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The Florida Chapter of the  
National Association of Water Companies

**FLORIDA  
WATERWORKS  
ASSOCIATION**

P.O. Box 4268, Tallahassee, Fla. 32315 (904) 878-4399

Florida Public Service Commission  
Ms. Blanca S. Bayo  
Division of Records and Reporting  
2540 Shumard Oak Blvd.  
Tallahassee, Florida 32399-0850

3/11/99

Re: Docket No. 990006-WS Annual Reestablishment of Authorized Range of Returns on  
Common Equity for Water and Wastewater Utilities, Pursuant to Section 367.081(4)(f),  
Florida Statutes.

Dear Ms. Bayo :

The Florida Waterworks Association provides the following general comments in regards  
to the Annual Reestablishment of Authorized Range of Returns (ROR) on Common  
Equity for Water and Wastewater Utilities. These comments are of the Association and  
may coincide or differ from individual water and wastewater utilities that participate in  
this Docket.

- ACK \_\_\_\_\_
- AFA Hester
- APP \_\_\_\_\_
- CAF \_\_\_\_\_
- CMU \_\_\_\_\_
- CTR \_\_\_\_\_
- EAG \_\_\_\_\_
- LEG 1
- LIN \_\_\_\_\_
- OFC \_\_\_\_\_
- ROH \_\_\_\_\_
- SEC 1
- WAS 1
- OTH \_\_\_\_\_

As an overall point which was noted in the FPSC 1999 legislative write up of "Small  
Systems- Lack of Economies of Scale" (page 57 attached) a significant problem exists for  
a substantial number of Florida systems: " many small water utilities are unable to attract  
capital through the mechanisms available to larger utilities due mainly to their size and  
weak financial structure. Therefore, the cost of capital for small utilities is generally  
higher and adds to the upward pressure on rates."

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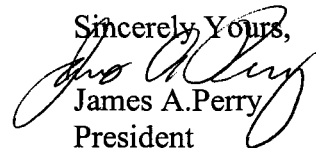
FPSC-RECORDS/REPORTING

## GENERAL COMMENTS

- The present prime rate is 7.75% while the current computation of the leverage formula has a range of 8.57 to 9.85%. In many cases the cost of debt for a utility will be prime plus 100-300+ basis points for a range of 8.75% to 10.75+% which exceeds the ROR allowed on the equity investment. The current leverage formula is inherently inadequate in that it does not provide for an adequate risk premium for equity investment!
- Regressive rate making practices by the FPSC have a greater impact on a utility's actual achieved rate of return than the deficiency of the current leverage formula. These practices include non recognition of reuse facilities as 100% used and useful, inadequate time frames for margin reserve with imputation of CIAC, nonrecognition of economies of scale, and nonrecognition of facilities being used and useful when they are necessary to comply with FDEP requirements. These are not all inclusive.
- In 1995 an extensive review of the leverage formula was conducted by the FPSC, Public Counsel and the Industry. Almost all of the comments and recommendations made by the Industry are still applicable. These recommendations are incorporated in the February 1995 study by Roger A. Morin, Ph.D. which study was then filed with the commission. Attached is the executive summary of that study.

If any changes are to be made to the proposed leverage formula they need to incorporate the recommendations included in Dr. Morin's study to reflect an adequate risk premium for equity investment. It is intuitive that the current leverage formula ROR range reductions for water and wastewater utilities are askew to the market for equity risk.

Sincerely Yours,



James A. Perry  
President

C.C. Division of Legal Services (Vaccaro)  
Division of Auditing and Financial Analysis (Lester, Draper, Samaan)  
Division of Water and Wastewater (Bethea)  
Office of Public Counsel (Burgess)  
M. Feil, Esquire  
K. Hoffman, Esquire

Attachments: FPSC page #57  
Executive Summary Dr. Morin Study 1995

## Industry Consolidation

With the rapidly rising costs of providing service, the PSC is increasingly faced with the challenge of balancing the affordability of service with the obligation to provide adequate revenues for utilities to meet service requirements. While rising costs impact all utilities, the greatest impact is felt by customers of small utilities, which comprise most of Florida's systems.

As stated above, small systems cannot achieve economies of scale available to large utilities, often lack adequate capital to make needed improvements and have insufficient revenue streams to adequately maintain the system. As a result of these factors, Florida has many troubled small systems.

Differing population characteristics, water quality and environmental conditions throughout the state greatly affect the cost of providing service. Northern areas of the state have abundant and relatively clean water resources, while more populous central, southern and coastal regions are experiencing severe water shortages and contamination due to the effects of increasing aquifer withdrawals and pollution. Consequently, there can be huge disparities in the level of monthly rates, region to region and system to system, even among systems owned by large multi-system utilities. In these critical areas, the additional treatment costs to provide safe drinking water and cleaner wastewater are significant.

Industry consolidation is one potential answer to the problem of affordability. The PSC is attempting to implement policies that encourage the consolidation of Florida's water and wastewater industry. Not only can consolidation result in more efficient use of a company's resources and lower regulatory costs, but it also provides the opportunity to reduce rate impact to customers of high cost systems through implementation of non-traditional rate structures, such as uniform rates. Some consolidation is naturally taking place as large national companies are acquiring and operating systems throughout the state. Local governments also continue to acquire PSC regulated utilities, especially troubled systems that have been abandoned. The PSC is presently considering incentives that will encourage large utilities to take over troubled systems as well.

Consolidation provides the opportunity for the PSC to implement uniform rates for large multi-system companies. Although controversial for the water and wastewater industry (single tariff pricing is standard for the telecommunications and electric industries), uniform rates can provide a fair and reasonable solution to the affordability problem, because costs can be spread to a larger customer base. Regulatory costs are also lessened, because a company can include all its systems in one rate case. Initial implementation of uniform rates will initially produce higher rates for lower cost systems within the group and lower rates for the high cost systems. Long term, however, as costs continue to rise, average rates for all systems should be lower.

As stated above, the transition to uniform rates will not occur without controversy. Florida Water Services, Inc. (formerly known as Southern States Utilities, Inc.) is Florida's largest investor owned utility that operates hundreds of water and wastewater systems throughout the state. In a 1992 rate case, the PSC approved a uniform rate for all of the utility's systems. The

# RETURN ON COMMON EQUITY DETERMINATION FOR FLORIDA WATER & WASTEWATER UTILITIES

## EXECUTIVE SUMMARY

### Purpose

- Determine how changes in operating environment of FWUs have increased their investment risk and their cost of capital
- Review the Commission's leverage formula
- Recommend modifications for improving the leverage formula

### Changing Investment Risks

- Capital requirements are increasing and a large portion of capital needs will be financed externally
- FWUs small size, low market visibility and low liquidity increase risk of securing capital
- Realized returns on average equity have been decreasing
- Authorized returns are below the gas and electric industries
- Major risk factors
  - Mounting water quality regulations
  - Uncertainty regarding future demand
  - Uncertainty regarding future supply and safety of water
  - Earnings erosion
  - Regulatory risks
  - New construction risks

**The leverage formula employed by the FPSC to measure water utilities' cost of equity capital should be amended. Several specific suggestions include:**

- The addition of the Capital Asset Pricing model to the cost of equity determination.
- The correction of the DCF computation currently utilized
- An added risk premium to the gas premium cost of equity estimate
- An adjustment to the bond yield differential to account for the private placement of debt and the Baa3 - A spread
- An amended leverage formula linked to formal financial theory
- Variance in the cost of debt over the equity range
- Relaxation of the 40% equity floor