

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION
DOCKET NO. 150071-SU,
KW RESORT UTILITIES CORPORATION RATE CASE
DIRECT TESTIMONY OF J. TERRY DEASON
September 14, 2016

1 **Q. Please state your name and business address.**

2 A. My name is Terry Deason. My business address is 301 S. Bronough
3 Street, Suite 200, Tallahassee, FL 32301.

4
5 **Q. By whom are you employed and what position do you hold?**

6 A. I am a Special Consultant for the Radey Law Firm, specializing in the
7 fields of energy, telecommunications, water and wastewater, and public
8 utilities generally.

9
10 **Q. Please describe your educational background and professional**
11 **experience.**

12 A. I have thirty-nine years of experience in the field of public utility
13 regulation spanning a wide range of responsibilities and roles. I served
14 as a consumer advocate in the Florida Office of Public Counsel ("OPC")
15 on two separate occasions, for a total of seven years. In that role, I
16 testified as an expert witness in numerous rate proceedings before the
17 Florida Public Service Commission ("Commission" or "PSC"). My tenure

1 of service at OPC was interrupted by six years as Chief Advisor to
2 Florida Public Service Commissioner Gerald L. Gunter. I left OPC as its
3 Chief Regulatory Analyst when I was first appointed to the Commission
4 in 1991. I served as Commissioner on the Commission for sixteen
5 years, serving as its chairman on two separate occasions. Since retiring
6 from the Commission at the end of 2006, I have been providing
7 consulting services and expert testimony on behalf of various clients,
8 including public service commission advocacy staff and regulated utility
9 companies. I have also testified before various legislative committees
10 on regulatory policy matters. I hold a Bachelor of Science Degree in
11 Accounting, summa cum laude, and a Master of Accounting, both from
12 Florida State University.

13
14 **Q. For whom are you appearing as a witness?**

15 A. I am appearing as a witness for Monroe County.

16
17 **Q. What is the purpose of your testimony?**

18 A. The purpose of my testimony is to discuss Florida's regulatory policy of
19 establishing rates on appropriate test years and the need for the correct
20 matching of investment, expenses, and revenues in those test years. I
21 refer to this principle as the "matching principle." Recognizing that a
22 utility's revenues are simply its sales (e.g., kilowatt-hours of electricity, or
23 gallons of water or wastewater service provided to customers) times its

1 rates, it is clear that the “matching principle” requires that rates be
2 determined using the utility’s allowed revenues (referred to as its
3 “revenue requirements” in regulatory terminology) and its sales units
4 from the same time period in which the rates will be in effect.
5

6 **Q. Are you sponsoring any exhibits?**

7 A. Yes. I am sponsoring Exhibit JTD-1, which is my curriculum vita.
8

9 **Q. How is your testimony organized?**

10 A. My testimony is organized into three parts. First, I provide a brief
11 overview of the regulatory compact that provides the foundation for the
12 setting of rates for a regulated utility. Second, I discuss the need for test
13 years when setting rates. Third, I discuss the need for appropriate
14 adjustments to comply with the matching principle.
15

16 I. Regulatory Compact

17 **Q. What is the regulatory compact?**

18 A. The regulatory compact is an implied contract that exists between a
19 regulated public utility, its regulators, and its customers. It lays the
20 foundation for regulation and balances the interests (and risks) of all
21 stakeholders. It has been employed to characterize the set of mutual
22 rights, obligations, and benefits that exist between the utility and its
23 customers. These rights, benefits, and obligations are supervised and

1 enforced by regulatory utility authorities such as the Florida PSC.

2

3 **Q. How does the regulatory compact balance the interests of the utility**
4 **and its customers?**

5 A. Under the regulatory compact, the interests of the utility and its
6 customers are balanced by the following considerations:

7 • A regulated utility has the obligation to provide reliable and cost-
8 effective service to its customers. To fulfill this obligation to serve,
9 the utility must deploy needed capital and obtain the labor,
10 materials, and supplies necessary to operate and maintain its
11 system to serve its customers. Inherent in this obligation is a
12 responsibility to manage costs and mitigate risks where
13 reasonably possible.

14 • Correspondingly, the utility is granted a monopoly in its service
15 area, and its rates are set by the utility commission (the PSC in
16 Florida) to recover all of the utility's reasonable and prudent
17 operating and maintenance costs and to provide fair
18 compensation for its capital investments.

19 • All utility investments are subject to a determination of prudence,
20 based on the reasonably anticipated costs, risks, and benefits of
21 said investment that are known or reasonably known at the time
22 that the investment is made. Concomitant with this principle is
23 that future changed circumstances that can be known and applied

1 only in hindsight are not a valid basis to reverse a previous
2 determination of prudence.

- 3 • All prudently incurred investments that are used and useful in
4 providing service are to be afforded rate recovery treatment, both
5 in the form of a reasonable return on the investment and a
6 reasonable return of the investment, generally over the useful life
7 of said investment. The return on investment refers to the
8 interest expense and the return on the equity investment made by
9 the utility's owners or shareholders. The return of investment
10 refers to the allowance for depreciation of the capital assets over
11 time, where such allowance is also built into the utility's rates. It is
12 useful to think of the depreciation allowance as the principal
13 component of a mortgage payment, and the interest expense and
14 return on equity as being comparable to the interest component of
15 a mortgage payment, made to fairly compensate the lender for
16 the use of its money.
- 17 • The reasonable rate of return is a necessary cost to provide
18 service and should be set at a level to adequately compensate
19 investors for the risk of their investment and to be fair to
20 customers on whose behalf the capital is deployed. Inherent in
21 this principle is the expectation that customer and investor
22 interests are balanced in a fair and symmetrical manner.
- 23 • While the reasonable return on investment is not guaranteed,

1 there is an expectation that rates will be set to afford a utility a
2 reasonable opportunity to actually earn its authorized rate of
3 return.

- 4 • The reasonable rate of return is set and monitored to fall within an
5 established band, so that the return is neither excessive nor
6 deficient.

7 These considerations are part of the regulatory compact that has been
8 the foundation of fair and effective utility regulation in this country for
9 decades.

10

11 **Q. What is the role of the PSC in setting the utility's rates under the**
12 **regulatory compact?**

13 A. From the utility's perspective, the PSC (in Florida or anywhere else) is
14 responsible to set rates that allow the utility to recover its reasonable
15 operating and maintenance costs and the opportunity to recover its
16 interest costs and earn a reasonable return on the owners' or
17 shareholders' investment in capital assets. From the customers'
18 perspective, the PSC is responsible to set rates based on the
19 reasonable and prudent costs of providing service. In Florida and
20 elsewhere, this standard is frequently articulated as requiring rates to be
21 fair, just, and reasonable.

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II. Test Year Considerations

Q. How does the PSC determine the amount of revenues to be generated from a utility’s rates that will allow the utility to recover its operating costs and reasonable interest expense, and that, in turn, will also produce the targeted reasonable rate of return on the equity investment of the utility’s owners or shareholders?

A. A representative test year is used to determine the amount of revenues, expenses, and investments that are representative of operations during the time that rates will be in effect. The selected test year can either be historic, with needed adjustments to make it representative, or it could be a fully projected test year, again with any adjustments necessary to make it representative of operations during the time that rates will be in effect. The critical requirements are that the test year, whether historic or projected, must be representative of the period in which rates will be in effect, and that the key variables – investments, expenses, revenues, and sales – used in setting rates are all representative of the same time period.

Q. Does the Commission have a policy on the selection of a test year?

A. Yes, the Commission has a policy of requiring utilities to demonstrate the appropriateness of any selected test year and the standard is one of being representative of anticipated operations, costs, investments, revenues, and sales during the time period in which the rates will be in

1 effect. For water and wastewater utilities, the Commission has adopted
2 Rule 25-30.430(1), Florida Administrative Code ("F.A.C."), which
3 requires that:

4 (1) Prior to the filing of an application for a general rate
5 increase, a utility shall submit to the Commission a written
6 request for approval of a test year, supported by a statement
7 of reasons and justifications **showing that the requested**
8 **test year is representative of utility operations.** The
9 Commission Chairman will then approve or disapprove the
10 request within 30 days from the receipt of the request. In
11 disapproving the requested test year, the Chairman may
12 suggest another test year. Within 30 days of the Chairman's
13 approval or disapproval of a test year, upon request of any
14 interested person the full Commission may review the
15 Chairman's test year decision.

16 I added the emphasis in the cited provision to demonstrate the
17 Commission's recognition of the importance of having a test year that is
18 representative of the utility's operations during the time period in which
19 rates will be in effect,

20 Similarly, for electric utilities, the Commission has adopted Rule
21 25-6.140 (1)(a), in which a requesting utility must provide:

22 An explanation for requesting the particular test period. If

23 an historical test year is selected, there shall be an

1 explanation of why the historical period is more
2 representative of the company's operations than a
3 projected period. If a projected test year is selected, there
4 shall be an explanation of why the projected is more
5 representative than an historical period

6

7 **Q. Has the Commission defined the appropriate use of a test year for a**
8 **water and sewer utility company?**

9 A. Yes. In its Order No. 15725, addressing a petition for an increase in
10 water and sewer rates by Martin Downs Utilities, Inc., the Commission
11 stated:

12 The test year is an analytical device used in ratemaking
13 proceedings to compute current levels of investment and
14 income in order to determine the amount of revenue that
15 will be required to assure a company a fair return on its
16 investment. Test year data must be adjusted to properly
17 reflect conditions in the future period for which rates are
18 being fixed. Based upon historical data we anticipate
19 Martin Downs will continue to experience a rapid growth of
20 demand for its services. Therefore, we believe a projected
21 test year is appropriate in this case.

22

23

1 **Q. In your opinion, is this appropriate utility regulatory policy? Why**
2 **or why not?**

3 A. Yes, this is the essence of sound and appropriate regulatory
4 ratemaking policy, because it ensures that the rates charged by
5 the utility will produce the revenues needed to cover the utility's
6 costs of providing service and a reasonable return on and of its
7 investment. This is the essence of determining rates that are fair,
8 just, and reasonable. If rates were set using non-representative
9 cost, investment, or sales data, they would likely be unfair, unjust,
10 or unreasonable, or all of the above, to either the utility or its
11 customers.

12
13 **Q. Does the Commission have a preference for projected versus**
14 **historic test years?**

15 A. For electric utilities, the Commission has primarily relied on projected
16 test years, especially after the Florida Supreme Court addressed their
17 use back in 1983. Nevertheless, the Commission still relies on test
18 years, either historic or projected, that are most representative of future
19 utility operations and has placed the burden on requesting utilities to so
20 demonstrate.

21
22 **Q. What did the Florida Supreme Court say on the subject?**

23 A. In an appeal of a Commission order taken by the Southern Bell

1 Telephone and Telegraph Company in 1983, 443 So.2d 92, the Court
2 stated:

3 Nothing in the decisions of this Court or any legislative act
4 prohibits the use of a projected test year by the
5 Commission in setting a utility's rates. We agree with the
6 Commission that it may allow the use of a projected test
7 year as an accounting mechanism to minimize regulatory
8 lag. The projected test period established by the
9 Commission is a ratemaking tool which allows the
10 Commission to determine, as accurately as possible, rates
11 which would be just and reasonable to the customer and
12 properly compensatory to the utility.

13 Thus, the Court has recognized that the Commission may utilize
14 ratemaking tools that minimize regulatory lag and determine, as accurately
15 as possible, rates that are just and reasonable during the time period that
16 the rates will be in effect.

17

18 **Q. The Court mentioned regulatory lag. What is it?**

19 A. Regulatory lag is the difference in time between when rates should be
20 changed and when new rates can be implemented.

21

22 **Q. Does regulatory lag always mean that rates are lower than they**
23 **should be for longer than is necessary?**

1 A. No. Regulatory lag will exist either when rates are lower than they should
2 be, exposing the utility to not recovering its costs and earning an adequate
3 return, or when rates are higher than they should be, exposing customers
4 to paying rates that are higher than justified by the utility's costs. In other
5 words, regulatory lag cuts both ways. If rates are not based upon the
6 most appropriate test year information, the utility could quickly experience
7 either underearnings or overearnings soon after the new rates are
8 implemented. That is why it is important that rates be set as close as
9 possible to what a representative test year shows is the relationship
10 between investment, expenses, and revenues during the time that rates
11 will be in effect. This minimizes regulatory lag in both directions.

12
13 **Q. Has the Commission previously addressed the need to adjust the**
14 **test year to prevent possible overearnings?**

15 A. Yes. In a staff-assisted rate case for Burkim Enterprises, Inc., Docket No.
16 010396-WS, the Commission opted to use a projected test year, citing the
17 potential for overearnings if rates were set only on historical information.
18 In its Order No. PSC-01-2511-PAA-WS, the Commission stated:

19 For audit purposes, we selected a historical test year
20 ending May 31, 2001. Because the utility is growing at an
21 exceptionally high rate (29 connections per year), rates
22 based on historical data alone will be significantly different
23 than rates based on current or even future conditions, and

1 the potential for overearning exists if a projected test year is
2 not used. We find that a projected test year ending May 31,
3 2003 is appropriate in this case and will better match
4 increasing revenues with the high level of DEP required pro
5 forma additions that are being approved.

6

7 **Q. What is the test year proposed by KW Resort Utilities Corporation in**
8 **its request for increased rates in this case?**

9 A. The requested test year is the historic year ended December 31, 2014,
10 with significant adjustments for pro forma plant additions and increased
11 pro forma expenses in the future. As this case has developed, the PSC
12 has issued a proposed order that will have customers pay one set of rates,
13 called "Phase I rates," for the period beginning in April 2016, and another
14 set of rates, called "Phase II rates," for the period beginning sometime in
15 2017 when KWRU's new wastewater treatment plant comes into service.
16 My understanding is that the utility has also asked that its new rates
17 include the costs of a new air vacuum tank that is expected to come into
18 service in roughly the same time frame as the new treatment plant, but the
19 utility did not include the costs of the new tank in its original filing for a rate
20 increase.

21

22 **Q. Does Monroe County object to this test year?**

23 A. Monroe County does not object to the selected test year per se. Monroe

1 County does object to pro forma adjustments (or a lack of certain pro
2 forma adjustments) which results in a test year that is not representative of
3 future operations and that violates the matching principle by not properly
4 matching KWRU's costs with its sales during the time periods in which the
5 utility's rates will be in effect.

6
7 **III. The Matching Principle**

8 **Q. What is the matching principle?**

9 A. From an accounting standpoint, the matching principle requires a
10 company to match expenses with related revenues in order to accurately
11 report a company's net income for any given time interval of financial
12 reporting. This same principle also applies to the amount of investment,
13 expenses, and revenues reported in a regulated utility's test year used to
14 prospectively set rates.

15 From a regulatory ratemaking standpoint, the matching principle
16 requires that the utility's rates be set using the utility's costs, investments,
17 revenues, and sales units from the same time period, and that they be
18 representative of the time period in which the new rates will be in effect.

19
20 **Q. If the matching principle is not followed, can distortions result?**

21 A. Yes. For example, if a hypothetical company attempted to inappropriately
22 report current year revenues as being applicable to a future year in an
23 attempt to reduce a current tax liability, a distortion would result which

1 would not be viewed favorably by the Internal Revenue Service.

2 Likewise, if a hypothetical company attempted to inappropriately
3 include revenues properly attributable to a future period in its current
4 year's results in an attempt to inflate its earnings, a distortion would result
5 that would likely get the attention of its auditors and perhaps the Securities
6 and Exchange Commission.

7 And in the world of utility ratemaking, if a utility or its public utility
8 regulatory authority did not properly match its revenues and sales with the
9 amount of anticipated investment and expenses, a distorted test year that
10 is not properly representative would be the result. If not corrected, this
11 would almost certainly result in rates that are not fair, just and reasonable.

12

13 **Q. Is the amount of investment, expenses, and revenues included in a**
14 **test year important to the matching principle?**

15 A. Yes. Utilities generally are capital intensive and have an obligation to
16 serve customers within their authorized territories. To meet this
17 obligation, utilities often have to make substantial investments that can
18 be driven by the need for modernization, the need to meet environmental
19 requirements, and the need to meet the demands of new customers
20 and/or increased demand from existing customers. In the situation
21 where additional investment is being made, or additional expenses are
22 being incurred, or both, to serve a growing customer base or growing
23 customer demands for service, or both, it is imperative that rates be set

1 taking into consideration the additional revenues that will be produced.
2 In the simplest terms, revenues are equal to units sold times rates; for
3 any given level of revenues authorized by the PSC, the lower the
4 amount of sales units used to calculate rates, the higher the utility's rates
5 will be. This was the conclusion reached by the Commission in the
6 Burkim case I earlier referenced.

7

8 **Q. Is it appropriate for the Commission to recognize the additional**
9 **revenues that will be produced by KW Resort's additional**
10 **investments?**

11 A. Yes. This will result in a better matching and would be consistent with
12 good ratemaking policy and previous decisions of the Commission and the
13 Florida Supreme Court.

14

15 **Q. How should this be accomplished?**

16 A. The amount of test year revenue should be increased to properly account
17 for the amount of revenue that will be generated at existing rates due to
18 increased customer usage. This will better indicate the amount of any
19 revenue deficiency that may exist at existing rates. Once the correct test
20 year revenue requirements are determined, the utility's new rates should
21 be set using the new, current-billing-period billing determinants to
22 generate the amount of revenues needed to afford a reasonable
23 opportunity for KW Resort to recover its reasonable and prudent operating

1 costs and to earn its authorized rate of return on its prudent investments.

2

3 **Q. If there is credible evidence that the gallonage of wastewater treated**
4 **and billed by KWRU is likely to be greater in 2017 than in 2016,**
5 **should the Commission take that evidence into account when setting**
6 **KWRU's rates in this case?**

7 A. Yes. This is particularly important in this instance because the new Phase
8 II rates will likely not be implemented until March or April of 2017, which
9 should be contemporaneous with KWRU's new WWTP coming on line to
10 serve customers. Accordingly, greater usage in 2017, when the new plant
11 that is driving the need for new rates is actually on line and providing
12 service, strongly indicates that rates should be based on such greater
13 usage. Otherwise, in my opinion, KWRU's rates would likely not be fair,
14 just, and reasonable.

15

16 **Q. Have you quantified these adjustments to account for increased**
17 **customer usage?**

18 A. No. The purpose of my testimony is to address the policy reasons for
19 making the needed adjustments. The quantifications are supported in the
20 testimony of Witness Patricia Merchant, who is testifying on behalf of the
21 Citizens of the State of Florida, represented by their Public Counsel.

22

23

1 **Q. Please state the main conclusions of your testimony.**

2 A. The Florida Public Service Commission has a longstanding regulatory
3 policy of establishing rates on appropriate test years, and this policy
4 recognizes the need to match the utility's investment, expenses, and
5 revenues in those test years in order to ensure that the rates approved by
6 the PSC recover the costs incurred during the period or periods in which
7 those rates will be in effect. I refer to this principle as the "matching
8 principle." Where a utility is experiencing significant growth in investment
9 and expenses to serve growth in customers' demands for service, as is
10 the case with KWRU in this proceeding, it is critical that this matching
11 principle be followed in order to ensure, to the maximum extent possible,
12 that the utility's rates are fair, just, and reasonable.

13 In conclusion, I strongly recommend that the Commission apply the
14 matching principle in this case to ensure that KW Resort's rates are fair,
15 just, and reasonable.

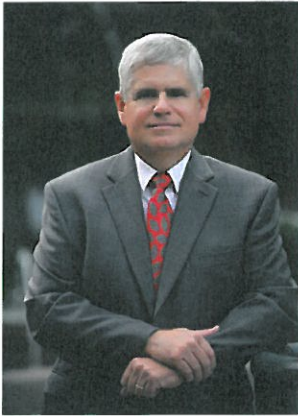
16

17 **Q. Does this conclude your testimony?**

18 A. Yes, it does.

19

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- Florida Public Service Commission, Chairman, 1993 - 1995, 2000 - 2001
- Office of the Public Counsel, Chief Regulatory Analyst, 1987 - 1991
- Florida Public Service Commission, Executive Assistant to the Commissioner, 1981 - 1987
- Office of the Public Counsel, Legislative Analyst II and III, 1979 - 1981
- Ben Johnson Associates, Inc., Research Analyst, 1978 - 1979
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Terry Deason*

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Member, Committee on Utility Association Oversight
- National Association of Regulatory Utility Commissioners (NARUC) 2002 *Member,*
Rights-of-Way Study
- Nuclear Waste Strategy Coalition, 2000 - 2006, *Board Member*
- Federal Energy Regulatory Commission (FERC) South Joint Board on Security
Constrained Economic Dispatch, 2005 - 2006, Member
- Southeastern Association of Regulatory Utility Commissioners, 1991 - 2006, *Member*
- Florida Energy 20/20 Study Commission, 2000 - 2001, *Member*
- FCC Federal/State Joint Conference on Accounting, 2003 - 2005, *Member*
- Joint NARUC/Department of Energy Study Commission on Tax and Rate
Treatment of Renewable Energy Projects, 1993, Member
- Bonbright Utilities Center at the University of Georgia, 2001, *Bonbright Distinguished Service*
Award Recipient
- Eastern NARUC Utility Rate School - Faculty Member



BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Application for Increase)
In Wastewater Rates in Monroe) DOCKET NO. 150071-SU
County By K W Resort Utilities)
Corp.) FILED: September 14, 2016
_____)

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and correct copy of the foregoing was furnished to the following, by electronic delivery, on this 14th day of September, 2016.

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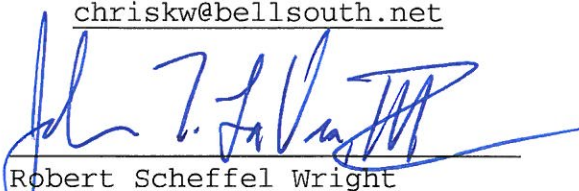
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