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May 22, 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 an original and seven (7) copies of United Water Florida Inc.'s Memorandum of Law Regarding Variances and Waivers of Rules Under Section 120.542, Florida Statutes (1997). Also please find enclosed a double sided high density diskette, WordPerfect for Windows 6.1, containing United Water Florida's Memorandum of Law.

Please file the original and distribute the copies in accordance with your usual procedures.

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

Sincerely yours,

James L. Ade
James L. Ade

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FLORIDA PUBLIC SERVICE COMMISSION
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Enclosures

cc: Ms. Rosanne Gervasi
Mr. Harold McLean
Mr. David E. Chardavoyne
Mr. Walton F. Hill
Mr. Robert J. Iacullo
Mr. Munipalli Sambamurthi

DOCUMENT NUMBER-DATE

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FPSC-RECORDS/REPORTING

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.)
_____)

DOCKET NO.: 971596-WS
Date Submitted for
Filing: May 22, 1998

MEMORANDUM OF LAW
REGARDING VARIANCES AND WAIVERS OF RULES
UNDER SECTION 120.542, FLORIDA STATUTES (1997)

Persons to contact concerning
this pleading

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DOCUMENT NUMBER-DATE

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FPSC-RECORDS/REPORTING

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for a Limited)
Proceeding Regarding Other)
Postretirement Employee) DOCKET NO.: 971596-WS
Benefits and Petition for)
Variance from or Waiver of) Date Submitted for
Rule 25-14.012, Florida) Filing: May 22, 1998
Administrative Code by)
United Water Florida Inc.)
_____)

MEMORANDUM OF LAW
REGARDING VARIANCES AND WAIVERS OF RULES
UNDER SECTION 120.542, FLORIDA STATUTES (1997)

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 ("FAC"), by United Water Florida Inc. ("Petition"), United Water Florida Inc. ("United Water Florida") hereby files this Memorandum of Law to demonstrate that the Florida Public Service Commission's ("Commission") granting of the waiver or variance will comply with Section 120.542(2), Florida Statutes (1997), and further demonstrate that strict application of Rule 25-14.012, FAC, would create a substantial hardship to United Water Florida.

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 promote the purpose of the underlying statutes that United Water Florida's rates be "just, fair, reasonable, compensatory and not unfairly discriminatory." The denial of the request will frustrate that purpose. The waiver and variance

provision was designed to allow agencies to grant relief in this type of situation, one in which the strict enforcement of a rule will lead to unreasonable, unfair, and unintended results.

The strict application of the rule will impose a substantial hardship on United Water Florida. United Water Florida will not recover more than a million dollars in otherwise properly recoverable costs and its rate of return on equity will be greatly diminished. Furthermore, the denial of the Petition may adversely affect United Water Florida's borrowing capability and expenses. The strict application of the rule will also violate principles of fairness and affect United Water Florida significantly differently from other companies. The Commission should comply with the intent of Section 120.542, Florida Statutes (1997), and grant the Petition.

BACKGROUND

United Water Florida filed its Petition seeking a variance from or waiver of Rule 25.14.012(2) and (3), FAC, to the extent necessary that (1) United Water Florida recover through rates over fifteen (15) years the Unrecovered OPEB Costs, as defined in the Petition; and (2) use as the reduction to rate base for unfunded OPEB costs an amount comprised of (a) one-fifteenth (1/15) of the unfunded Unrecovered OPEB Costs and (b) the unfunded portion of OPEB Costs for 1997 not contained in the Unrecovered OPEB Costs. See Petition, pp. 10-13. The resulting revenue increase will be less than one percent (1%) (0.7033% for water and 0.6715% for wastewater).

STATUTORY REQUIREMENTS

Section 120.542(2), Florida Statutes (1997), provides, in pertinent parts, that:

[v]ariances and waivers shall be granted when the person subject to the rule demonstrates that the purpose of the underlying statute will be or has been achieved by other means by the person and when application of a rule would create a substantial hardship or would violate principles of fairness.

The statute also states that:

[f]or purposes of this section, "substantial hardship" means a demonstrated economic, technological, legal, or other type of hardship to the person requesting the variance or waiver. (Emphasis added).

The statute provides further that:

For purposes of this section, "principles of fairness" are violated when the literal application of a rule affects a particular person in a manner significantly different from the way it affects other similarly situated persons who are subject to the rule.

If the petitioner can demonstrate the achievement of the statutory purpose and either hardship or unfairness, then the statute dictates that the waiver or variance shall be granted.

The purpose of Section 120.542, Florida Statutes (1997), is to promote flexibility by agencies to make waivers and variances from their rules. See, Donna E. Blanton and Robert M. Rhodes, Flexibility, Flexibility, Flexibility, The New Variance and Waiver Provision, 71 Fla. B.J. 35 (Mar. 1997). The Florida Legislature set forth its intent regarding waiver and variance in Section 120.542(1), Florida Statutes (1997), stating:

Strict application of uniformly applicable rule requirements can lead to unreasonable, unfair, and unintended results in particular instances. The Legislature finds that it is appropriate in such cases to adopt a procedure for agencies to provide relief to persons subject to regulation.

As stated by Governor Lawton Chiles at the Bill Signing Ceremony for the revisions to the Administrative Procedure Act, including this section,

This legislation loosens the chains that had been placed on our agencies for too long. It gives them the flexibility to use a more common sense approach--encouraging state employees to solve problems rather than create roadblocks.

See, Donna E. Blanton and Robert M. Rhodes, Loosening the Chains That Bind: The New Variance and Waiver Provision in Florida's Administrative Procedure Act, 24 Fla. St. U. L. R. 353 (Winter 1997).

Accordingly, the purpose of this statute is to promote flexibility from rules to solve problems, problems like the one facing United Water Florida. In accordance with Rule 25-14.012, FAC, United Water Florida is seeking Commission approval for deferral accounting treatment of OPEB costs. United Water Florida is seeking such approval prior to the related OPEB costs being included in rates. However, United Water Florida is not seeking approval prior to the accelerated recognition of the costs required by SFAS 106.

Purpose of the Underlying Statutes Achieved

The Commission adopted Rule 25-14.012, FAC, "under its statutory authority to set rates which allow regulated utilities

sufficient revenue to recover prudently incurred costs of providing utility service, and a fair rate of return on the utilities' rate base." Citizens of the State of Florida v. Public Service Commission, 15 FALR 1776, 1777, Case No. 92-5717RP ("Rule Approval Decision").

The Commission's statutory authority for its rate setting power is contained in Section 367.121(1), Florida Statutes (1997), but such authority is limited by other statutes, primarily Section 367.081, Florida Statutes (1997). Section 367.121(1)(a), Florida Statutes (1997), provides, in part, that:

... the commission shall have power:

(a) to prescribe fair and reasonable rates and charges....

However, Section 367.081, Florida Statutes (1997), mandates that:

[t]he commission shall ... fix rates which are just, reasonable, compensatory, and not unfairly discriminatory.

It is undisputed that utility companies are to recover their OPEB costs from their customers. In the decision approving the actual rule involved in the Petition, it was stated that, "the utility rate payers pay the costs of the OPEBs and other expenses in their utility rates." Rule Approval Decision, 15 FALR at 1782. The 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. The Commission also has approved United Water Florida's recovery of OPEB costs in

its rates. See In re: Application for rate increase in Duval, Nassau, and St. Johns Counties by United Water Florida Inc., Docket No. 960451-WS, Order No. PSC-97-0618-FOF-WS, issued May 30, 1997.

In order for the purpose of the underlying statutes to be achieved, United Water Florida's rates must be fair, just, reasonable, compensatory and not unfairly discriminatory. The Commission's authority is "to set rates which allow regulated utilities sufficient revenue to recover prudently incurred costs of providing utility service [including OPEB costs] and a fair rate of return on the utilities' rate base." Rule Approval Decision, 15 FALR at 1777. In order to achieve the purpose of the underlying statutes, United Water Florida has filed its Petition.

If the Petition is granted, United Water Florida's rates will be fair, just, reasonable, compensatory and not unfairly discriminatory, and the purpose of the underlying statutes will be achieved. Furthermore, the purpose of the rule will be accomplished because United Water Florida will have sought and obtained Commission approval for deferral accounting of its OPEB costs. If the Petition is not granted, not only will the purpose of the underlying statutes not be achieved - the purpose will be frustrated. United Water Florida's rates will not be fair, just, reasonable or compensatory because they will not provide for recovery of a cost that has been determined by the Commission to be legitimate. The Commission will not have set rates which allow United Water Florida to recover its prudently incurred costs of providing service and a fair rate of return on its rate base.

Hardship or Unfairness Demonstrated

To satisfy the statutory requirements, the petitioner need demonstrate that the purpose of the underlying statute will be or has been achieved by other means by the person and only one of the following two (2) elements: hardship or unfairness.

Demonstration of Hardship to United Water Florida

The hardship to be demonstrated can be economic, technological, legal or other type of hardship. The statute specifically states that the only hardship to be examined is the hardship to the person requesting the variance or waiver, in this case, United Water Florida. The statute does not provide for the balancing or even consideration of hardships to others. The focus is strictly on the petitioner's hardship.

The application of the rule and the denial of United Water Florida's Petition will create a substantial economic hardship to United Water Florida. United Water Florida will lose the opportunity to recover \$1,100,098 of its prudently incurred costs through rates, on a pretax basis. United Water Florida will have to pay \$854,230 in OPEB costs in the future without any recovery in rates as well as being denied a recovery of \$247,022 in payments already made to its Voluntary Employee Benefit Association ("VEBA") account. Such OPEB costs are to be recovered from a utility's customers through rates, but application of the rule will harm United Water Florida because it will not recover such OPEB costs in its rates. United Water Florida will have to charge a \$1,100,098 reduction to its earnings if the Petition is not granted. As shown

in the Petition, the writeoff which will result from a denial of the Petition would produce an immediate erosion of approximately 130 basis points in overall rate of return (and a much larger erosion in the rate of return on equity), well above the Commission's standard for materiality of 100 basis points on equity return. United Water Florida will still have to expend cash in later years to pay for such OPEB costs. It is only because of an extraordinary change in accounting policy to accelerate the timing of the recognition of such costs that United Water Florida faces being prevented from recovery of such costs in its rates. If not for the accrual method of accounting adopted by Statement of Financial Accounting Standards No. 106 regarding Employer's Accounting for Postretirement Benefits Other Than Pensions ("SFAS 106"), United Water Florida would recover its OPEB costs in the years of payment, most of which have not occurred.

United Water Florida has analyzed its return on equity for 1994, 1995, 1996, and through May 31, 1997. In 1997, the Commission determined that United Water Florida was earning an overall rate of return of 4.43% for water and 6.82% for wastewater. The Commission established United Water Florida's overall rate of return at 9.57% and its rate of return on equity at 11.57%. Even without any reduction for OPEB expenses, United Water Florida's rate of return on equity from January 1994 through May 1997 was already more than 100 basis points below 11.57%. A schedule setting forth the rate of return on equity prior to reduction for OPEB costs is attached as Schedule A. Had United Water Florida

recorded its costs in those years, clearly the already inadequate rate of return would have been further reduced. In addition, the low achieved rate of return on equity and the requirement that OPEB costs be recovered in rates make it clear that, had United Water Florida requested a deferral of OPEB costs or the recovery of such OPEB costs through rates prior to its adoption of SFAS 106, the Commission likely would have granted such a request.

Furthermore, a charge to earnings of \$1,100,098 may adversely affect United Water Florida's borrowing capability and expenses. United Waterworks Inc. ("United Waterworks") provides all external financing for its subsidiaries, including United Water Florida. Attached as Exhibit B is a May 8, 1998 memorandum regarding United Waterworks credit rating analysis. United Waterworks currently has an "A" rating. Measured by revenue, United Water Florida is the largest United Waterworks subsidiary, and its capital budget represents about thirty percent (30%) of United Waterworks' total borrowings in the next five years. A failure to recover the costs in question could have two separate adverse consequences in terms of financing United Water Florida's capital additions, both of which would result from the corresponding perception of increased investment risk. First, borrowing costs for United Waterworks could increase because such a significant portion of the financing will be invested in what will be perceived by rating agencies as a less supportive regulatory environment. Because United Water Florida's rates are based on United Waterworks' capital structure and debt cost rates, this increase in financial cost would be

passed on to United Water Florida. Second, like any other investor, United Waterworks serves as a "traffic cop" for the direction of scarce capital resources to the most efficient use, and like any other investor United Waterworks will direct its capital investment to those uses where the risk/return relationship is most favorable. The denial of this Petition will have a clearly adverse impact on the earnings and therefore the investment risk of United Water Florida. This situation will be exacerbated, and capital made even more scarce, by United Waterworks' goal of reducing capital expenditures by ten percent (10%).

Demonstration of Unfairness to United Water Florida

The hardships set forth above also serve to demonstrate the unfairness of a denial of the Petition, because such a denial will severely impact United Water Florida, while granting the Petition will produce no hardship for customers. As explained above, United Water Florida is not requesting that customers pay anything in addition to costs of OPEBs determined by the Commission to be normally recoverable. In fact, under United Water Florida's proposals, its customers will receive an economic benefit because more than \$1 million of costs that would have been normally recoverable in 1994, 1995, 1996 and 1997 will in fact be paid in rates over a fifteen (15) year period. This provides a substantial benefit to customers in the time value of money. In addition, customers have and will continue to benefit from a rate base deduction for unfunded OPEB liability which they have not paid. The clear and substantial economic hardship to United Water Florida

which will result from a denial of the Petition must be evaluated against the fact that customers will not be harmed by granting it. In fact, customers will be better off under United Water Florida's proposal than if the prior OPEB costs had been recovered in the prior years. Granting the Petition will be fair to the Company and its customers.

The application of the rule to United Water Florida will violate principles of fairness and affects United Water Florida significantly different from other entities subject to the rule.

In discussing the affect of SFAS 106, one point raised by a Staff member was that companies like Ford and GM have taken large charges to earnings because of OPEB expenses at the time they adopted FSAS 106, and, therefore, why should United Water Florida be treated differently? Ford and GM are not regulated companies. Unlike United Water Florida, the pricing structure for Ford's and GM's products and their earnings are not limited by the actions of a regulatory agency's determination of the costs that are prudently incurred in a year. Ford's and GM's pricing structure and rate of return are determined by the competitive market. United Water Florida is a regulated utility company. Its earnings are limited by regulation and in return for this limitation it is allowed to recover its reasonable costs of operation through rates from its customers. A denial of the Petition will result in the abrogation of this regulatory compact since United Water Florida will not be allowed to recover its reasonable costs of operation, while at the same time its earnings are limited by regulation, and it can only

recover its costs through its approved rates. Ford and GM can vary their pricing structure in order to recover their costs and achieve an appropriate rate of return. United Water Florida does not have that luxury. If United Water Florida is required to charge the unrecovered OPEB costs to earnings, it will be treated differently from Ford and GM in that it will never have the opportunity to recover its OPEB costs.

The literal application of the rule also affects United Water Florida in a manner significantly different from other regulated utility companies subject to this rule. First, if a utility company either (1) does not have OPEB costs, or (2) has OPEB costs, but is recovering them in rates or such costs are being deferred, the utility company, unlike United Water Florida, is not being harmed because it is not being denied the opportunity to recover all of its costs. United Water Florida is not aware of any utility companies which are faced with the same severe impact as United Water Florida through the strict application of the rule. For example, United Water Florida is only aware of four (4) other water and wastewater utility companies with OPEB costs. The four (4) companies sought deferred accounting and amortization of the OPEB costs in cases before the Commission. The cases involving the deferral requests occurred before the creation of the waiver and variance procedure in Section 120.542, Florida Statutes (1997). See, In Re: Petition for Certain Accounting and Ratemaking Authority Associated With Implementation of Statement of Final 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, 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 on September 20, 1993; In Re: Application for a Rate Increase in Osceola/Polk Counties by Poinciana Utilities, Inc., Docket No. 930912-WS, Order No. PSC-94-1168-FOF-WS, issued on September 26, 1994.

In each of the cases, the Commission employed a 100 basis point reduction test on the return on equity and found that each utility company was not sufficiently harmed to a level that the Commission needed to act. However, as shown earlier, United Water Florida is being significantly harmed and its harm exceeds the Commission's own materiality level.

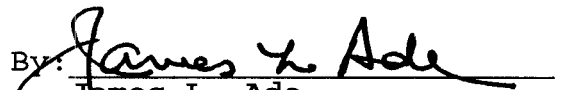
Accordingly, the literal application of Rule 25-14.012, FAC, affects United Water Florida in a manner significantly different from other companies, including other companies subject to the rule.

SUMMARY

United Water Florida has met the burden of demonstrating that the purpose of the underlying statute will be achieved as well as satisfying the hardship standard and the fairness standard, only one of which is required to be satisfied. Therefore, pursuant to Section 120.542, Florida Statutes (1997), the Commission should grant United Water Florida's Petition.

Respectfully submitted,

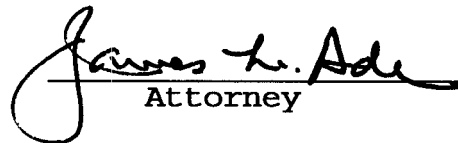
**MARTIN, ADE, BIRCHFIELD &
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Telephone: (904) 354-2050

**Attorneys for United Water
Florida Inc.**

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that the original and seven (7) copies of the Memorandum of Law Regarding Variances and Waivers of Rules under Section 120.542, Florida Statutes (1997), has been furnished by Federal Express this 22nd day of May, 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; Harold McLean, Esquire, Office of Public Counsel, c/o The Florida Legislature, 111 W. Madison Street, Room 812, Tallahassee, Florida 32399-1400; and Carroll Webb, Executive Director and General Counsel, Administrative Procedures Committee, The Holland Building, Room 120, Tallahassee, Florida 32399-1200 by U.S. Mail, this 22nd day of May, 1998.



Attorney

UNITED WATER FLORIDA
 RATE OF RETURN ON EQUITY
 PRIOR TO REDUCTION FOR OPEB COSTS

| | <u>1994</u> | <u>1995</u> | <u>1996</u> | <u>1997</u> |
|--|--------------|--------------|--------------|--------------|
| Rate Base | \$54,819,343 | \$58,648,780 | \$68,082,425 | \$76,412,631 |
| Equity Portion @ 43.51% | 23,851,896 | 25,518,084 | 29,622,663 | 33,247,136 |
| Net Income | 2,179,961 | 2,413,686 | 3,102,145 | 1,432,327 |
| Return on Equity Achieved | 9.1396% | 9.4587% | 10.4722% | 4.3081% |
| Return on Equity Allowed (Docket No. 960451-WS) | 11.57% | 11.57% | 11.57% | 11.57% |

SCHEDULE A

United Water

United Water Resources
200 Old Hook Road
Harrington Park, NJ 07640-1799
telephone 201 767 9300
facsimile 201 767 6512

Memo

Date: May 8, 1998
To: R. Iacullo
From: T. MacClave
Subject: United Waterworks Credit rating Analysis

Enclosed are four charts indicating where UWW would theoretically be rated today if reviewed by Standard & Poor's Rating Agency.

The information covers the years 1994 through 1997 and indicates that the Company has not improved its financial performance over the past four years. Based on criteria utilized by S&P for rating water utilities, results indicate the Company would not only lose its current "A" rating, but is in danger of sliding all the way down to a "BB".

This obviously would have an extremely negative impact, both on our ability to borrow needed capital and on the price we would have to pay to do so. Much of this financial erosion is due to the level of capital investment required over the past few years and our inability to adequately recover a return on these investments.

As an example of the impact this might have on us, UWW projects new capital spending of \$178 million over the next five years. Assuming a lowering of our credit rating from "A" to "BBB", current market conditions would indicate a 135 basis point increase in our cost of borrowing on a 30-year issue of this magnitude. This equates to an increase in borrowing costs of approximately \$2.4 million per year for United Waterworks. Interestingly, UW Florida represents approximately 30% of our capital program over this five-year period. Assuming our borrowing costs would be allocated on the same basis as capital spending, this would equate to an increase in borrowing costs to the UW Florida customers of \$700,000 per year.

If you have any questions or would like to discuss this further, please give me a call.

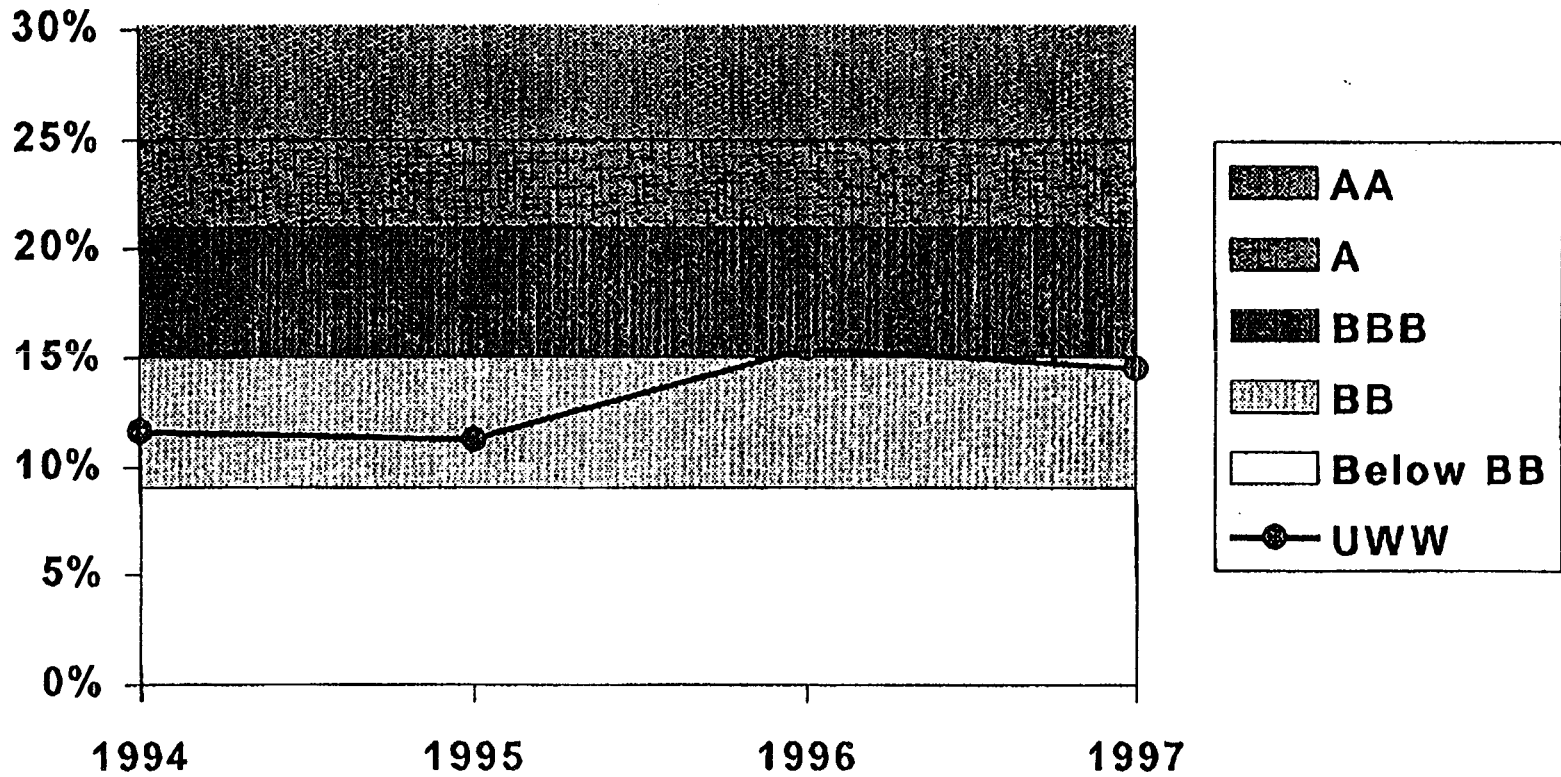


SCHEDULE B

UWW Credit Rating Analysis

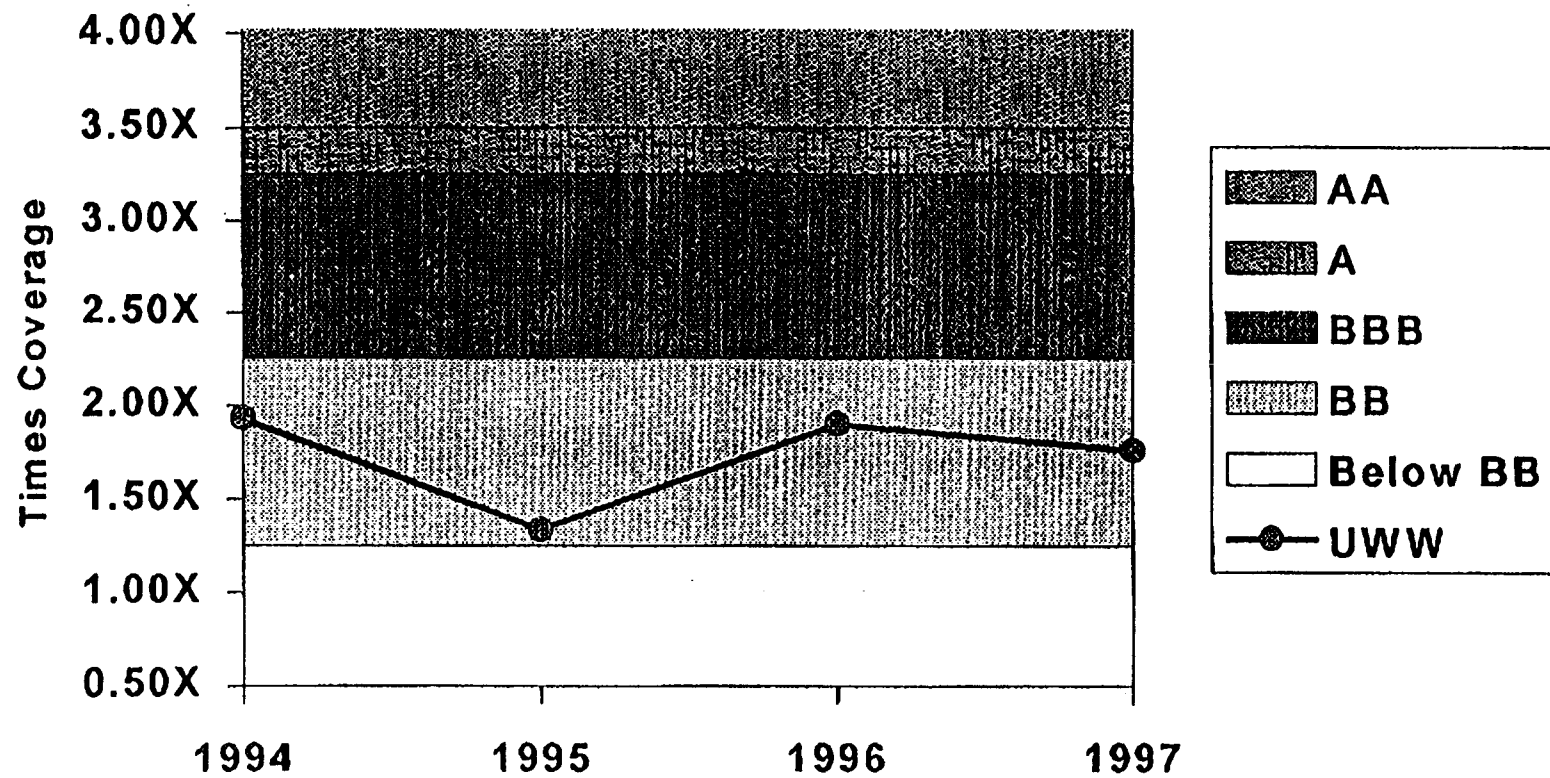
UWW

Funds from Operations to Average Total Debt



UWW

Funds from Operations Interest Coverage



UWW

Net Cash Flow to Capital Spending

(Regulated Utility Capital Exp. Only)

