

M E M O R A N D U M

SEPTEMBER 16, 2002

TO: DIVISION OF THE COMMISSION CLERK AND ADMINISTRATIVE SERVICES

FROM: OFFICE OF THE GENERAL COUNSEL (VINING) *AEV/ndt*

RE: DOCKET NO. 020006-WS - PROPOSED REESTABLISHMENT OF THE AUTHORIZED RANGE OF RETURN ON COMMON EQUITY FOR WATER AND WASTERWATER UTILITIES.

Attached is the Direct Testimony of Marshall W. Willis, on behalf of Commission Staff to be filed in the above referenced docket.

AEV/jb

DOCUMENT NUMBER DATE

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FPSC-COMMISSION CLERK

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Water and wastewater
industry annual reestablishment
of authorized range of return on
common equity for water and
wastewater utilities pursuant to
Section 367.081(4)(f), F.S.

DOCKET NO. 020006-WS

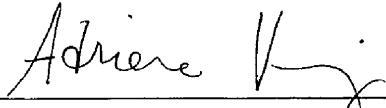
FILED: SEPTEMBER 16, 2002

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the DIRECT
TESTIMONY OF MARSHALL W. WILLIS, on behalf of The Florida Public
Service Commission has been furnished by U. S. Mail this 16th day
of September, 2002 to the following:

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DOCKET NO. : 020006-WS Proposed Reestablishment of the
Authorized Range of Return on Common Equity for Water and
Wastewater Utilities

WITNESS: Direct Prefiled Testimony of Marshall W Willis.
Appearing on Behalf of the Staff of the Florida Public Service
Commission

DATE FILED: September 16, 2002

DIRECT TESTIMONY OF MARSHALL W. WILLIS

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- Q. Please state your name and address?
- A. Marshall Willis, 2540 Shumard Oak Blvd., Tallahassee, Florida, 32399-0850.
- Q. What is your occupation?
- A. I am employed by the Florida Public Service Commission (Commission) as the Bureau Chief of the Bureau of Rate Filings in the Division of Economic Regulation.
- Q. What are your responsibilities as the Bureau Chief of the Bureau of Rate Filings?
- A. As the Bureau Chief, I am responsible for supervising all of the functions of the Bureau as well as the personnel within the Bureau. I am responsible for supervising a variety of professionals which includes, both now and in the past, certified public accountants, accountants, professional engineers, engineers, economists and regulatory analysts. My Bureau is responsible for processing a variety of work which includes rate case filings, staff assisted rate cases, limited proceedings, tariff filings, reuse cases, service availability cases, index applications, pass through applications, rule proceedings and customer complaints. The processing of these cases includes a thorough analysis of each case, preparation of staff recommendations, and the preparation and presentation of testimony when necessary.
- Q. Are you also a Certified Public Accountant?
- A. Yes. I am a Certified Public Accountant licensed by the State of Florida and have been since 1980.

1 Q. Have you ever testified as an expert?

2 A. Yes. I have testified in over fifty cases before the Commission and the
3 Florida Division of Administrative Hearings. I have testified as an
4 expert in the areas of accounting, incomes taxes, cost of capital,
5 utility rate making and utility regulation.

6 Q. Please briefly state your educational background and experience?

7 A. I have a Bachelor of Arts degree in Accounting from the University of
8 West Florida. In addition to testifying, I have also taught utility
9 rate making at the National Association of Regulatory Utility
10 Commissioner's Eastern Utility Rate School. I was the only non-lawyer
11 speaker at the 1981 District Court of Appeals - Public Service
12 Commission Seminar where I presented a basic course in utility rate
13 making to the Judges of the Florida District Court Appeals. I am a
14 member of the NARUC Staff Subcommittee on Accounting and Finance. I
15 also co-authored the 1984 NARUC Uniform System of Accounts for Water and
16 Wastewater Utilities and I am the author of the amended 1996 NARUC
17 Uniform System of Accounts for Water and Wastewater Utilities. The 1996
18 NARUC Uniform System of Accounts for Water and Wastewater Utilities is
19 the current version published by NARUC.

20 Q. How long have you worked for the Commission?

21 A. I have worked for the Commission for over twenty six years, the majority
22 of which has been in management positions within different divisions of
23 the Commission.

24 Q. What is the purpose of your testimony here today?

25 A. The purpose of my testimony is to explain the proposal made by the

1 Commission to reestablish the authorized returns on equity for water and
2 wastewater companies and to address some of the concerns raised by Mr.
3 Seidman in his direct testimony filed on behalf of Florida Water
4 Services Corporation.

5 Q. Would you please explain the Commission's proposal?

6 A. The Commission, in its proposed order, used the current leverage formula
7 which was established in this docket, to reestablish the authorized
8 return on equity (ROE) for all water and wastewater utilities that
9 currently have authorized ROEs. The Commission did not propose to
10 reestablish ROEs annually, but only when there had been significant
11 changes in the capital markets to warrant this type of action. In Order
12 No. PSC-01-2514-FOF-WS, issued December 24, 2001, the Commission
13 significantly changed the equity leverage graph which materially raised
14 the range of equity returns from prior years. Because of this
15 significant change, the Commission decided to change the authorized
16 ROE's to reflect the current market conditions. The Commission believed
17 that it would be more cost effective and therefore appropriate to use
18 this current proceeding to change the authorized ROEs in order to avoid
19 a more costly and inefficient piecemeal approach.

20 The Commission regulates approximately 200 water and wastewater
21 utilities of which there are currently 94 utilities that have authorized
22 ROEs. Many of these utilities have authorized ROEs that are outside of
23 the range of returns indicated by the current leverage formula. A
24 utility's authorized ROE and range can affect many things outside of a
25 rate case, such as, excess earnings reviews, index and pass-through

1 applications and Allowance for Funds Used During Construction (AFUDC)
2 rate. It can also affect the level of interim rates when a utility
3 files a rate case. The Commission's proposal to update the ROE's will
4 limit the chance of overstating or understating the true economic cost
5 to the utilities and bring many outdated ROEs in line with the current
6 economic returns expected by investors. It will help facilitate the
7 Commission's ability to prescribe fair, just, reasonable and
8 compensatory rates as required by statute.

9 As I stated before, the Commission took this action to bring the
10 large number of water and wastewater utilities with authorized ROE's
11 more in line with current market conditions. The Commission's proposal
12 would have the effect of raising 36 and lowering 32 utilities'
13 authorized ROEs. The remaining 26 would remain relatively unchanged
14 since they fall within the current range of equity returns produced by
15 the equity leverage formula. For the Commission to change the
16 authorized ROE's of this many utilities in separate limited proceeding
17 dockets would have been administratively inefficient.

18 Q. Has the Commission ever reestablished the ROE for any utility outside
19 of a rate proceeding.

20 A. Yes. The Commission has changed the authorized ROE for utilities
21 outside of an individual rate case in the electric, telephone, natural
22 gas, water and wastewater industries. An example in the water and
23 wastewater industry is Order No. PSC-95-1228-FOF-WS, issued November 1,
24 1995, in Docket No. 950371-WS involving Indiantown Company. This case
25 was a limited proceeding, pursuant to section 367.0822, Florida

1 Statutes, initiated solely to establish a more appropriate ROE. The
2 Commission reduced the utility's authorized ROE from 16.35 percent to
3 10.43 percent to reflect current market conditions.

4 In addition, in 1993, the Commission reset the ROE to eleven
5 percent for several natural gas utilities outside of an individual rate
6 case. This was done by a stipulation with each utility with the
7 exception of Docket No. 931098-GU, City Gas Company of Florida and
8 Docket No. 931100-GU, Florida Public Utilities Company. Neither of
9 these utilities filed agreements to stipulate to an eleven percent
10 return on equity until after the Commission voted to conduct a hearing
11 solely on the utilities' return on equity.

12 The Commission, in 1994, held a hearing on the issue of the
13 appropriate return on equity in Docket No. 930987-EI, involving Tampa
14 Electric Company. In that case, the Commission issued a proposed agency
15 action order which adopted a settlement proposed by Tampa Electric
16 Company. The Office of Public Counsel protested the order. The
17 Commission held a full evidentiary hearing on the appropriate return on
18 equity which resulted in Order No. PSC-94-0337-FOF-EI, issued on March
19 25, 1994, which lowered the authorized ROE to 11.35%.

20 I have attached an exhibit that lists some of the of cases where
21 the Commission has changed a utility's ROE outside of a rate proceeding.
22 It is appended as Exhibit MWW-1.

23 Q. Do you agree with Mr. Seidman that the Commission's proposal would
24 result in a piecemeal approach to ratemaking?

25 A. No. I do not believe that the Commission's proposal to reestablish the

1 ROE for approximately 94 utilities would result in piecemeal regulation.
2 I believe that most water and wastewater utilities are aware of the
3 annual changes to the equity leverage formula. Contrary to Mr
4 Siedman's testimony, the Commission staff does not look solely at the
5 established ROE of a utility when evaluating potential overearnings.
6 The Commission staff compares each utility's current earnings to the
7 current equity leverage formula each year when making a determination
8 of whether an overearnings proceeding should be recommended to the
9 Commission. In making this annual determination, all of the factors
10 which Mr. Siedman discusses, which are enumerated in section 367.081,
11 Florida Statutes, are taken into account.

12 Likewise, I would certainly believe most utilities would be aware
13 of the changes to the equity leverage formula and how this annual change
14 affects each utility's ability to seek rate relief. Any decision to
15 seek rate relief should be based on the current equity leverage formula
16 compared to the utility's current financial situation. A utility would
17 not wait for the Commission to change the company's ROE to make that
18 decision. The fact that a company has a current ROE established has no
19 bearing on the final rates in an overearnings or rate case proceeding.
20 It only comes into play in a rate case or overearnings proceeding when
21 determining the level of interim rates pursuant to section 367.082,
22 Florida Statutes. Ratemaking should not be a stagnant process. The
23 Commission weighs all factors when considering any potential
24 overearnings. Likewise, I do not believe that utility management would
25 look at the need for a rate increase on a piecemeal basis either.

1 Q. Mr. Seidman expressed concern that the interim rate procedure would be
2 unworkable. Do you agree?

3 A. No, I do not. Mr. Siedman, according to his testimony, believes that
4 the Commission's proposal and the statutory procedure for interim rates
5 are in conflict. He testifies that the required rate of return on
6 equity is based on the last authorized rate of return on equity
7 established in the most recent individual rate proceeding. Section
8 367.082(5)(b)3 states that "the last authorized return on equity for
9 purposes of this subsection shall be established only: in the most
10 recent rate case of the utility; in a limited scope proceeding for the
11 individual utility; by voluntary stipulation of the utility approved by
12 the Commission; or pursuant to section 367.081(4)(f)." The Commission
13 made this proposal under the authority granted the Commission by
14 sections 367.011(2) and 367.081(2)(a), Florida Statutes. However, the
15 Commission could just as easily have issued this proposal using section
16 367.0822, Florida Statutes, which is the Commission's authority to
17 conduct a limited scope proceeding. If Mr. Siedman's concern is that
18 the Commission didn't use the limited scope proceeding in this docket,
19 which is one of the four procedures mentioned in the interim statute,
20 that can easily be cured by the Commission issuing the final order in
21 this case using section 367.0822, Florida Statutes. Regardless of which
22 statutory authority is used, I still believe that this is a proceeding
23 for each individual utility.

24 Q. How do you consider the Commission's proposal as a proceeding for each
25 individual utility?

1 A. Because each utility may not end up having the same ROE established.
2 Each ROE established for the approximately 94 utilities with established
3 ROEs will be based on each individual utility's debt equity ratio as
4 applied to the current equity leverage formula. Therefore, each utility
5 will end up with its own unique authorized ROE based on the current
6 equity leverage formula. The Commission could have accomplished the
7 same proposal by opening 94 dockets instead of one. Each utility had
8 the ability to protest the Commission's action. The outcome would be
9 the same for each utility. The opening of one docket was purely for
10 administrative efficiency.

11 Q. Do you believe that there will be an increase in rate case expense
12 because of the Commission's proposal?

13 A. No. As I explained earlier, the Commission staff does not look at ROE
14 in isolation in deciding future rates nor do I believe that utility
15 management would do so either.

16 Q. Do you believe that the Commission's proposal would have a detrimental
17 effect on a utility's planning and budgeting?

18 A. It may have some effect but I do not believe it would be a "detrimental"
19 effect. As I stated earlier, utility management should normally be
20 considering the annual impact of the change in the current ROE leverage
21 formula. This is one of the factors that final rates would be based on
22 in a rate proceeding and would be one of the factors for the Commission
23 staff when considering overearnings proceedings. I do not see the
24 Commission's proposal changing the fact that it is the utility's
25 responsibility to seek an increase in rates nor that it has always been

1 the responsibility of the Commission and the Office of Public Counsel
2 to seek a rate decrease. Utilities have always been subject to the
3 Commission initiating an overearnings proceeding if the facts before the
4 Commission warrant that action. The Commission staff's determination
5 of when to request an overearnings proceeding will not change because
6 of this proposal to change the established returns on equity.

7 Q. Under what circumstances would you envision that the Commission staff
8 would seek a future change, like you have in this proceeding, in the
9 established ROEs for water and wastewater utilities?

10 A. I believe the utilities need to know under what circumstances the
11 Commission staff would consider the need to seek a change in the
12 established returns on equity. I would propose, as an internal
13 guideline, that the Commission staff would not start considering
14 recommending a change in the established returns on equity until there
15 has been a minimum 100 basis point change in the high end of the
16 Commission's equity leverage formula from the base ROE. The high end
17 of the equity leverage formula is the resulting ROE using a forty
18 percent equity ratio. I believe that you need to use a single equity
19 ratio as the base ROE, because the actual range of equity returns
20 produced by the equity leverage formula can vary with each year. I
21 chose to use the forty percent equity ratio as the base ROE because the
22 majority of the water and wastewater utilities are at the high end of
23 the range. The base ROE would be 11.10 percent using the new equity
24 leverage formula established in this docket at a forty percent equity
25 ratio. What this means under this proposal is that the Commission staff

1 would not consider the need to change the established ROEs unless the
2 equity leverage formula adopted by the Commission in future years, using
3 a forty percent equity ratio, was above 12.10 percent or below 10.10
4 percent. I use the term "consider" because it would not be an automatic
5 action by staff. Staff naturally must weigh many factors when deciding
6 to make this kind of recommendation. In other words, just because a
7 trigger point is reached does not mean an action will follow. I believe
8 that this proposal would ameliorate the regulatory uncertainties and
9 unpredictability discussed in Mr. Seidman's testimony.

10 Q. Does this conclude your testimony?

11 A. Yes, it does.

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Order No. PSC-99-1047-PAA-EI, Issued May 24, 1999, Docket Nos. 990250-EI and 990244-EI, In Re: Investigation Into the Earnings and Authorized Return on Equity of Gulf Power Company; In Re: Petition by Gulf Power Company for Approval of Proposed Plan for an Incentive Revenue-Sharing Mechanism that Addresses Certain Regulatory Issues Including a Reduction to the Company's Authorized Return on Equity.

Order No. PSC-95-1328-FOF-WS, Issued November 1, 1995, Docket No. 950371-WS, In Re: Investigation into the Authorized Return on Equity (ROE) of Indiantown Company, Inc. in Martin County.

Order No. PSC-94-0852-FOF-EI, Issued July 13, 1994, Docket Nos. 940621-EI, 930867-EI, In Re: Investigation into Currently Authorized Return on Equity and Earnings of Florida Power Corporation; In Re: Petition for Authorization to Implement a Self-Insurance Program for Storm Damage to its Transmission and Distribution (T & D) Lines and to Increase Annual Storm Damage Expense by Florida Power Corporation.

Order No. 94-0645-FOF-TL, Issued May 26, 1994, Docket No. 920195-TL, In Re: Modified Minimum Filing Requirements of Quincy Telephone Company.

Order No. PSC-94-0549-FOF-TL, Issued May 11, 1994, Docket No. 940198-TL, In Re: Investigation into the Authorized Return on Equity and Earnings of Gulf Telephone Company.

Order No. PSC-94-0548-FOF-TL, Issued May 11, 1994, Docket No. 940197-TL, In Re: Investigation into the Authorized Return on Equity of Florala Telephone Company.

Order No. PSC-94-0545-FOF-TL, Issued May 11, 1994, Docket No. 940199-TL, In Re: Investigation into the Authorized Return on Equity and Earnings of Indiantown Telephone System, Inc.

Order No. 94-0383-FOF-TL, Issued March 31, 1994, Docket Nos. 940196-TL, 92-260-TL, In Re: Investigation into Authorized Return on Equity and Earning of Alltel Florida, Inc.; In Re: Comprehensive Review of the Revenue Requirements and Rate Stabilization Plan of Southern Bell Telephone and Telegraph Company.

Order No. PSC-94-0337-FOF-EI, Issued March 25, 1994, Docket No. 930987-EI, In Re: Investigation into Currently Authorized Return on Equity of Tampa Electric Company.

Order No. PSC-94-0249-FOF-GU, Issued March 7, 1994, Docket No. 931100-GU, In Re: Investigation into the Appropriate Equity Return for Florida Public Utilities Company.

Order No. PSC-93-1820-FOF-GU, Issued December 22, 1993, Docket No. 9301098-GU, In Re: Investigation into the Appropriate Equity Return for City Gas Company of Florida.

Order No. PSC-93-1772-FOF-GU, Issued December 10, 1993, Docket No. 930199-GU, In Re: Investigation into the Appropriate Equity Return for Florida Division of Chesapeake Utilities Corporation.

Order No. PSC-93-1777-FOF-GU, Issued December 10, 1993, Docket No. 931105-GU, In Re: Investigation into the Appropriate Equity Return for West Florida Natural Gas Company, Inc.

Order No. PSC-93-1776-FOF-GU, Issued December 10, 1993, Docket No. 931104-GU, In Re: Investigation into the Appropriate Equity Return for South Florida Natural Gas Company.

Order No. PSC-93-1775-FOF-GU, Issued December 10, 1993, Docket No. 931102-GU, In Re: Investigation into the Appropriate Equity Return for St. Joe Natural Gas Company.

Order No. PSC-93-1774-FOF-GU, Issued December 10, 1993, Docket No. 931103-GU, In Re: Investigation into the Appropriate Equity Return for Sebring Gas System, Inc.

Order No. PSC-93-1773-FOF-GU, Issued December 10, 1993, Docket No. 931101-GU, In Re: Investigation into the Appropriate Equity Return for Peoples Gas System, Inc.

Order No. PSC-93-1024-FOF-EI, Issued July 13, 1993, Docket No. 930612-EI, In Re: Reduction of Authorized Return on Equity for Florida Power and Light Company.

Order No. PSC-92-0022-FOF-EI, Issued March 10, 1992, Docket No. 920062-EI, In Re: Investigation into Earnings and Return on Equity for Tampa Electric Company.

Order No. 23924, Issued December 24, 1990, Docket Nos. 891281-EI, 900072-EI, 900295-EI, In Re: Petition of the Citizens of the State of Florida for a Limited Proceeding to Reduce Tampa Electric Company's Authorized Return on Equity; In Re: Change in Allowance for Funds Used During Construction (AFUDC) Rates of Tampa Electric Company Effective January 1, 1990; In Re: Minimum Filing Requirement Report of Tampa Electric Company in Compliance with Section 366.06(3), Florida Statutes.

Order No. 23819, Issued December 3, 1990, Docket No. 900875-TL, In Re: Investigation into the Authorized Return on Equity and Earnings of Alltel Florida, Inc.

Order No. 22377, Issued January 8, 1990, Docket No. 891239-TL, In Re: Investigation into United Telephone Company of Florida's Authorized Return on Equity and Earnings.

Order No. 22367, Issued January 3, 1990, Docket Nos. 890292-TL, 891237-TL, In Re: Resolution by Gadsden County Board of County Commissioners for Extended Area Service Between Gadsden County and Tallahassee; In Re: Investigation into Quincy Telephone Company's Authorized Return on Equity and Earnings.

Order No. 22352, Issued December 29, 1989, Docket Nos. 870171-TL, 890216-TL, In Re: Petition of the Citizens of the State of Florida for a Limited Proceeding to Reduce General Telephone Company of Florida's Authorized Return on Equity; In Re: Investigation into the Proper Application of Rule 25-14.003, F.A.C., Relating to Tax Savings Refunds for 1988 and 1989 for GTE Florida Incorporated.

Order No. 22284, Issued December 11, 1989, Docket No. 891238-TL, In Re: Investigation into St. Joseph Telephone and Telegraph Company's Authorized Return on Equity and Earnings.

Order No. 22273, Issued December 7, 1989, Docket No. 891236-TL, In Re: Investigation into Northeast Florida Telephone Company's Authorized Return on Equity and Earnings.

Order No. 17783, Issued June 30, 1987, Docket Nos. 861361-TL, 861611-TL, 861612-TL, 861613-TL, 870266-TL, 861145-PU, In Re: Investigation into Earnings of Central Telephone Company of Florida; In Re: Public Counsel's Petition to Reduce the Authorized Rate of Return on Equity of Centel and Institute a Reverse-Make-Whole Proceeding; In Re: Public Counsel's Petition for a Limited Proceeding to Reduce Centel's Authorized Return on Equity to 12.25%; In Re: Public Counsel's Petition for a Limited Proceeding to Reduce the Rates and Charges of Centel to Reflect a Reduction in Tax Expenses Due to the Change in the Corporate Tax Rate from 46% to 34%; In Re: Central Telephone Company of Florida 1986 Earnings Investigation; In Re: Investigation into Effect of 1986 Federal Tax Reform on Revenue Requirements for Regulated Utilities.