

ORIGINAL

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February 26, 1998

VIA FEDERAL EXPRESS

Blanca Bayo, Director  
Division of Records and Reporting  
Florida Public Service Commission  
2540 Shumard Oak Boulevard  
Tallahassee, Florida 32399-0850

Dear Ms. Bayo:

In connection with the Petition for Limited Proceeding Regarding Other Postretirement Employee Benefits and Petition for Variance From or Waiver of Rule 25-14.012, Florida Administrative Code, by United Water Florida Inc., please find enclosed for filing the following documents:

1. An original and seven (7) copies of United Water Florida Inc.'s Memorandum of Law. Also please find enclosed a double sided high density diskette, WordPerfect for Windows 6.1, containing United Water Florida's Memorandum of Law.
2. An original and five (5) copies of United Water Florida Inc.'s Responses to Data Requests Nos. 1, 2 and 3. *Leg & WAW Forwarded*

ACK \_\_\_\_\_ Please file the originals and distribute the copies in accordance with your usual procedures.

AFA \_\_\_\_\_

APP \_\_\_\_\_ If you have any questions or need any additional information regarding this matter, please do not hesitate to call.

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Sincerely yours,

*James L. Ade*  
James L. Ade

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Enclosures

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Mr. Harold McLean  
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ORIGINAL

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for a Limited )  
Proceeding Regarding Other )  
Postretirement Employee )  
Benefits and Petition for )  
Variance From or Waiver of )  
Rule 25-14.012, Florida )  
Administrative Code by United )  
Water Florida Inc. )

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DOCKET NO.: 980112-WS

Date Submitted for  
Filing: February 26, 1998

MEMORANDUM OF LAW

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this pleading

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for a Limited )  
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Postretirement Employee ) DOCKET NO.: 980112-WS  
Benefits and Petition for )  
Variance From or Waiver of ) Date Submitted for  
Rule 25-14.012, Florida ) Filing: February 26, 1998  
Administrative Code by United )  
Water Florida Inc. )  
\_\_\_\_\_ )

MEMORANDUM OF LAW

In connection with the Petition for Limited Proceeding Regarding Other Postretirement Employee Benefits and Petition for Variance From or Waiver of Rule 25-14.012, Florida Administrative Code, by United Water Florida Inc. ("Petition"), United Water Florida Inc. ("United Water Florida") hereby files this Memorandum of Law in response to an inquiry of the Staff of the Florida Public Service Commission ("Commission") as to whether the relief sought by United Water Florida would constitute "retroactive ratemaking."

SUMMARY OF MEMORANDUM OF LAW

United Water Florida's request for the deferral and amortization of its Other Postretirement Employee Benefits ("OPEBs") should be granted by the Commission. The granting of the request will comply with the Florida Legislature's statutory charge that rates be "just, reasonable, compensatory and not unfairly discriminatory" and the Florida Supreme Court's requirement that ratemaking is a matter of fairness and that equity requires that ratepayers and utilities be treated in a similar manner.

The granting of United Water Florida's request will not violate the limitation on retroactive ratemaking because the request does not ask that new rates be established and applied retroactively to prior consumption. Even if United Water Florida's request were to be classified as retroactive ratemaking, the request fits within two of the exceptions to the limitation against retroactive ratemaking. First, the request results from an extraordinary change in ratemaking convention that recognizes a previously unrecognized cost. Second, fairness and equity require that United Water Florida be allowed to recover its OPEB costs from its ratepayers.

United Water Florida is not seeking to charge ratepayers a greater amount of costs than they otherwise would be charged, the ratepayers merely incur costs over a different period of time. United Water Florida always intended to collect its OPEB costs from future ratepayers, under either its earlier "pay-as-you-go" basis of accounting or its Statement of Financial Accounting Standards No. 106 ("SFAS 106") basis of accounting. Future ratepayers are not burdened with charges that they never would have borne under the "pay-as-you-go" basis of accounting.

Granting United Water Florida's request will comply with the Commission's own materiality test of approximately 100 basis points on return on equity to measure the financial impact of the nondeferral of OPEB costs. The failure of the Commission to grant the request will reduce United Water Florida's return on equity by substantially more than the 130 basis point reduction in United

Water Florida's overall rate of return and the Commission's 100 basis point materiality test.

In order to allow United Water Florida's rates to be "just, reasonable, compensatory and not unfairly discriminatory" to United Water Florida, the Commission should grant United Water Florida's request for the deferral and amortization of its OPEB costs for 1994 through May 1998. The deferral and amortization will not constitute retroactive ratemaking as defined by the Florida Supreme Court, the Florida First District Court of Appeal or the Commission.

#### HISTORY OF OPEBS

As more fully discussed in the Petition, traditionally utility companies accounted for OPEBs on a "pay-as-you-go" or cash basis of accounting. During the time period of the OPEB costs which are the subject of the Petition (1994 through May, 1997), United Water Florida's rates were calculated on the "pay-as-you-go" basis for its OPEBs. United Water Florida's last rate proceeding prior to that time period was based on a test year ending December 31, 1980, which was long before the adoption of SFAS 106.

"SFAS 106 generated diverse responses by ratemaking authorities throughout the nation." GTE Florida Inc., v. Deason, 642 So.2d 545 (Fla. 1994). In GTE v. Deason, the Florida Supreme Court stated:

Regarding SFAS 106, our research has disclosed that this relatively new accounting standard has created some confusion throughout the nation. In simple terms, SFAS 106 establishes a new "accrual" method of accounting for costs associated with post-retirement benefits other

than pensions (PBOPs), replacing the earlier "pay-as-you-go" accounting method. Under the accrual method, PBOP costs are deemed "paid" for financial accounting purposes as each employee earns them rather than when the PBOPs are actually paid to employees after retirement. Thus, SFAS 106 essentially is a change in the timing at which PBOP costs are used to offset company profits for accounting purposes.

In GTE v. Deason, the Commission had required GTE to defer ten million dollars in OPEB costs. In Re: Application for a rate increase by GTE Florida Incorporated, Docket No. 920188-TL, Order No. PSC-93-108-FOF-TL, issued January 21, 1993, 1993 FPSC Reporter 1:491, 575; Order No. PSC-93-0818-FOF-TL, issued May 27, 1993, 1993 FPSC Reporter 5:611, 617. The Florida Supreme Court affirmed the Commission's order on the ten million dollar deferral, stating:

Partly because of the obvious confusion created by SFAS 106 in the ratemaking context, we cannot say we fault the PSC for exercising some degree of caution. While unsupported statements may have been made about GTE's future earnings, we find that an independent basis supports the PSC's determination regarding SFAS 106: the uncertainties still associated with the accrual method of accounting for PBOPs in ratemaking. Several other jurisdictions have expressed some doubt whether SFAS 106 is even appropriate in the context of ratemaking. In light of these uncertainties, the PSC is well within its discretion to proceed with some caution in changing over to the accrual method for ratemaking purposes. We so hold. In fact, we believe the PSC would be within its discretion to entirely reject SFAS 106 for ratemaking purposes in light of the doubts surrounding such use. Id. at 547.

#### DEFINITION OF RETROACTIVE RATEMAKING

Retroactive ratemaking occurs "where a new rate is requested and then applied retroactively." GTE Florida Inc. v. Clark, 668

So.2d 971, 973 (Fla. 1996). As noted by the Commission in previous orders:

Technically, retroactive ratemaking occurs when an additional charge is made for past use of utility service, or the utility is required to refund revenues collected, pursuant to then lawfully established rates, for such past use.

...

A rate is fixed or allowed when it becomes effective ... and the rates must be fixed prospectively from their effective date. G.S. 62-136(a) provides that the Commission shall determine rates 'to be thereafter observed and in force'. The Commission may not fix rates retroactively so as to make them collectible for past services ....

In re: Application of Tampa Electric Company for authority to increase its rates and charges, Docket No. 800011-EU(PR), Order No. 9810, issued February 23, 1981, quoting Utilities Commission v. Edmisten, 232 S.E.2d 184, 194 (N.C. 1977); see also In re: Application of Gulf Power Company for authority to increase its rates and charges, Docket No. 800001-EU (PR), Order No. 9852, issued March 5, 1981.

The Commission has also stated that "retroactive ratemaking occurs when new rates are applied to prior consumption." In re: Application for rate increase in Brevard, Charlotte/Lee, Citrus, Clay, Duval, Highlands, Lake, Marion, Martin, Nassau, Orange, Osceola, Pasco, Putnam, Seminole, Volusia, and Washington Counties by Southern States Utilities, Inc.; Collier County by Marco Shores Utilities (Deltona); Hernando County by Spring Hill Utilities (Deltona); and Volusia County by Deltona Lakes Utilities, (Deltona), Docket No. 920199-WS, Order No. PSC-95-1292-FOF-WS,

issued October 19, 1995, 1995 FPSC Reporter 10:371, 375. See also Gulf Power Co. v. Cresse, 410 So.2d 492 (Fla. 1982), and Citizens v. Public Service Commission, 448 So.2d 1024, 1027 (Fla. 1984).

**RATIONALE AGAINST  
RETROACTIVE RATEMAKING**

The principal case in Florida on the establishment of a limitation on "retroactive ratemaking" is City of Miami v. Florida Public Service Commission, 208 So.2d 249 (Fla. 1968). In City of Miami, one of the issues was whether the Commission erred in allowing a telephone company and an electric company to retain past charges deemed excessive rather than making such reduction orders retroactive. 208 So.2d at 259. The Florida Supreme Court reviewed the pertinent statutes on the Commission's authority in Chapters 364 and 366, Florida Statutes. Id. The Florida Supreme Court noted that the Florida Legislature had limited the Commission's ratemaking authority by virtue of the specific language in the statutes requiring the rates "to be thereafter observed in force," "to be thereafter installed, observed and used," "to be thereafter charged," and "to be imposed, observed, furnished, or followed in the future." Id. The Court determined that the specific language used by the Florida Legislature precluded the Commission from ordering a rate reduction retroactively. Id.

Chapter 367, Florida Statutes (1997), does not contain the same statutory limitations discussed in City of Miami. The Florida Legislature gave the Commission the power "[t]o prescribe fair and reasonable rates and charges." Section 367.121 (1)(a), Florida Statutes (1997). The prime statutory directive in Chapter 367 in

connection with ratemaking is that "[t]he commission shall ... fix rates which are just, reasonable, compensatory, and not unfairly discriminatory." Section 367.081(2)(a), Florida Statutes (1997). The Florida Legislature's use of this language contrasted with the language considered in City of Miami indicates that the Florida Legislature did not include a prohibition against "retroactive ratemaking" in Chapter 367, Florida Statutes and only required that the rates be "just, reasonable, compensatory, and not unfairly discriminatory."

Furthermore, Florida courts have found that the prohibition against retroactive ratemaking does not always apply. In Gulf Power Co. v. Florida Public Service Commission, 487 So.2d 1036 (Fla. 1986), the Florida Supreme Court found that a Commission order requiring Gulf Power Co. to issue a \$2,000,000 refund predicated on findings of managerial imprudence was not retroactive ratemaking. The Florida Supreme Court stated that the "authorization to collect fuel costs close to the time they are incurred should not be used to divest the commission of the jurisdiction and power to review the prudence of these costs." Id. at 1037. See also Richter v. Florida Power Corp., 366 So.2d 798 (Fla. 2nd DCA 1979), ("We perceive that the requirement of fairness which compels adjustment in rates to compensate utilities for escalating fuel costs also compels retrospective reconciliation to exclude charges identifiably resulting from unreasonable computations or inclusions," quoting with approval, Ohio Power Co.

v. Public Utilities Comm., 54 Ohio St.2d 342, 376 N.E.2d 1337 [Ohio 1978]).

In addition, in connection with the use of a cost recovery rule of the Commission, the Florida Supreme Court stated:

The Commission also rejected Citizens' contention that its application of the rule in this case constituted retroactive ratemaking, concluding that retroactive ratemaking only occurs when new rates are applied to prior consumption. ... We agree with the Commission that its application of the cost recovery factor rule in this case was not retroactive ratemaking.

Citizens v. Public Service Commission, 448 So.2d 1024, 1027 (Fla. 1984) (emphasis added).

#### RECOVERY OF PAST LOSSES

Although Florida courts have defined retroactive ratemaking as "where a new rate is requested and then applied retroactively," prior to the Florida Supreme Court's ruling in GTE v. Deason, some Commission orders could be interpreted as classifying the recovery of prior losses as "retroactive ratemaking."

For example, In Re: Application of Meadowbrook Utility Systems, Inc. for increased rates to its customers in Palm Beach County, Florida; and an Investigation into Overearnings, Docket No. 850062-WS, Order No. 17304, issued March 19, 1987, 1987 FPSC Reporter 3:209, 216, the Commission denied a utility company's request that the Commission make an adjustment to its common equity and that it be allowed to recover "lost revenues" because the interim rates granted in a prior order did not allow for a fair rate of return. Id. The order cites two Florida cases as authority

for the proposition that Florida law prohibits retroactive ratemaking and utilizes a North Carolina case to derive support for the position that the recovery of the lost revenue is retroactive ratemaking. However, neither Florida case prohibits retroactive ratemaking nor states that recovery of the lost revenue is retroactive ratemaking.

In Westwood Lake, Inc. v. Dade County, 264 So.2d 7, 12 (Fla. 1972), the first Florida case cited, the Florida Supreme Court addressed a petition for declaratory judgment brought by a utility company against Dade County and the Dade County Water and Sewer Board ("Dade Board") seeking a determination as to whether the application of various positions of the Dade Board to the utility company were unconstitutional so that the resulting rate base was confiscatory and deprived the utility of a constitutionally guaranteed fair rate of return on its investment. The Florida Supreme Court discussed several of the positions of the Board and remanded the case to the lower court for consideration of the petition for declaratory judgment. Id. at 12. After deciding to grant the utility company an opportunity to make its showing before the lower court, the Florida Supreme Court observed that "another factor of interest in connection" with this matter, was the Dade Board's announced position on applying specific test years (e.g., September 1, 1962 to August 31, 1963). The Florida Supreme Court noted:

Whatever a base year may show, it apparently is intended that the same rate should carry through arbitrarily for other years involved. On the face of it this would not appear to

allow a fair application of rates which of course vary in a utility, depending on investments and circumstances from year to year. Ratemaking is prospective, not retroactive, and therefore the test years should be the most current time in relation to the hearing date to fix rates in the future. This is another factor to be considered by the trial court in its weighing of the application of the ordinance as proposed to be applied by the Board, in making a declaration of the rights of the utility in this regard. Id. at 12.

Apparently, the Commission's order relied on the phrase "[r]atemaking is prospective, not retroactive" as its authority, but the case was addressing the need for the test year to be as current as possible, not whether recovery of certain costs or revenues was retroactive ratemaking.

In Pinellas County v. Mayo, 218 So. 2d 749 (Fla. 1969), the second Florida case cited, the Florida Supreme Court stated that "the questions [under consideration are] ... now moot for all practical purposes...." Id. at 751. It is interesting to note that the North Carolina case quoted in the order also states that "[t]he surcharge ... is a charge to customers for power used after the surcharge took effect and, therefore, is not, technically, retroactive ratemaking". Utilities Commission v. Edmisten, 232 S.E. 2d 184, 194 (N.C. 1977).

In Re: Application for a rate increase in Duval County by Ortega Utility Company, Docket No. 940847-WS, Order No. PSC-95-1376-FOF-WS, issued November 6, 1995, 1995 FPSC Reporter 11:246, the Commission considered a request for a rate base adjustment to reflect cumulative losses which the utility company believed could

be traced to unrecovered depreciation. The Commission stated that it believed that the reversal of depreciation expense, which had already been recognized, is a request to recover past losses, which in turn is a request for retroactive ratemaking. Id.

Subsequent to the Ortega case, however, the Florida Supreme Court corrected the Commission's misinterpretation of retroactive ratemaking. In GTE v. Clark, "[t]he PSC ... argues that the imposition of a surcharge would constitute retroactive ratemaking." 668 So.2d at 972. The Florida Supreme Court held:

We ... reject the contention that GTE's requested surcharge constitutes retroactive ratemaking. This is not a case where a new rate is requested and then applied retroactively. The surcharge we sanction is implemented to allow GTE to recover costs already expended that should have been lawfully recoverable in the PSC's first order. Id. at 973 (emphasis added).

Furthermore, even in the Ortega case, the Commission did make an adjustment, which increased rate base without constituting retroactive ratemaking. The Commission required the adjustment to remove "the increment associated with adoption of guideline rates for MFR reporting purposes before service rates were increased to recover that additional expense. 95 FPSC 11:258. The Commission compared the utility company's unapproved request with the Commission's required adjustment:

[The utility company's] adjustment would eliminate all wastewater depreciation charges from 1988 until June of 1994 because income was presumably deficient. Our adjustment covers a different period, from January 1987 until June 1989, when the rates approved in Docket No. 871262-WS had not yet been implemented. Our adjustment covers

depreciation expenses that were approved but were designed to be recovered on a prospective basis; the utility's proposed adjustment addresses a failure to achieve sufficient income which the utility believes can be attributed to depreciation in general. Id. at 259.

Unlike the utility companies in Meadowbrook and Ortega, United Water Florida is not requesting (1) that its common equity be adjusted and that it recover "lost" revenue related to underearning during the time when interim rates were in effect or (2) that it be allowed to recover a portion of cumulative losses. United Water Florida is seeking to establish a procedure to recover costs which only became costs capable of recovery after its rates for the time in question (pre May 31, 1997) were established.

Furthermore, United Water Florida's request is consistent with the relief granted by the Commission in the Ortega case. United Water Florida's requested remedy is designed to address the problem created when an accounting rule is changed and, as a result of the change, the utility company incurs additional costs which it would not recover in its rates. Like the adjustment in Ortega, (1) United Water Florida's requested remedy seeks to defer the increase in FSAS 106 cost arising because of a change in an accounting rule and (2) the time for the accumulation of the increase in cost ends when new rates went into effect recovering the increased cost.

**REQUESTED REMEDY IS NOT RETROACTIVE RATEMAKING**

United Water Florida's requested remedy does not request that new rates be established and applied retroactively to prior consumption. United Water Florida's requested new rates would be

applied to future consumption. Accordingly, United Water Florida's requested remedy is not "retroactive ratemaking."

**EXCEPTIONS TO THE  
LIMITATION AGAINST RETROACTIVE RATEMAKING**

While technically not "retroactive ratemaking," some state public service commissions disallow the recovery of past losses through future rates, treating such a recovery similarly to "retroactive ratemaking." Even if the Commission decided to treat United Water Florida's requested remedy as a type of "retroactive ratemaking," the remedy falls within two of the exceptions to a limitation against "retroactive ratemaking."

**Extraordinary Cost Exception**

One exception to the prohibition against "retroactive ratemaking" occurs when an extraordinary cost is incurred that does not arise from company mismanagement or imperfect forecasts in the ratemaking process. See MCI Telecommunications Corp. v. Public Service Commission of Utah, 840 P.2d 765 (Utah 1992).

Utah employs a broader definition of "retroactive ratemaking" than does Florida: "As a general proposition, a utility's recoupment of costs that were greater than projected or revenues that were less than projected from future rates constitutes retroactive ratemaking." MCI, 840 P.2d at 770. However, the court also acknowledged that exceptions had to be made to the general rule.

If this treatment is not to be permitted, not only would there be a serious question as to whether the Company has been afforded a fair opportunity to earn a reasonable rate of return, it would also imply the need for an

upward revision of the rate of return on all cases in the future. Such a revision, of course, would have to be based on a prediction of inherently unpredictable events.

...

Once it is clear that a particular cost is 'extraordinary' and that it does not result from company mismanagement, or imperfect forecasts, treatment of such costs through appropriate amortization in future rate determinations does not constitute a true-up of past calculations, because such a truly extraordinary cost by definition would not be factored into the original rate." quoting In re: Green Mountain Power Corp., 519 A.2d 595, 597 (Vt. 1986) (emphasis in original); MCI, 840 P.2d at 771.

The MCI court also stated that:

To achieve fairness, the exception allows recoupment of such expenses either in future rates or in some other appropriate fashion.

The [retroactive rate making] rule ... is a sound ratemaking principle, but it only applies to 'missteps in the ratemaking process.' It does not apply where justice and equity require that adjustments be made for unforeseen windfalls or disasters not caused by the utility. Id. at 771.

The extraordinary expense exception has been recognized in other jurisdictions as well. See e.g., Philadelphia Electric Co. v. Pennsylvania Public Utility Comm., 502 A.2d 722 (Pa. Cmwlth. 1985), in which the court stated:

The general rule is that there may be no line examination of the relative success or failure of the utility to have accurately projected its particular items of expense or revenue and an excess over the projection of an isolated item of revenue or expense may not be, without more, the subject of the Commission's order of refund or recovery, respectively, on the occasion of the utility's subsequent rate increase requests.

An exception to this rule in the case of retroactive recovery of unanticipated expenses has been recognized where the expenses are extraordinary and nonrecurring.

### Fairness And Equity Exception

Another exception to the prohibition against retroactive ratemaking is fairness and equity. Actually, fairness and equity are more than an exception--they are the underlying concepts in ratemaking. As stated by the Florida Supreme Court:

We view utility ratemaking as a matter of fairness. Equity requires that both ratepayers and utilities be treated in a similar manner.

GTE Florida Inc. v. Clark, 668 So. 2d 971, 972 (Fla. 1996). In GTE v. Clark, the Florida Supreme Court rejected the contention that the proposed surcharge constituted "retroactive ratemaking," holding that:

This is not a case where a new rate is requested and then applied retroactively. The surcharge we sanction is implemented to allow GTE to recover costs already expended that should have been lawfully recoverable in the PSC's first order. Id. at 973 (emphasis added).

Even if United Water Florida's requested remedy is thought to be retroactive ratemaking, it comes within the two exceptions. First, the imposition of SFAS 106 was not foreseeable at the time when United Water Florida's rates were established, using a December 31, 1980, test year. As noted in the section on the History of OPEBs, the imposition of SFAS 106 for OPEBs caused great confusion and diverse ratemaking approaches and was an extraordinary and significant accounting change. Second, as set

forth in the Petition, United Water Florida will suffer significant losses in its earnings, a thirteen and three-fourths percent (13-3/4%) reduction in operating income, a reduction in its overall rate of return of approximately 130 basis points and a reduction in its return on equity of substantially more than the 130 basis point reduction in its overall rate of return. Such an extraordinary result did not arise from company mismanagement or imperfect forecasts, but rather from the imposition of SFAS 106. Furthermore, it would be unfair and inequitable to shift the payment of OPEB costs, which are to be recoverable from ratepayers in rates, to the shareholders of a company merely because a recent accounting change shifted the timing of the recognition of the costs.

#### OPEB COSTS AND RECOVERY OF OPEB COSTS

OPEB costs can be divided into two categories: OPEB costs for the current year and OPEB costs for prior years. OPEB costs for prior years include the transition obligation (which the Commission has allowed United Water Florida to recover) and prior deferrals. A utility company is to recover its OPEB costs through its rates. "The utility rate payers pay the cost of the OPEBs ... in their utility rates." Citizens of the State of Florida v. Florida Public Service Commission, 15 FALR 1776, 1782, Case No. 925717 RP. United Water Florida has not yet recovered its OPEB costs for 1994, 1995, 1996, and through May, 1997, through its rates. "Ultimately, the costs of retirement benefits under FAS No. 106 will not vary from costs under pay-as-you-go accounting, but the timing of the

recognition of these costs will be different." In re: Petition for a rate increase by Florida Power Corporation, Docket No. 910890-EI, Order No. PSC-92-1197-FOF-EI, issued on October 22, 1992, 1992 FPSC Reporter 10:408, 418.

Collection of the OPEB costs for prior years over an amortization period has been found not to violate retroactive ratemaking. See Town of Norwood, Massachusetts v. Federal Energy Regulatory Commission, 53 F.3d 377, 381 (D.C. Cir. 1995). In Norwood, the court acknowledged that the transition obligation of OPEB costs from prior years entails some violation of the matching principle and that the Federal Energy Regulatory Commission ("FERC") recognized that "[c]harging current ratepayers for the transition obligation is unquestionably charging for costs incurred to provide service to other, earlier ratepayers." Id. at 381, quoting 61 F.E.R.C. ¶ 61,331 at 62,215. FERC ruled that, "when ratemaking conventions change to recognize a previously unrecognized cost, some of which has already been accumulated, the Commission allows the utility to make up for the amount that has already been accumulated: the 'make-up' provision 'is a permissible way to make a utility whole for properly deferred, prior period costs.'" Id. at 381.

FERC had conducted a proceeding on PBOPs (also known as OPEBs). FERC issued a Statement of Policy in which it adopted the accrual method and addressed the question of whether the accrual method violated the "filed rate" doctrine and constitutes retroactive ratemaking. Re Post-Employment Benefits Other Than

Pensions, 61 FERC 61330, 138 PUR 4th 353 (1993). The Statement of Policy proclaimed:

Those PBOPs earned in a prior period which were not immediately recovered in rates, because there had been no recognized expense under the Commission's accounting or ratemaking requirements, were deferred under the legitimate expectation that such costs would be allowed in rates in future periods. Companies are now required to recognize this expense during the working life of employees, well in advance of the payment of the PBOPs. Recovery of prior period PBOP costs under the cash method or under the accrual method does not violate the filed rate doctrine. Id. at 359.

In Norwood, the Court found that the transition obligation does not violate the proscription against "retroactive ratemaking." 53 F.3d at 381. The court stated:

The retroactive ratemaking doctrine prohibits the Commission from authorizing or requiring a utility to adjust current rates to make up for past errors in projections. If a utility includes an estimate of certain costs in its rates and subsequently finds out that the estimate was too low, it cannot adjust future rates 'to recoup past losses'.... As detailed below, however, the transition obligation does not run afoul of the retroactive ratemaking prescription, because NEP has not shifted any costs that it tried but failed to collect in the past: it has always planned to collect these costs from future ratepayers, the only shift is the timing within the future. Id. (emphasis in original).

The court observed that in a similar situation involving a transition from flow through accounting to tax normalization accounting, including a makeup provision, the court had upheld the makeup provision against a charge that it constituted retroactive ratemaking stating:

Petitioners argue that the make-up provision is illegal retroactive ratemaking. Unlike the agency action in the cases cited by petitioners, however, the provision does not adjust for shortfalls in prior rates. It only adjusts future rates so that tax costs will not fall disproportionately on one ratepayer generation. Ratepayers are not charged for a greater tax allowance under the provision than they otherwise would be; they merely incur the cost over a different time period. Id. at 382.

Comparing the two situations, the court noted that:

In each case there is a quantity of money that the company (a) planned to collect from future ratepayers under the earlier method, but (b) would have collected from past ratepayers if it had been using the new method all along.... [t]his Court held that it is not retroactive ratemaking for the company to collect this quantity of money from future ratepayers over a set period of time because it was expected all along that this money would be collected from future ratepayers. The make-up provision changed only the timing of the collection; it did not burden future ratepayers with charges that they would never have borne under the old system. By the same reasoning, the transition provision at issue in this case is not retroactive ratemaking.

As the Court noted, "[i]n sum, because the transition provision only shifts the timing of collection of PBOP costs among future ratepayers, it does not constitute retroactive ratemaking ...." Id. at 384.

The issue of "retroactive ratemaking" and OPEBs was also addressed in Popowsky v. Pennsylvania Public Utility Commission, 164 Pa. Cmwlth 600, 643 A. 2d 1146 (Pa. Cmwlth 1994). The Office of Consumer Advocate (OCA) argued that the commission erred in allowing deferral and amortization of the transitional obligation because it requires consumers to pay the cost of past services

instead of current services and violates the rule against retroactive ratemaking. Id. at 1148. In response to OCA's arguments on "retroactive ratemaking", the Court stated:

Customers of PAWC would still be required to pay for the benefits represented by the transitional obligation if cash accounting remained in effect at the time such benefits were actually paid. Thus, there is considerable force in the Company's argument that the approval of PAWC's claim is not retroactive ratemaking because only the timing of the Company's OPEB recovery, and not the amount was changed. Id. at 1149.

The Court also noted that this was an exception to retroactive ratemaking:

PAWC's rate increase request does not arise out of inaccurate projections of its OPEB obligations in prior rate authorizations but arises out of the change from cash to accrual accounting.

...

An exception to this rule in the case of retroactive recovery of unanticipated expenses has been recognized where the expenses are extraordinary and non-recurring. Id. at 1149.

The Court went on to hold that:

The transitional obligation arises from an extraordinary and non-recurring one time event -- the change from cash to accrual accounting -- and the allowance of the recovery of that obligation amortized over a period of twenty years is not retroactive ratemaking. Id.

With respect to OCA's argument that, "allowing the transitional obligation creates inter-generational inequities because current customers will be paying for services rendered to past customers," the Court stated:

It is not equitable to pass the entire obligation to future customers, which occurs under cash accounting. Nor is it equitable to charge the obligation to investors who had no opportunity to seek rate relief until now.

...

This Court finds it not to be unreasonable to place the burden on both present and future customers by amortizing the obligation over a period of twenty years. Id. at 1150.

The Pennsylvania Commission recently issued an order in a United Water Pennsylvania ("UWP") rate case in which it permitted the recovery of the transition obligation as well as deferrals for SFAS 106 costs for years after the imposition of SFAS 106. (Pennsylvania Public Utility Commission, et al. v. United Water Pennsylvania Inc., Docket Number R-00973947, Order entered January 30, 1998.) In the order, the Pennsylvania Commission granted UWP's recovery of OPEB costs. In addition to allowing the recovery of the annual accrued SFAS 106 expense, the Commission also allowed the recovery for deferred SFAS 106 costs totaling \$1,416,142 for years 1996 and 1997 over a fourteen (14) year amortization period. The Commission rejected OCA's argument that the deferred SFAS 106 costs should be disallowed. Thus, the Commission allowed recovery of deferred costs in addition to the transition obligation. It should be noted that recovery of SFAS 106 expenses was granted even though UWP had not received prior approval from the Commission to defer such expenses.

The Florida Public Service Commission has approved recovering in rates OPEB costs under SFAS No. 106, including the transition obligation. See In re: Application for a rate increase by United

Telephone Company of Florida, Docket No. 910980-TL, Order No. PSC-92-0708-FOF-TL, issued July 24, 1992, 1992 FPSC Reporter 7:555, 588-595. In Re: Petition for a rate increase by Florida Power Corporation, Docket No. 910090-EI, Order No. PSC-92-1197-FOF-EI, issued October 22, 1992, 1992 FPSC Reporter 10:408, 419-420, the Commission addressed the amortization of the transition obligation and stated:

OPC and FIPUG testified that using FAS No. 106 for ratemaking purposes can create an intergenerational inequity since the amortization of the transition obligation is a part of FAS No. 106 expense. The transition obligation is, essentially, the unrecognized amount of the postretirement benefit obligation as of the date a company initially applies FAS No. 106. The transition obligation represents the present value of benefits to be paid in the future and the amortization of the transition obligation allocates the present value of those future benefits to a 20 year period in the future. Under pay-as-you-go accounting, there will always be a mismatch between [the] ... time an employee earns postretirement benefits and the time the company recognizes the cost of those benefits. Even with the amortization of the transition obligation, FAS No. 106 is closer to achieving intergenerational equity than the pay-as-you-go method.

...

OPC argued that the transition obligation should remain on a pay-as-you-go basis, stating that it would be unwise for the Commission to change its policy "midstream." However, the calculation of the FAS No. 106 expense includes the amortization of the transition obligation. As stated above, FAS No. 106 is appropriate for ratemaking purposes.

### DEFERRAL OF OPEB COSTS

The Commission has approved the deferral of OPEB costs. See In re: Application for a rate increase by United Telephone Company of Florida, Docket No. 910980-TL, Order No. PSC-92-0708-FOF-TL, issued July 24, 1992, 1992 FPSC Reporter 7:555, 590. In fact, the Commission has required the deferral of OPEB costs over the objection of a company. In Re: Application for a rate increase by GTE Florida Incorporated, Docket No. 920188-TL, Order Nos. PSC-93-0108-FOF-TL, 1993 FPSC Reporter 1:491, 572; PSC-93-0818-FOF-TL, 1993 FPSC Reporter 5:611, 617.

The Commission found it appropriate to require GTE to defer the excess of the incremental interstate FSAS 106 cost above the amount included in the cost of service by the Commission, but not to require the deferral of more than ten million dollars. In its order on the utility company's motion for reconsideration, the Commission again found its decision to require the deferral to be appropriate. 1993 FPSC Reporter 5:617-624. The Commission rejected the company's argument that the deferral violated principals of test year concepts. Id. at 617-618. The Commission stated that it did not ignore FSAS 106 liability--instead it recognized FSAS 106 costs through two mechanisms. Id. at 618-619. The incremental FSAS 106 costs were directly included in the 1993 rates, and the company was given the opportunity to defer up to ten million dollars of additional FSAS 106 costs. Id. The Commission noted that, "[s]ince we approved the deferral and amortization of the additional SFAS 106 costs, it should not impact the Company's

income statement for external financial purposes." Id. at 619. The Commission stated that it was deferring the OPEB costs to prevent the company from receiving a windfall in earnings. Id. at 621. The Commission also observed that the company's shareholders would not be harmed by the deferral. The Commission stated:

We anticipate that GTEFL's earnings will increase by \$23,000,000 in 1994. If we do not defer the OPEB costs, evidence indicates that the Company will receive a windfall of that amount. United Telephone of Florida asked for reconsideration of our decision to defer a portion of United's OPEB costs based upon the grounds that its property would be confiscated. In our decision in that case, we stated:

We do not believe that United's stockholders will be harmed by our decision. The Other Post Retirement Benefits (OPEBs) deferral and expense amounts for future periods are offset by the decline in depreciation amortization schedules and earnings growth.....Whether the FAS 106 amounts are offset by the growth in earnings or the decline in depreciation amortization expense, we do not believe that the stockholders are harmed. (Order No. PSC-92-1277-FOF-TL)

Upon review, we find that the same rationale applies equally to GTEFL's circumstance. The evidence indicates that there will be an increase in 1994 earnings which can support the deferral of the OPEB expense. Id. at 621-622.

The Commission disagreed with the company's argument that the deferral of the FSAS 106 cost was bad public policy. Id. at 619. The Commission ordered that the deferred amount was to be recorded as a regulatory asset. Id.

The Florida Supreme Court affirmed the Commission's deferral of SFAS 106 costs. GTE v. Deason, 642 So.2d at 547. In its approval, the Florida Supreme Court noted,

We also do not believe that any adjustments to the accrual method in future rate cases will violate the prohibition against retroactive ratemaking provided these adjustments do not retroactively leave a utility in a worse position than was established in prior rate cases, and provided they also do not impair existing contractual obligations in a manner prohibited by constitutional law." Id.(emphasis in original)

The Commission previously has considered whether to allow deferral accounting treatment of OPEB costs incurred from the effective date of SFAS 106 (January 1, 1993) until the Commission recognizes the deferred costs associated with SFAS 106 as a regulatory asset and approves the inclusion of these costs in rates in the utility companies' next rate cases. The utility companies also requested that the deferred costs be amortized over a reasonable period. In Re: Petition for Certain Accounting and Ratemaking Authority Associated With Implementation of Statement of Financial Accounting Standards No. 106 in Brevard, Collier and Lee Counties by FLORIDA CITIES WATER COMPANY, Docket No. 921158-WS; In Re: Petition for Certain Accounting and Ratemaking Authority Associated With Implementation of Statement of Financial Accounting Standards No. 106 in Osceola and Polk Counties by POINCIANA UTILITIES, INC., Docket No. 921159-WS; Order No. PSC-93-1328-FOF-WS, issued September 9, 1993; In Re: Petition for Authority to Defer SFAS No. 106 Costs by SOUTHERN STATES UTILITIES, INC., in Bradford, Brevard, Citrus, Clay, Collier, Duval, Hernando,

Highlands, Lake, Lee/Charlotte, Marion, Martin, Nassau, Orange, Osceola, Pasco, Putnam, Seminole, Volusia, and Washington Counties, and by LEHIGH UTILITIES, INC. in Lee County, Docket No. 921301-WS, Order No. PSC-93-1377-FOF-WS, issued September 20, 1993.

The Commission evaluated the effect of the denial of the deferral of OPEB costs on the return on equity for the three utility companies and determined that there would be less than a 100 basis point reduction in the three returns on equity. Id. The Commission noted that the allowed range of return on equity is plus or minus 100 basis points. Id. Therefore, the returns on equity of the three companies were within the allowed range.

If United Water Florida is not granted the requested remedy, it will incur a reduction in its overall rate of return of 130 basis points and a reduction in its return on equity of substantially more than the 130 basis points, which exceeds the Commission's 100 basis point test.

**APPLICATION OF LAW TO  
UNITED WATER FLORIDA'S REQUESTED REMEDY**

The Florida Legislature has directed the Commission to fix rates which are "just, reasonable, compensatory, and not unfairly discriminatory." Section 367.081(2)(a), Florida Statutes (1997). The Commission has been given the power to "prescribe fair and reasonable rates and charges" and "to do all things necessary or convenient to the full and complete exercise of its jurisdiction and the enforcement of its orders and requirements." Section 367.121 (1)(a) and (g), Florida Statutes (1997).

The Commission has acknowledged that it has "broad statutory and legal authority to prescribe fair and reasonable rates and charges." In re: Application for rate increase in Brevard, Charlotte/Lee, Citrus, Clay, Duval, Highlands, Lake, Marion, Martin, Nassau, Orange, Osceola, Pasco, Putnam, Seminole, Volusia, and Washington counties by Southern States Utilities, Inc.; Collier County by Marco Shores Utilities (Deltona); Hernando County by Spring Hill Utilities (Deltona); and Volusia County by Deltona Lakes Utilities, (Deltona), Docket No. 920199-WS, Order No. PSC-98-0143-FOF-WS, issued January 23, 1998, page 12. The Commission has acknowledged its ability to impose surcharges, "[a]ccordingly, we reject the argument that we lack the authority to impose a surcharge." Id.

The Commission has also stated that:

[W]e find the issue of whether the imposition of surcharges would constitute retroactive ratemaking has been addressed in the GTE and Southern States decisions. In GTE the Supreme Court rejected the contention that the imposition of a surcharge upon certain customers would constitute retroactive ratemaking where the utility is seeking to recover expenses and costs that should have been lawfully recovered in the Commission's first order. Id.

The Commission does have limits on its ratemaking authority. In addition to the Florida Legislature's directives, the Florida Supreme Court has held that "ratemaking [is]... a matter of fairness" and that "[e]quity requires that both ratepayers and utilities be treated in a similar manner." GTE v. Clark, 668 So. 2d at 972. The requirements that ratemaking be fair and that

equity requires that both ratepayers and utilities be treated in a similar manner was recently reenforced by the Florida courts. See Southern States Utilities v. Florida Public Service Commission, 22 Fla. L. W. D1492 (Fla. 1st DCA 1997).

The Commission has acknowledged that its ratemaking is subject to these requirements. As set forth in Order No. PSC-98-0143-FOF-WS:

From a policy standpoint and now confirmed by law, the Commission must make its decisions after considering the impact on all customers and the utility. (Citations omitted). In our opinion the GTE court defined equity very broadly, 'equity requires that both ratepayers and utilities be treated in a similar manner.' Order No. PSC-98-0143-FOF-WS at p. 23 (emphasis in original).

Accordingly, the Commission must be fair in its ratemaking, treat both ratepayers and United Water Florida equitably, and fix rates for United Water Florida which are just, reasonable, compensatory, and not unfairly discriminatory.

Unlike the statutes in the electric and telephone utility area discussed in City of Miami v. Florida Public Service Commission, 208 So. 2d 249 (Fla. 1968), Chapter 367 of the Florida Statutes does not impose a limitation against "retroactive ratemaking" in the water and wastewater area. Moreover, if the Commission is precluded from "retroactive ratemaking" in connection with water and wastewater utility companies, United Water Florida's requested remedy or a surcharge to collect the unrecovered OPEB costs would be allowed under Florida law. See GTE Florida Inc. v. Clark, 668 So. 2d 971 (Fla. 1996).

Even if the Commission's more expansive definition of "retroactive ratemaking" were applied, which the Commission used prior to GTE v. Clark, and it was determined that the requested remedy was "retroactive ratemaking", United Water Florida's situation falls within two exceptions to "retroactive ratemaking": (i) Extraordinary Expense and (2) Fairness and Equity. The conversion from a cash basis of accounting to an accrual basis of accounting for OPEB costs has resulted in an extraordinary increase in OPEB costs. The increase in OPEB costs was not the result either of company mismanagement or imperfect forecasts. Ratemaking conventions have changed to recognize a previously unrecognized cost, some of which has already been accumulated. United Water Florida could not forecast the change in OPEB accounting procedures at the time its rates were set. If United Water Florida does not receive relief in this matter, it will suffer an extraordinary effect on its earnings, the loss of more than one million dollars. Utility companies are allowed to recover their transition costs of OPEBs in many jurisdictions, including Florida, without it being a violation of "retroactive ratemaking." The transition cost is a recovery of costs for past service amortized over a period of time. This is the same result sought by United Water Florida with its requested remedy. The difference is the end date to which costs for prior service are collected. If United Water Florida does not recover its unrecovered OPEB costs in its rates, the rates established by the Commission not only will be unfair, unjust and inequitable, but will not "compensate" United Water Florida as

required by statute. Section 367.081 (2)(a), Florida Statutes (1997).

It has been suggested that allowing United Water Florida to recover its unrecovered OPEB costs would be the same as allowing a utility company to recover missed depreciation expense from prior years. This is not the case. Such missed depreciation would not be an extraordinary event and would have been the result of imperfect forecasts. Furthermore, unlike depreciation and similar expenses, United Water Florida did not incur OPEB costs (above pay-as-you-go OPEB costs) for ratemaking purposes until the use of new ratemaking and accounting procedures were imposed on United Water Florida by outside agencies. In addition, in connection with the Commission's review of depreciation expense in the Ortega case, the Commission granted relief similar to the relief requested by United Water Florida.

United Water Florida has not sought to charge ratepayers for a greater amount of costs than they would otherwise be charged, rather the ratepayers merely incur the costs over a different time period. United Water Florida always planned to collect OPEB costs from future ratepayers under the earlier method, but it would have collected the OPEB costs from its past ratepayers if it had been using the new mandated accounting method from the time its rates were established for the period, which was prior to SFAS 106. United Water Florida's requested remedy only changes the timing of the collection; it does not burden future ratepayers with charges that "they never would have borne under the old system." United

Water Florida always intended to collect these costs from future ratepayers.

OPEB costs are to be recovered from ratepayers. The Commission has approved the recovery of OPEBs in rates, including the transition obligation. The Commission has not only allowed deferrals of OPEBs, but required deferrals over the objections of some companies in order to avoid windfalls in favor of the companies. Under the principle of fairness and equity, if it is fair and equitable to require a deferral of OPEB costs to avoid a windfall to a utility company, then it is equally fair and equitable to allow a deferral of OPEB costs to avoid an extraordinary loss to a utility company. Applying the one hundred basis point test on the return on equity used by the Commission in its previous decisions on requests for deferrals of OPEB costs, United Water Florida's situation clearly warrants relief. United Water Florida is earning below its authorized rate of return on equity, even if its revenues were annualized for 1997 to account for its rate increase. Furthermore, a denial of relief itself would result in approximately a three hundred basis point reduction in the return on equity of United Water Florida.

Although a Commission rule requires prior approval of deferrals, in this Docket United Water Florida has requested a waiver of that rule and approval of the deferral. Such a waiver and remedy would not only be consistent with and a promotion of the purpose of the underlying statutes, but it would also enable the Commission to grant rates in a fair and equitable manner.

Moreover, granting the rule waiver and the requested remedy would enable the Commission to comply with another important mandate from the GTE cases. In GTE vs. Deason, the Florida Supreme Court stated,

We also do not believe that any adjustments to the accrual method in future rate cases will violate the prohibition against retroactive ratemaking provided these adjustments do not retroactively leave a utility in a worse position than was established in prior rate cases. Id. at p. 547 (emphasis added).

Before the conversion of United Water Florida from a pay-as-you-go basis to an accrual basis of accounting for OPEBs, United Water Florida would have collected all of its OPEB expenses in future rates. If the Commission does not grant the requested relief, United Water Florida will never recover in rates more than a million dollars of OPEB costs. Contrary to the requirement in GTE v. Deason, the adjustment of United Water Florida to the accrual method would retroactively leave United Water Florida in a far worse position than was established in prior rate cases. Accordingly, the Commission should grant the relief requested by United Water Florida.

#### CONCLUSION

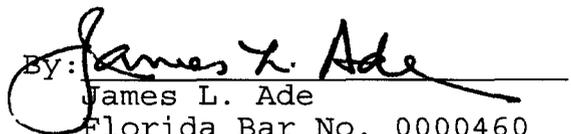
United Water Florida's requested remedy does not request that new rates be established and applied retroactively to prior consumption and, therefore, it does not require retroactive ratemaking. Even if the requested remedy were retroactive ratemaking, it is within two of the exceptions to retroactive ratemaking. Furthermore, in order to comply with the Florida

Legislature's statutory charge to the Commission that rates be "just, reasonably, compensatory, and not unfairly discriminatory" and the Florida Supreme Court's requirements of fairness and equity, the Commission should grant the requested remedy. Moreover, such approval will comply with the Florida Supreme Court's requirement that SFAS 106 accrual adjustments not leave a utility company in a worse position than it started.

Dated this 26th day of February, 1998.

Respectfully submitted,

MARTIN, ADE, BIRCHFIELD &  
MICKLER, P.A.

BY:   
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Attorneys for United Water  
Florida Inc.

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that the original and seven copies of the Memorandum of Law, has been furnished by Federal Express this 26th day of February, 1998, to Blanca Bayo, Director, Division of Records and Reporting, Florida Public Service Commission, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, and a copy of the foregoing has been furnished to Rosanne Gervasi, Attorney for the Staff of the Florida Public Service Commission, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, and to Harold McLean, Esquire, Office of Public Counsel, c/o The Florida Legislature, 111 W. Madison Street, Room 812, Tallahassee, Florida 32399-1400, by U.S. Mail, this 26th day of February, 1998.

  
Attorney

*Legal*

Response to Commission Staff's  
First Set of Data Requests  
to United Water Florida Inc.  
Docket No. 971596-WS

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REGULATORY AND  
REPORTING

**Data Request Number 1:**

Please provide a copy of UWF's most recent audited financial statements, including all notes to the financial statements. If UWF's balance sheet and income statement are included in audited consolidated or combined financial statements, please provide a copy of such statements, including all notes to the financial statements.

**Response:**

Six (6) copies of the Consolidated Financial Statements of United Waterworks Inc. and subsidiaries for the year ended December 31, 1996, including the Report of Independent Accountants by Price Waterhouse LLP, have been submitted with this response.

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FEB 27 1998  
LEGAL DIVISION

Response to Commission Staff's  
First Set of Data Requests  
to United Water Florida Inc.  
Docket No. 971596-WS

Data Request Number 2.

SFAS 106 was issued in December, 1990 and was effective for fiscal years beginning after December 15, 1992. Rule 25-14.012 was issued on August 4, 1993. In its petition, UWF asserts that it first incurred OPEB costs in 1994. Please provide UWF's rationale for not requesting recovery of OPEB costs prior to the date such costs were incurred by UWF.

**Response:** Until the merger of UWF's ultimate parent, GWC Corporation ("GWC"), with United Water Resources (UWR) on April 22, 1994, GWC and its subsidiaries, including UWF, recorded Other Postretirement Employee Benefit ("OPEB") costs on a cash basis. Prior to the merger GWC believed that UWF's OPEB costs were not material.

After the merger took place, UWR reviewed the pension and other retirement plans of GWC and determined that it was necessary to perform an actuarial evaluation of the post-retirement benefit plans other than pensions since such an evaluation had not been done for GWC and its subsidiaries. UWR then compiled the census data, medical claims information, and cost experience data needed for the actuarial evaluation.

This study ultimately produced the SFAS 106 amounts that are the subject of this Petition. When the evaluation was completed in December 1994, the SFAS 106 liability was recorded on UWF's books at that time. Since the liability was being recorded in the 1994 fiscal year, UWF was able to account for the change as of the date of the merger, April 22, 1994.

UWF does not believe that it is necessary to request recovery of OPEB costs prior to the date such costs were incurred. For example, the transition costs under SFAS 106 were incurred for periods occurring prior to 1993. Recovery of such transition costs in rates has been requested and granted after the incurrance of such costs in many jurisdictions, including Florida. For more information on this subject, see the Memorandum of Law concurrently filed with this Response (pp. 16-25). UWF's request for recovery of prior deferrals is very similar to its request to recover the transition obligation in that both relate to the recovery of prior costs. The Commission has granted UWF's request for recovery of the transition obligation. In addition, as noted in the 1994 Florida Supreme Court case, GTE Florida Inc. v. Deason, 642 So.2d 545, 547 (Fla. 1994), adjustments to the accrual method in future rate cases will not violate the prohibition against retroactive ratemaking provided the adjustments do not retroactively leave a utility in a worse position than established in prior rate cases. If UWF does not recover the Unrecovered OPEB Costs, it will be left in a worse position than established in its prior rate cases.

For the time period in question, 1994 through May 1997, except for annual price index and pass-through rate changes each year since 1981, UWF's rates were from a previous rate case filing which used a test year ended December 31, 1980. UWF's July 30, 1996 rate filing was its first in fifteen (15) years. At the hearing on the 1996 rate case filing, UWF attempted to introduce evidence as to its 1995 and 1996 OPEB costs, which also included its 1994 OPEB costs. The evidence was stricken by the Commission for technical reasons. However, as noted by the Commission, "we did not disallow these expenses." Order PSC-97-1146-FOF-WS, page 8. Following the completion of the 1996 rate case, UWF filed its Petition for Limited Proceeding to get the evidence and the request for recovery of the Unrecovered OPEB Costs properly before the Commission for its review and decision.

The Commission uses a materiality test of approximately 100 basis points on the return on equity to measure the financial impact of the FSAS 106 issue. See Southern States Utilities, Inc., Docket No. 921301-WS, Order No. PSC-93-1328-FOF-WS, issued September 20, 1993, and Florida Cities Water Company and Poinciana Utilities, Inc., Docket Nos. 921158-WS and 921159-WS, Order No. PSC-93-1328-FOF-WS, issued September 9, 1993. As stated in UWF's Petition (pages 7 and 8), denial of recovery of the "Unrecovered OPEB Costs" would reduce UWF's overall rate of return by more than 130 basis points. See also Exhibit 4 to the Petition. Clearly, the reduction of 130 basis points in the overall rate of return, when applied to the capital structure set by the Commission in

UWF's recent rate case, will produce a reduction in the return on equity substantially higher than both the reduction in the overall rate of return and the Commission's own 100 basis point materiality test. The Commission's own materiality standard clearly shows the severe financial impact associated with a denial of recovery of the Unrecovered OPEB Costs.

Response to Commission Staff's  
First Set of Data Requests  
to United Water Florida Inc.  
Docket No. 971596-WS

Data Request Number 3:

Please provide UWF's rationale for recording deferred OPEB costs without prior Commission approval in apparent violation of Rule 25-14.012(2).

**Response:** Until the merger of UWF's ultimate parent, GWC, with UWR on April 22, 1994, GWC and its subsidiaries, including UWF, recorded OPEB costs on a cash basis. Prior to the merger GWC believed that UWF's OPEB costs were not material and a deferral was not necessary.

After the merger took place, UWR reviewed the pension and other retirement plans of GWC and determined that it was necessary to perform an actuarial evaluation of the post-retirement benefit plans other than pensions since such an evaluation had not been done for GWC and its subsidiaries. UWR then compiled the census data, medical claims information, and cost experience data needed for the actuarial evaluation.

This study ultimately produced the SFAS 106 amounts that are the subject of this Petition. When the evaluation was completed in December 1994, the SFAS 106 liability was recorded on UWF's books at that time. Since the liability was being recorded in the 1994 fiscal year, UWF was able to account for the change as of the date of the merger, April 22, 1994.

With respect to the Data Request, UWF is now requesting Commission approval for recording deferred OPEB costs with this Petition. When the rule was issued, UWF was not aware that it had material OPEB costs. UWF was not aware that it was required to request prior approval for deferral accounting entries from the Commission until the 1996 rate case. As noted in GTE v. Deason, in 1994 there were uncertainties still associated with the accrual method of accounting for OPEBs in ratemaking. 642 So.2d at 547. The Florida Supreme Court stated that

In light of these uncertainties, the PSC is well within its discretion to proceed with some caution in changing over to the accrual method for ratemaking purposes. We so hold. In fact, we believe the PSC would be within its discretion to entirely reject SFAS 106 for ratemaking purposes in light of the doubts surrounding such use. Id.

UWF has taken appropriate remedial action--it is requesting approval of its deferred OPEB costs with this Petition and addressed the "prior" issue with its request for a rule waiver. UWF should not be penalized over a million dollars for not previously filing a deferral petition. Denial of recovery of the deferred amounts will result in a reduction of UWF's return on equity by substantially higher than the Commission's 100 basis points materiality test.

In a situation similar to this limited proceeding, GTE Florida Inc. ("GTE") appealed a Commission decision disallowing costs arising from transactions between GTE and two of its affiliated companies. The Supreme Court of Florida reversed this part of the Commission's Order and remanded for further action. The Commission

then issued an order allowing recovery of the disputed expenses on a prospective basis only. On appeal, the Supreme Court again reversed the Commission and mandated that GTE be allowed to recover erroneously disallowed expenses for a prior period of time retroactively, through the use of a surcharge. The Commission argued that the imposition of a surcharge to recover past deficiencies would constitute retroactive ratemaking. The Supreme Court rejected that contention, stating: "We view utility ratemaking as matter of fairness. Equity requires that both ratepayers and utilities be treated in a similar manner. ... This is not a case where a new rate is requested and then applied retroactively. The surcharge we sanction is implemented to allow GTE to recover costs already expended that should have been lawfully recoverable in the PSC's first order. ... We find that the surcharge for recovery of costs expended is not retroactive ratemaking any more so than an order directing a refund would be." GTE Florida Incorporated v. Clark, 668 So. 2d 971 (Fla. 1996).

Like GTE, UWF has already expended money (in this case to comply with SFAS 106) and the Commission did not authorize recovery of such expenditures in its Order in UWF's base rate case, issued May 30, 1997. This was based on an evidentiary defect, not on the merits of the claim. As stated in the GTE v. Clark decision, the authorization in this proceeding of the recovery of costs already expended does not constitute retroactive ratemaking.

The Commission has required utility companies to defer OPEB costs in order to prevent utility companies from receiving a

windfall in earnings. See e.g., In Re: Application for a rate increase by GTE Florida Incorporated, Docket No. 920188-TL, Order Nos. PSC-93-0108-FOF-TL, 1993 FPSC Reporter 1:491, 572; PSC-93-0818-FOF-TL, 1993 FPSC Reporter 5:611, 617. The Commission required this deferral of OPEB costs over the objections of the utility companies. If it were fair and equitable to require utility companies to defer OPEB costs to avoid a windfall of earnings, then it is fair and equitable to allow a utility company to defer OPEB costs to avoid a great loss.

For more information on retroactive ratemaking, see the Memorandum of Law concurrently filed in this Response.

**UNITED WATERWORKS INC.**  
**AND SUBSIDIARIES**

**(A wholly-owned subsidiary of**  
**United Water Resources Inc.)**

**CONSOLIDATED FINANCIAL STATEMENTS**

**DECEMBER 31, 1996**

***Price Waterhouse LLP***



*Price Waterhouse LLP*



**REPORT OF INDEPENDENT ACCOUNTANTS**

February 20, 1997

To the Board of Directors and Shareholders of  
United Waterworks Inc.

In our opinion, the accompanying consolidated balance sheet and the related consolidated statements of income and retained earnings and of cash flows present fairly, in all material respects, the financial position of United Waterworks Inc. (a wholly-owned subsidiary of United Water Resources Inc.) and its subsidiaries (the Company) at December 31, 1996 and 1995, and the results of their operations and their cash flows for the year ended December 31, 1996 and 1995, and the nine-month period ended December 31, 1994, in conformity with generally accepted accounting principles. These financial statements are the responsibility of the Company's management; our responsibility is to express an opinion on these financial statements based on our audits. We conducted our audits of these statements in accordance with generally accepted auditing standards which require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, and evaluating the overall financial statement presentation. We believe that our audits provide a reasonable basis for the opinion expressed above.

As discussed in Note 1 to the financial statements, effective April 1, 1994, the Company was acquired and became a wholly-owned subsidiary of United Water Resources Inc. The acquisition resulted in the fair valuing of the Company's assets and liabilities. As a result, the Company's financial position and results of operations subsequent to April 1, 1994 are not comparable with those of prior periods.

*Price Waterhouse LLP*

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
(A wholly-owned subsidiary of United Water Resources Inc.)  
**Consolidated Balance Sheet**  
(thousands of dollars)

	December 31,	
	1996	1995
<b>Assets</b>		
Utility plant, including \$13,379 and \$10,868 under construction	\$ 666,637	\$ 693,461
Less accumulated depreciation	<u>126,123</u>	<u>128,267</u>
	<u>540,514</u>	<u>565,194</u>
<b>Utility plant acquisition adjustments</b>		
Less accumulated amortization of \$8,231 and \$3,221	64,374	74,196
<b>Real estate and other investments</b>	1,621	1,305
<b>Current assets:</b>		
Cash and cash equivalents	871	173
Restricted cash	3,311	2,895
Accounts receivable and unbilled revenues, less allowance of \$125 and \$125	22,928	24,068
Note receivable from affiliated company	39,000	23,500
Prepaid and other current assets	<u>3,837</u>	<u>3,826</u>
	<u>69,947</u>	<u>54,462</u>
<b>Deferred charges and other assets:</b>		
Regulatory assets	37,136	29,422
Prepaid employee benefits	1,980	2,144
Unamortized debt expense	8,473	8,675
Other deferred charges and assets	<u>2,981</u>	<u>4,230</u>
	<u>50,570</u>	<u>44,471</u>
	<u>\$ 727,026</u>	<u>\$ 739,628</u>
<b>Capitalization and Liabilities</b>		
<b>Capitalization:</b>		
Common stock and retained earnings	\$ 259,181	\$ 249,489
Preferred stock with mandatory redemption	654	797
Long-term debt	<u>222,738</u>	<u>214,370</u>
	<u>482,573</u>	<u>464,656</u>
<b>Current liabilities:</b>		
Long-term debt due within one year	16,240	11,308
Accounts payable and other current liabilities	12,204	11,173
Due to affiliated companies	8,367	9,246
Accrued taxes	1,709	2,497
Accrued interest and dividends	<u>4,436</u>	<u>4,813</u>
	<u>42,956</u>	<u>39,037</u>
<b>Deferred credits and other liabilities:</b>		
Deferred income taxes and investment tax credits	58,566	46,564
Customer advances for construction	17,644	19,841
Contributions in aid of construction	114,956	124,398
Other deferred credits and liabilities	<u>10,331</u>	<u>45,132</u>
	<u>201,497</u>	<u>235,935</u>
Commitments and contingencies (Note 3)	<u>\$ 727,026</u>	<u>\$ 739,628</u>

*The accompanying notes are an integral part of these financial statements.*

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
**(A wholly-owned subsidiary of United Water Resources Inc.)**  
**Statement of Consolidated Income and Retained Earnings**  
(thousands of dollars)

	Year ended <u>12/31/96</u>	Year ended <u>12/31/95</u>	Nine months ended <u>12/31/94</u>
Operating revenues	\$ 134,844	\$ 136,999	\$ 105,936
Operating expenses:			
Operation and maintenance	63,270	64,727	48,627
Depreciation and amortization	14,573	14,255	10,564
General taxes	<u>15,304</u>	<u>14,895</u>	<u>10,967</u>
Total operating expenses	<u>93,147</u>	<u>93,877</u>	<u>70,158</u>
Operating income	<u>41,697</u>	<u>43,122</u>	<u>35,778</u>
Interest and other (income) expenses:			
Interest expense	20,733	19,819	13,598
Allowance for funds used during construction	(1,799)	(1,441)	(786)
Gain on New Mexico settlement	(10,372)	-	-
Other (income) expense	<u>(3,501)</u>	<u>(2,928)</u>	<u>1</u>
Total interest and other (income) expenses	<u>5,061</u>	<u>15,450</u>	<u>12,813</u>
Income before income taxes	36,636	27,672	22,965
Provision for income taxes	<u>15,943</u>	<u>10,694</u>	<u>8,735</u>
Net income applicable to common stock	<u>\$ 20,693</u>	<u>\$ 16,978</u>	<u>\$ 14,230</u>
Retained earnings at beginning of period	\$ 139,576	\$ 129,598	\$ 122,742
Net income applicable to common stock	20,693	16,978	14,230
Dividends to parent	(11,000)	(7,000)	(7,374)
Retained earnings at end of period	<u>\$ 149,269</u>	<u>\$ 139,576</u>	<u>\$ 129,598</u>

*The accompanying notes are an integral part of these financial statements.*

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
(A wholly-owned subsidiary of United Water Resources Inc.)  
**Statement of Consolidated Cash Flows**  
(thousands of dollars)

	<u>Year ended 12/31/96</u>	<u>Year ended 12/31/95</u>	<u>Nine months ended 12/31/94</u>
<b>Operating activities:</b>			
Net income	\$ 20,693	\$ 16,978	\$ 14,230
Adjustments to reconcile net income to net cash provided by operating activities:			
Depreciation and amortization	14,573	14,255	10,564
Gain on New Mexico settlement	(10,372)	-	-
Deferred income taxes and investment tax credits, net	12,788	(5,074)	867
Allowance for funds used during construction	(1,799)	(1,441)	(786)
Changes in assets and liabilities, net of effect of New Mexico settlement:			
Accounts receivable and unbilled revenues	1,145	(1,633)	(3,186)
Prepaid and other current assets	(137)	(259)	1,054
Prepaid employee benefits	226	1,335	(1,124)
Regulatory assets	(9,271)	2,854	(242)
Accounts payable and other current liabilities	(879)	(5,587)	8,172
Due to affiliated companies	1,031	1,900	2,072
Accrued taxes	(788)	(3,480)	(624)
Accrued interest and dividends	(110)	996	(1,831)
Other, net	2,512	729	(368)
<b>Net cash provided by operating activities</b>	<u>29,612</u>	<u>21,573</u>	<u>28,798</u>
<b>Investing activities:</b>			
Additions to utility plant (excludes allowance for funds used during construction)	(54,066)	(52,156)	(45,852)
Additions to real estate and other investments	(316)	(584)	-
Proceeds from New Mexico settlement	31,670	35,330	-
Change in restricted cash	(416)	(626)	85
<b>Net cash used in investing activities</b>	<u>(23,128)</u>	<u>(18,036)</u>	<u>(45,767)</u>
<b>Financing activities:</b>			
Change in notes payable	-	(13,700)	10,500
Note receivable from affiliated company	(15,500)	(23,500)	-
Additional long-term debt	25,890	30,447	14,531
Reduction in long-term debt	(12,733)	(4,862)	(7,313)
Dividends to parent	(11,000)	(7,000)	(7,255)
Net contributions and advances for construction	7,557	11,546	5,505
<b>Net cash (used in) provided by financing activities</b>	<u>(5,786)</u>	<u>(7,069)</u>	<u>15,968</u>
<b>Net increase (decrease) in cash and cash equivalents</b>	<b>698</b>	<b>(3,532)</b>	<b>(1,001)</b>
Cash and cash equivalents at beginning of year	173	3,705	4,706
<b>Cash and cash equivalents at the end of year</b>	<u>\$ 871</u>	<u>\$ 173</u>	<u>\$ 3,705</u>

*The accompanying notes are an integral part of these financial statements.*

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
*(A wholly-owned subsidiary of United Water Resources Inc.)*

*Notes to Consolidated Financial Statements*

**Note 1 - Summary of Significant Accounting Policies**

**Principles of consolidation:** The consolidated financial statements include the accounts of United Waterworks (the Company) and the subsidiaries in which it has more than 50% ownership.

The preparation of these financial statements in conformity with generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosures of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reported period. Actual results could differ from these estimates.

**New basis of accounting:** On April 22, 1994, United Water Resources (United Water) completed a merger (the Merger) with GWC Corporation (GWC) in which United Water was the surviving corporation. As a result of the Merger, the Company became a wholly-owned subsidiary of United Water. The accounts of the Company were adjusted to record a new basis of accounting effective April 1, 1994, and the Company recorded a \$66.9 million utility plant acquisition adjustment. Accordingly, the Company's financial position and results of operations subsequent to April 1, 1994 are not comparable with those of prior periods.

**Description of business:** The Company provides water and wastewater services to approximately one million people in 13 states. United Waterworks' utility subsidiaries are subject to regulation by the public utility commissions (the Commissions) of the states in which they operate. Their accounting policies comply with the applicable uniform systems of accounts prescribed by these Commissions and conform to generally accepted accounting principles as applied to rate regulated public utilities. The Company continues to follow Statement of Financial Accounting Standards (SFAS) No. 71 "Accounting for the Effects of Certain Types of Regulation" for its regulated utilities. SFAS No. 71 provides for the recognition of regulatory assets and liabilities as allowed by state regulators that are considered probable of recovery or refund.

**Utility plant:** Utility plant is recorded at original cost, which includes direct and indirect labor and cost of materials associated with construction activities, related operating overheads and an allowance for funds used during construction (AFUDC). AFUDC is a non-cash credit to income and includes both the cost of borrowed funds and a return on equity funds attributable to plant under construction.

The original cost of utility property retired or otherwise disposed of in the normal course of business is charged to accumulated depreciation, and salvage (net of removal cost) is credited thereto; no gain or loss is recognized. The costs of property repairs, replacements and renewals of minor property items are included in maintenance expense when incurred.

**Utility plant acquisition adjustments:** Utility plant acquisition adjustments represent the difference between the purchase price and the book value of net assets acquired, and are amortized, generally, on a straight-line basis over a 40-year period.

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
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Notes to Consolidated Financial Statements

**Advances and contributions in aid of construction:** When required by the Commissions of the states in which the Company's utility subsidiaries operate, outside parties, generally customers and developers, make payments to the subsidiaries to fund certain utility capital expenditures to provide water or wastewater service to new customers. Non-refundable amounts received are recorded as contributions in aid of construction. Refundable amounts received are recorded as advances, and are refundable, for limited periods of time, generally as new customers begin to receive service. The remaining balance of any advances received, after the Company has made all required refunds of such advances, is transferred to contributions in aid of construction.

The balances of advances and contributions are used to reduce utility plant in determining rate base, and plant funded by advances and contributions is generally not depreciated. However, the Commissions in several of the states in which the Company operates permit the depreciation of plant funded by contributions in aid of construction, but also require that contributions be amortized, so that there is no net effect on income from the depreciation of the contributed plant. For income tax purposes, advances and contributions received after 1986 and through June 1996 are included as taxable income, and the related plant is depreciated for tax purposes. In accordance with changes in the tax law, effective June 12, 1996, advances and contributions are no longer included in taxable income, nor is the related plant depreciated for tax purposes.

**Regulatory assets:** Included in deferred charges and other assets are regulatory items which are expected to be recognized when included in future rates and recovered from customers as directed by the Commissions of the states in which the Company's utility subsidiaries operate. These regulatory assets include items that the Commissions have ordered the Company's subsidiaries to defer and prudently incurred costs where the Company expects that recovery is probable because of the past practices of the Commissions.

Regulatory assets consisted of the following at December 31:

<i>(thousands of dollars)</i>	1996	1995
Recoverable income taxes	\$ 17,527	\$ 14,112
Deferred employee benefits	12,071	9,657
Tank painting	2,731	2,354
Other	4,807	3,299
<b>Total regulatory assets</b>	<b>\$ 37,136</b>	<b>\$ 29,422</b>

**Unamortized debt expense:** Debt premium, debt discount and deferred debt expenses are amortized to income or expense over the lives of the applicable issues.

**Revenues:** The Company recognizes as revenues billings to customers, plus estimated revenues for consumption for the period from the date of the last billing to the balance sheet date. In cases where customers are billed in advance, the unearned billings are deferred and are recognized as revenue when earned.

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
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*Notes to Consolidated Financial Statements*

**Depreciation:** Depreciation of utility plant is recognized using the straight-line method over the estimated service lives of the properties, generally as prescribed by the Commissions. The provisions for depreciation were equivalent to 1.97%, 1.93% and 1.97% in 1996, 1995 and 1994, respectively, of average depreciable utility plant in service. For federal income tax purposes, depreciation is computed using accelerated methods and, in general, shorter depreciable lives as permitted under the Internal Revenue Code.

**Income taxes:** United Waterworks and its qualifying subsidiaries are included in the consolidated federal income tax return of United Water beginning April 22, 1994.

Federal income taxes are deferred under the liability method in accordance with SFAS No. 109, "Accounting for Income Taxes." Under the liability method, deferred income taxes are provided for all differences between the financial statement and tax basis of assets and liabilities. Additional deferred income taxes and offsetting regulatory assets or liabilities are recorded to recognize that income taxes will be recoverable or refundable through future revenues.

Investment tax credits arising from property additions are deferred and amortized over the estimated service lives of the related properties.

**Statement of cash flows:** The Company considers all highly liquid investments with original maturities of three months or less to be cash equivalents. The Company made cash payments for interest (net of amounts capitalized) and federal and state income taxes as follows:

<i>(thousands of dollars)</i>	1996	1995	Nine months ended December 31, 1994
Interest, net of amounts capitalized	\$ 20,288	\$ 18,823	\$ 14,400
Income taxes	7,948	13,655	8,200

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
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*Notes to Consolidated Financial Statements*

**Note 2 - Notes Payable**

The Company has credit lines, generally uncommitted, with various banks. Borrowings under these credit lines generally bear interest at rates between the London Interbank Offered Rate and the prime lending rate. The total credit lines available, the amounts utilized and the average interest rates at December 31 were as follows:

<i>(thousands of dollars)</i>	1996	1995
Total credit lines available	\$ 55,000	\$ 67,000
Utilized:		
Drawn	-	-
Pledged	1,500	3,000
Average interest rates	-	-

**Note 3 - Long-term Debt**

The long-term debt repayments over each of the next five years are as follows: 1997-\$16.2 million; 1998-\$19.3 million; 1999-\$21.3 million; 2000-\$2.3 million and 2001-\$2.3 million. The Company was in compliance with all restrictive debt covenants at December 31, 1996 and 1995.

In August 1995, the city of Jacksonville, Florida issued, on behalf of United Waterworks, \$20 million of 6.35% tax-exempt bonds due in 2025, the proceeds of which will be used to finance certain capital expenditures of United Water Florida. In June 1995, the Delaware Economic Development Authority issued, on behalf of United Waterworks, \$25 million of 6.2% tax-exempt bonds due in 2025, the proceeds of which will be used to finance certain capital expenditures of United Water Delaware. In prior years, United Waterworks entered into six similar tax-exempt financing agreements, aggregating \$101 million, for the purpose of funding capital expenditures in several of its larger utility operations. These tax-exempt financings, which are backed by loan agreements from United Waterworks, comprise an aggregate of \$146 million, at rates ranging from 5.85% to 7.25% and are due from 1997 to 2025. Funds are drawn down on all of the Company's tax-exempt financings as qualified capital expenditures are made. The tax-exempt financings are recorded on a net basis, with the Company including the proceeds in long-term debt only as funds are drawn down. At December 31, 1996, \$122 million of proceeds from the aggregate \$146 million of tax-exempt financings have been drawn down and are included in long-term debt on the balance sheet.

In December 1994, United Waterworks entered into a private placement medium-term note program that will enable the Company to issue up to \$75 million of debt with terms ranging from 9 months to 30 years. The interest rates and terms will be set as notes are issued under this program. In February 1995, United Waterworks issued the first \$10 million of notes under this program, at a rate of 8.84%, with the full amount maturing in 2025, and redeemed outstanding notes payable.

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
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Notes to Consolidated Financial Statements

**Note 4- Employee Benefits**

*Postretirement benefit plans other than pensions:* Prior to the April 1994 Merger with United Water, United Waterworks had not adopted Statement of Financial Accounting Standards (SFAS) No. 106, "Employers' Accounting for Postretirement Benefits Other Than Pensions". This standard requires that employers recognize these benefits on an accrual basis rather than on a cash basis. However, at the date of the Merger, the Company's postretirement benefit obligation was calculated in accordance with SFAS No. 106 and the Company recorded both the unfunded liability and an estimate of the amount of the liability expected to be recoverable in the regulatory process. Because of the rate recovery mechanism, the adoption of SFAS No.106 has not had a material effect on consolidated net income.

The Company sponsors a defined benefit postretirement plan that covers hospitalization, major medical benefits and life insurance benefits for salaried and non-salaried employees. A portion of the postretirement health care benefits were funded through contributions to Voluntary Employees' Beneficiary Association Trusts.

The following sets forth the plan's funded status and reconciles that funded status to the amounts recognized in the Company's balance sheet at December 31:

<i>(thousands of dollars)</i>	1996	1995
Accumulated postretirement benefit obligation (APBO):		
Retirees	\$ (1,595)	\$ (1,307)
Fully eligible actives	(5,891)	(6,519)
Other actives	(6,531)	(7,392)
Total	(14,017)	(15,218)
Plan assets at fair value	2,674	1,236
Funded status	(11,343)	(13,982)
Unrecognized prior service cost	2,730	3,371
Unrecognized gain	(3,080)	(417)
Accrued postretirement benefit cost	\$ (11,693)	\$ (11,028)

Net periodic postretirement benefit cost included the following components:

<i>(thousands of dollars)</i>	1996	1995	Nine months ended December 31, 1994
Service cost	\$ 1,468	\$ 1,612	\$ 313
Interest cost	963	1,098	565
Actual return on plan assets	(94)	-	-
Amortization of prior service cost	152	164	-
Amortization of gain	(25)	-	-
Net periodic postretirement benefit cost	\$ 2,464	\$ 2,874	\$ 878

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
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Notes to Consolidated Financial Statements

The assumed discount rate and expected return on assets used in determining the APBO were as follows:

	1996	1995	1994
Assumed discount rate	8.0%	7.375%	9.0%
Expected return on assets	9.5%	8.25%	8.25%

The associated health care cost trend rate used in measuring the postretirement benefit obligation at December 31, 1996 was 10.7%, gradually declining to 5.0% in 2002 and thereafter. Increasing the assumed health care cost trend rate by one percentage point in each year would increase the APBO as of December 31, 1996 by \$2 million, to a total of \$16 million, and the aggregate net periodic postretirement benefit cost for 1996 by \$580,000, to a total of \$3 million. At December 31 1996 and 1995, United Water had regulatory assets of \$12.1 million and \$9.7 million, respectively, for recovery in future rates.

**Defined benefit pension plans:** Most employees are covered by trustee, non-contributory, defined benefit pension plans. Benefits under these plans are based upon years of service and the employee's compensation during the last five years of employment. The policy is to fund amounts accrued for pension expense to the extent deductible for federal income tax purposes. It is expected that no funding will be made for 1996.

The components of net periodic pension cost were as follows:

<i>(thousands of dollars)</i>	1996	1995	Nine months ended December 31, 1994
Current year service cost	\$ 1,429	\$ 1,030	\$ 1,205
Interest cost	2,730	2,680	3,004
Actual return on plan assets	(5,118)	(8,628)	(848)
Net amortization and deferral	1.197	5.323	(2.515)
Net periodic pension cost	\$ 238	\$ 405	\$ 846

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
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Notes to Consolidated Financial Statements

The status of the funded plans is as follows:

<i>(thousands of dollars)</i>	1996	1995
Accumulated benefit obligation:		
Vested	\$ 31,698	\$ 32,760
Non-vested	441	1,627
Total	\$ 32,139	\$ 34,387
Fair value of plan assets (primarily stocks and bonds, including \$2.2 million and \$2 million, respectively, in common stock of United Water)	\$ 43,762	\$ 42,948
Projected benefit obligation (PBO)	37,991	41,382
Plan assets in excess of PBO	5,771	1,566
Unrecognized prior service cost	(2,564)	(2,808)
Unrecognized net (gain)/loss	(1,570)	3,071
Intercompany transfers	343	315
Prepaid pension cost recognized in the consolidated balance sheet	\$ 1,980	\$ 2,144

The major actuarial assumptions used in the foregoing calculations were as follows:

	1996	1995	1994
Assumed discount rate	7.75%	7.25%	9.0%
Assumed range of compensation increase	3.75-4.5%	3.75-5%	5.0%
Expected long-term rate of return on plan assets	9.5%	8.75%	8.75%

**Supplemental benefit plans:** Certain categories of employees are covered by non-funded supplemental plans. The projected benefit obligations of these plans at December 31, 1996 totaled \$298,000. The unfunded accumulated benefit obligation of \$236,000 has been recorded in other deferred credits and liabilities at December 31, 1996.

United Waterworks maintains defined contribution savings plans which permit employees to make voluntary contributions with Company matching as defined by the plan agreements. The Company also made contributions to defined contribution savings plans of \$472,000, \$454,000 and \$399,000 in 1996, 1995 and for the nine months ended December 31, 1994, respectively.

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
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Notes to Consolidated Financial Statements

**Note 5- Rate Matters**

The following rate increases were awarded to the Company's regulated utilities during 1996:

<i>(thousands of dollars)</i>	Effective Date	Allowed ROE	Annual Increase	% Increase
UW Florida - Water	6/20	--	116 *	1.7
UW Florida - Wastewater	6/20	--	134 *	1.0
UW Idaho	11/07	11.25	764	3.6
UW New Rochelle	11/19	10.70	786	4.0
UW Bethel	12/31	--	102	14.4
UW Delaware	10/26	--	2,237 **	15.0
UW Florida - Water	11/15	--	725 **	10.6
UW Florida - Wastewater	11/15	--	238 **	1.7
Totals			<b>\$ 5,102</b>	

\* Rate awards represent annual adjustment clause increases based on inflation and other factors.

\*\* Interim increases, granted subject to refund.

In July 1996, United Water Florida applied to the Florida Public Service Commission for rate relief in the amount of \$3.3 million, or 45.9%, in water revenues and \$5.1 million, or 32.6%, in wastewater revenues. The increases were requested primarily to fund capital investments and meet higher operation and maintenance costs. In November 1996, the Company was granted an interim rate increase subject to refund of \$725,000, or 10.6%, for water and \$238,000, or 1.7%, for wastewater. A decision on this application is expected before the end of the second quarter of 1997.

In August 1996, United Water Delaware applied to the Public Service Commission of Delaware for a \$3.7 million, or a 24.6% increase in annual revenues to meet increased investments in utility plant, higher operation and maintenance costs, as well as a proposed change in depreciation rates. In October 1996, the Company was granted \$2.2 million, or 15%, subject to refund. A decision on this application is expected before the end of the second quarter of 1997.

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
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*Notes to Consolidated Financial Statements*

**Note 6- Income Taxes**

*Current and deferred income tax assets and liabilities:* Deferred tax liabilities (assets) and deferred investment tax credits were comprised of the following at December 31:

<i>(thousands of dollars)</i>	1996	1995
Basis differences of property, plant and equipment	\$ 44,440	\$ 34,307
Other liabilities	7,636	3,984
Gross deferred tax liabilities	52,076	38,291
Gross deferred tax assets	(541)	1,047
Deferred investment tax credits	7,031	7,226
Total deferred income taxes and investment tax credits	\$ 58,566	\$ 46,564

*Income tax provision:* A reconciliation of income tax expense at the statutory federal income tax rate to the actual income tax expense was as follows:

<i>(thousands of dollars)</i>	1996	1995	Nine months ended December 31, 1994
Statutory tax rate	35%	35%	35%
Federal taxes at statutory rates on pretax income	\$ 12,822	\$ 9,685	\$ 8,037
Amortization of utility plant acquisition adjustments	1,742	584	444
State income taxes, net of federal benefit	1,415	642	592
Deferred investment tax credits	(195)	(185)	(173)
Other	159	(32)	(165)
Provision for income taxes	\$ 15,943	\$ 10,694	\$ 8,735

**UNITED WATERWORKS INC. AND SUBSIDIARIES**  
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Notes to Consolidated Financial Statements

Income tax expense consisted of the following:

<i>(thousands of dollars)</i>	1996	1995	Nine months ended December 31, 1994
<b>Current:</b>			
Federal	\$ 7,011	\$ 8,565	\$ 8,295
State	740	727	793
<b>Total current</b>	<b>\$ 7,751</b>	<b>\$ 9,292</b>	<b>\$ 9,088</b>
<b>Deferred (prepaid):</b>			
Accelerated depreciation	\$ 2,849	\$ 3,675	\$ 3,180
Contributions and advances for construction	(1,605)	(2,855)	(3,695)
Investment tax credits	(195)	(185)	(173)
State income taxes, net of federal benefits	958	239	100
Transfer of New Mexico operations	5,365	-	-
Other	820	528	235
<b>Total deferred</b>	<b>\$ 8,192</b>	<b>\$ 1,402</b>	<b>\$ (353)</b>
<b>Total provision for income taxes</b>	<b>\$ 15,943</b>	<b>\$ 10,694</b>	<b>\$ 8,735</b>

**Note 7 - Fair Value of Financial Instruments**

The carrying amount at December 31, 1996 of those current assets and liabilities which are considered financial instruments approximate their fair value at that date because of the short maturity of those instruments. Such current assets and liabilities include cash and cash equivalents, accounts receivable and unbilled revenues, accounts payable and other current liabilities and accrued interest and dividends. The Company has determined that there are no quoted market prices for its long-term debt. The fair values of United Waterworks' long-term debt has been determined by discounting their future cash flows using approximate current market interest rates for securities of a similar nature and duration.

The estimated fair values of United Waterworks' long-term debt are \$258.4 million and \$300.6 million at December 31, 1996 and 1995, respectively. United Waterworks' customer advances for construction have a carrying value of \$17.6 million and \$19.8 million at December 31, 1996 and 1995, respectively. Their relative fair values cannot be accurately estimated since future refund payments depend on several variables, including new customer connections, customer consumption levels and future rate increases.

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**Note 8 - Commitments and Contingencies**

The future net capital expenditures are projected to aggregate \$204.5 million over the next five years, including \$46 million and \$41.8 million in 1997 and 1998, respectively.

United Waterworks total rental expense was approximately \$1.9 million in 1996, \$1.3 million in 1995 and \$1.1 million for the nine months ending December 31, 1994.

The minimum future lease payments under all non-cancelable operating leases, which consist primarily of buildings and automobiles, at December 31, 1996 are as follows:

<i>(thousands of dollars)</i>	
1997	\$ 1,944
1998	1,302
1999	1,394
2000	498
2001	178
Thereafter	1,021
<b>Total minimum future lease payments</b>	<b>\$ 6,337</b>

United Waterworks owned a utility subsidiary which provided water and wastewater services to customers in Rio Rancho, New Mexico. In April 1995, the city of Rio Rancho (the City) and the Company's utility subsidiary entered into an original stipulation in settlement of a condemnation action and on June 30, 1995, the City assumed possession of the operations of the utility subsidiary. The original stipulation was contested by various parties, but the City retained possession of the utility's operations.

On March 29, 1996, the Company fully settled the condemnation proceeding with the City. Under the terms of the agreement, the Company accepted \$67 million for the water and wastewater systems of its New Mexico operations (including capital expenditures incurred in 1995). This transaction resulted in an after-tax gain of \$4.3 million which is included in the Company's 1996 earnings. United Waterworks loaned a portion of the proceeds, totaling \$39 million and \$23.5 million at December 31, 1996 and 1995, respectively, to its parent.

United Water Delaware, a subsidiary of United Waterworks, was the subject of a Criminal Violation Notice issued by New Castle County, Delaware Department of Public Works (the Notice). The Notice, dated April 15, 1992, describes the violation as being an illegal placement of fill in a floodplain in contravention of the New Castle County Zoning and Drainage Codes. United Water Delaware alleges that the illegal fill was placed on land it owns by one or more third parties without the knowledge or approval of United Water Delaware. Violation notice forms also were issued to other similarly situated property owners, and United Water Delaware has taken part in many discussions concerning the level of participation by all such parties in a remediation. An application for approval of this plan was submitted to the New Castle County Department of Planning on May 26, 1995 and the County accepted this proposal on September 1, 1995. United Water Delaware and New Castle County entered into a Release and Settlement Agreement (the Agreement) dated

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April 9, 1996. Pursuant to the Agreement, New Castle County has withdrawn the Criminal Violation Notice against United Water Delaware. The withdrawal of the Criminal Violation Notice is conditioned on United Water Delaware undertaking in good faith to implement the remediation plan. Management believes that the resolution of this matter will not have a material adverse effect upon the financial position or results of operations of the Company.

On October 28, 1994, IU International Corporation (IU) filed suit in the Superior Court of the State of Delaware against United Waterworks alleging breach of contract and seeking reimbursement from United Waterworks of more than \$3 million, as well as interest thereon. IU's claim is based on certain tax indemnifications that were part of a stock purchase agreement entered into by IU, Lyonnaise American Holding, Inc. (LAH), United Waterworks and GWC Corporation (former parent of United Waterworks) in connection with the 1982 purchase of 50% of the outstanding common stock of United Waterworks by LAH. On June 16, 1995, United Waterworks, LAH and IU entered into a settlement agreement pursuant to which United Waterworks agreed to pay IU \$800,000 on the date of execution of such agreement. In addition, United Waterworks agreed to pay IU an additional amount of up to approximately \$1.15 million plus interest thereon (such interest commencing as of September 15, 1993) at United Waterworks's average short-term borrowing rate. Such payments become due in the event and at the time that certain tax benefits, previously claimed by United Waterworks with respect to its 1992 tax year, reach "finality" through the running of the statute of limitations on the 1992 tax year or when it is determined that such tax benefits are allowable by the Internal Revenue Service. On June 15, 1995, United Waterworks paid \$800,000 to IU. Pursuant to the settlement agreement, on June 30, 1995, the parties filed with the court a stipulation of dismissal of the lawsuit with prejudice. On September 15, 1996, the statute of limitations expired on the 1992 tax year. As a result, on November 19, 1996, United Waterworks paid IU \$977,000 of the \$1.15 million. The remaining balance of approximately \$173,000 will be paid April 4, 1997. Management believes that the resolution of this matter will not have a material adverse effect upon the financial position or results of operations of the Company.

On July 20, 1994, the Townhouse at Lake Isle Home Owners Association, Inc. filed suit against United Water New Rochelle in the Supreme Court of the State of New York, Westchester County. The suit seeks to recover for alleged property damage arising out of repeated leaks in service lines installed in or about 1982 by the developer of a townhouse complex in Eastchester, New York. The bulk of the relief sought by plaintiff involves monetary damages for the cost of replacing the service lines, which belong to United Water. The plaintiff did not seek injunctive relief.

A default judgement on the issue of liability was entered against United Water New Rochelle on December 2, 1994. United Water has diligently prosecuted motions to reopen and appeal from the default judgement, on the principal ground that the default resulted from a failure by United Water's insurance carrier and claims processing service provider to timely file an answer to the plaintiff's complaint. To date, motions to vacate the default judgement have not been successful.

Following an inquest on the issue of damages, the Court issued a decision, dated December 20, 1996, awarding the plaintiff \$1,330,000. The Company has filed a motion to set aside the Court's December 20, 1996 decision on the ground that the relief granted exceeded the plaintiff's original demand. The Company plans to appeal the judgement and will consolidate therewith its appeals from prior decisions on its motions to vacate the

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default judgement. The Company believes that it has meritorious arguments on appeal and on the original matter, should it be reopened. Further, the Company expects to seek reimbursement from third parties of any ultimate liability resulting in this matter. Management believes the resolution of this matter will not have a material adverse effect upon the financial position or results of operations of the Company.

The Company has various purchase commitments for materials, supplies and other services incidental to the ordinary conduct of business. In addition, the Company is routinely involved in legal actions arising in the ordinary course of its utility operations. In the opinion of management, none of these matters will have a material adverse impact on the Company.