially offset an annual amortization of the cost within three years. Further, assuming a three-year amortization period, the projected effect on rate of return would be only one basis point. In view of the immateriality of the effect on rate of return, combined with the fact that the utility was already earning below its approved rate of return, staff does not believe that accounting for the cost under normal accounting methods imposes a hardship on the utility.

In summary, as a result of staff's analysis of the timing and effect of the costs associated with UWF's implementation of its ER program, staff believes that the impact of utilizing standard accounting methods is not sufficiently material to create an extraordinary circumstance. Further, Commission practice has not been to permit deferral accounting in similar situations. Accordingly, staff recommends that UWF's request be denied.

DOCKET NO. 001514-WS
DATE: APRIL 19, 2001

ISSUE 2: Should this docket be closed?

RECOMMENDATION: Yes, if no timely protest is received upon the expiration of the protest period, the Order should become final and effective upon the issuance of a Consummating Order and this docket should be closed. (CIBULA)

STAFF ANALYSIS: If no timely protest is received upon the expiration of the protest period, the Order should become final and effective upon the issuance of a Consummating Order and this docket should be closed.

Docket No. 001514-WS
United Water Florida, Inc.

Attachment 1

Rate of Return Impact of ER Program Costs Without Consideration of Benefits

Year Ended 12/31/1999

1 Rate Base per Utility	<u>97,977,080</u>
2 Net Operating Income, per Utility	7,153,178
3 After-Tax Cost of Writeoff of Total ER Program Expenses - 1 yr	<u>(664,913)</u>
4	<u>6,488,265</u>
5 Rate of Return (Ln 4/Ln 1)	<u>6.62%</u>
6 Net Operating Income, per Utility	7,153,178
7 Amortized After-Tax Cost of Total ER Program Expenses - 3 Yrs	<u>(221,637)</u>
8	<u>6,931,541</u>
9 Rate of Return (Ln 8/Ln 1)	<u>7.07%</u>

Calculation of Rate of Return Including Costs and Benefits

10 Rate Base per Utility - 1999	<u>97,977,080</u>
<u>Expensed in 1 Year</u>	
11 Net Operating Income, per Utility	7,153,178
12 After-Tax Cost of Writeoff of Total ER Program Expenses - 1 yr	(664,913)
13 Net Annual Payroll Savings (From Attachment 2)	<u>210,869</u>
14 Adjusted Net Operating Income	<u>6,699,134</u>
15 Rate of Return (Ln 14/Ln 10)	<u>6.84%</u>
<u>Amortized Over 3 Years</u>	
16 Net Operating Income, per Utility	7,153,178
17 Amortized After-Tax Cost of Total ER Program Expenses - 3 Yrs	(221,637)
18 Net Annual Payroll Savings (From Attachment 2)	<u>210,869</u>
19 Adjusted Net Operating Income	<u>7,142,410</u>
20 Rate of Return Including Costs and Benefits (Ln 19/Ln 10) (Amortized Over 3 Years)	<u>7.29%</u>
21 1999 Achieved Rate of Return Without ER Program	<u>7.30%</u>

Docket No. 001514-WS
 United Water Florida, Inc.

Attachment 2

Calculation of Annual Net Payroll

Detail of Expected Savings from Employees Electing Early Retirement

<u>Titles</u>	<u>Current Employees</u>		<u>Replacement Employees</u>		<u>Total Savings</u>
	<u>Salary</u>	<u>Benefits (42 %)</u>	<u>Proposed Salary</u>	<u>Benefits (51.7%)</u>	
1 Operator 3	41,461	17,414			58,875
2 Operator 2	37,315	15,672	(36,795)	(19,023)	(2,831)
3 Lead Operator	43,216	18,151	(43,569)	(22,525)	(4,727)
4 T & D Maintenance Supervisor	51,880	21,790			73,670
5 Working Crew Leader	38,569	16,199			54,768
6 Maintenance Operator	40,841	17,153			57,994
7 Maintenance Operator	40,841	17,153			57,994
8 Maintenance Supervisor	49,346	20,725	(38,000)	(19,646)	12,425
9 SCADA Operator	41,667	17,500	(44,096)	(22,798)	(7,727)
10 New Business Coordinator	48,817	20,503	(54,500)	(28,177)	(13,357)
11 Customer Service Representative	29,282	12,298	(23,192)	(11,990)	6,398
12 Customer Service Representative	29,035	12,195			41,230
13 Total	492,270	206,753	(240,152)	(124,159)	334,712
14 Expected ER Program Savings					334,712
15 Tax Effect (37%)					<u>(123,843)</u>
16 Net Annual Savings of ER Program					<u>210,869</u>