State of Florida

ORIGINAL

Public Service Commission

-M-E-M-O-R-A-N-D-U-M-

DATE: May 13, 1999

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FROM: CHRISTIANA T. MOORE, DIVISION OF APPEALS CTM

RE: PALM COAST UTILITY CORPORATION V. FLORIDA PUBLIC SERVICE COMMISSION, FIRST DISTRICT COURT OF APPEALS CASE NO. 97-1720; PSC DOCKET NO. 951056-WS

In a per curiam opinion issued May 10, 1999, the First District Court of Appeal affirmed in part and reversed in part the Commission's November, 1996, final order setting rates for Palm Coast Utility Corporation. The Florida Waterworks Association filed an amicus curiae brief in support of the utility. The Office of Public Counsel and Flagler County, which now has jurisdiction over the utility, participated as appellees. Palm Coast raised seven issues on appeal. As discussed below, the court reversed the Commission on some of the issues and affirmed on others.

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Lot Count Methodology

The court reversed on the use of the lot count methodology to determine the used and useful percentage of Palm Coast's water distribution and transmission lines and wastewater gravity mains serving general service, multi-family, and residential lots. The court found the Commission's decision to be a departure from the methodology it has previously used without an adequate basis in the record for the change, contrary to the requirements of the Administrative Procedure Act, Chapter 120, F.S. The court noted that when the Commission entered the Palm Coast order, it did not have the benefit of the court's 1998 decisions in Southern States Utilities v. Florida Public Service Comm'n, 714 So. 2d 1046, and Florida Cities

Water Co. v. Florida Public Service Comm'n, 705 So. 2d 620, holding that a shift in ratemaking policy must be supported by expert testimony, documentary evidence or other evidence appropriate to the nature of the issue involved.

In its final order, the Commission stated that it is the size of the lines that is the primary difference between a system sized to serve residential-only customers and one that serves high demand commercial areas. The Commission relied on testimony that the lot count methodology fairly allocates the cost of lines between current and future customers, and the staff engineering witness testimony that it is necessary to compare lots connected to lots available or convert lots available to ERCs in order to compare "apples to apples." Palm Coast argued that historically, the lot count method has been used by the Commission only for residential utility systems, and that the lot count methodology ignores that multi-family and general service customers account for approximately one-quarter of the facilities' use. The order did not discuss the issue subsequently raised on appeal of whether it was changing its policy with regard to "mixed use" systems and the basis for such a change.

The issue on appeal was complicated by the dispute that was raised on reconsideration about whether general service and multi-family lots were included in the different lot count totals used by the Commission in its calculations for each of the facilities. The Commission concluded that there was insufficient evidence in the record on the number of vacant general service and multi-family lots for water distribution lines and wastewater gravity mains. The Commission further concluded that since the totals used in the denominator of the calculation for those facilities did not include the general service and multi-family lots, the number of lots connected for those classes should not be used in the numerator.

Although stating that the Commission's used and useful determinations should be given great weight, the court found the record inadequate to support a change in Commission policy. Thus, the decision was reversed and remanded "with directions that the Commission provide explanation, with record support, for the change in methodology . . .."

Fire Flow Allowance

In Palm Coast's previous rate case, the Commission approved a fire flow allowance for wells, water treatment plant, and storage facilities. In this case, the Commission only included an allowance for the water treatment plant and the storage facilities, and denied the request for an allowance for the supply wells. The Commission concluded that it is not cost effective to size source of supply and treatment facilities to meet fire flow requirements based on Witness Biddy's testimony; however, it only denied the allowance for source of supply. In addition, the order acknowledged that both treatment and supply facilities have actually experienced demand resulting from forest fires, but approved the allowance only for the water treatment plant.

Palm Coast argued that this was a reversal of prior policy in reliance on the same testimony that the Commission had rejected in its previous rate case. Palm Coast also argued that it was arbitrary for the Commission to include fire flow for water treatment plant but deny it for source of supply while finding that both are actually used. The court reversed on the basis that the Commission's decision was a departure from its previous treatment that was not justified on the record, and remanded it "for further proceedings on this issue."

There is a mistake of fact in this section of the opinion. The court incorrectly states that the Commission denied a fire flow allowance for the water treatment plant.

Annual Average Daily Flow

As it did in the Florida Cities Water and the Southern States Utilities appeals, the court reversed the Commission's use of annual average daily flow (AADF) in the numerator of the used and useful calculation of wastewater treatment plant, instead of using the requested 3-maximum month average daily flow. The Commission in this case relied on staff testimony that to use any measure of flow demand other than the unit of measurement that the DEP permit is based upon would skew the used and useful ratio. In addition, based upon a preliminary engineering report for Palm Coast, the Commission inferred that the plant capacity would be larger if rated based on a 3-maximum month average daily flow.

In reversing this part of the order, the court addressed only the Commission's justification of its departure from previous practices based on DEP's permit. The court stated that this basis is insufficient by itself, citing to its decision in Southern States, and remanded the decision without further elaboration. Even though the court did not specifically mention the effluent disposal facilities in the opinion, it specifically reversed the use of AADF, which was also used in the numerator of the calculation of used and useful for effluent disposal facilities.

Margin Reserve and Imputation of CIAC

The court affirmed the Commission on its approval of an 18-month margin reserve period for Palm Coast's water treatment plant and 12 months for transmission lines, finding that there was competent substantial evidence to support this decision. The court also affirmed without discussion the Commission's decision to impute 50 percent of the CIAC to be collected during the margin reserve period.

The court reversed the approval of an 18-month margin reserve for the wastewater treatment plant, however, stating that there was no competent substantial evidence to support 18 months if the time to design and permit the facility are also considered. The court cited to the Commission's Florida Cities Golden Gate Division rate order, issued June 15, 1995, where the Commission decided that a 3-year margin reserve, which included the time for permitting and design, would be appropriate. In addition, there was staff testimony in Palm Coast's case supporting a three-year margin reserve period, and utility testimony for a five-year period. Thus, the court found that the Commission departed from its prior practice without record support. In a footnote, the court notes that the proposed margin reserve rule provides that DEP's guidelines for planning, designing, and construction of plant is one factor to be considered. The court remanded for a determination "based upon the competent substantial evidence in the record."

The court also reversed the Commission's use of the service availability charge requested by Palm Coast to determine the amount of CIAC to impute against the margin reserve allowance, rather than using the actual approved charge which was lower. The actual charge was set in a separate docket 21 days after the rate case decision was made. Because the actual approved charge was not in the evidentiary record, and because it believed it could not take

notice of its other decision, the Commission denied Palm Coast's request for reconsideration on this issue. The court disagreed, holding that the Commission "is certainly capable of taking notice of its own orders."

Effluent Disposal Facilities

In this case, the Commission made a separate used and useful determination for Palm Coast's effluent disposal facilities, also using AADF in the numerator of the calculation to match the DEP permitted capacity. On appeal, Palm Coast claimed that use of AADF in the calculation understated the demand during wet weather. Palm Coast also claimed that the Commission improperly reduced rate base by overstating the capacity of effluent disposal facilities by ignoring limitations during wet weather conditions. The court affirmed the Commission's decision on the capacity of the facilities.

Rate Base Value of Land

The Commission reduced the rate base value of Palm Coast's Rapid Infiltration Basin and sprayfield sites based on evidence that the utility's appraisals failed to adequately account for a number of factors that diminished the sites' values in relation to the sales relied upon as comparables by the utility's appraiser. The Commission discussed these factors at length in the final order, and concluded that the utility's appraisals were not credible indicators of the property's value for inclusion in rate base. On appeal, Palm Coast complained that these reasons were a "pretext" for reducing the values because the sales were between related parties, and that historically, the Commission has preferred independent appraisals. While this is true if the values are reasonable, here the Commission concluded they were not. Palm Coast also claimed that the Commission's method of valuing the second site in an amount proportionate to its reduction in value of the first site was "whimsical" and "fanciful." The court affirmed the Commission on this issue without discussion.

Reconciliation of Capital Structure to Rate Base

Palm Coast argued that the Commission improperly reconciled capital structure to rate base by denying its requested pro rata reconciliation of investment tax credits (ITCs), contrary to past practice. The Commission had concluded on reconsideration that Palm Coast had not provided any specific evidence to support pro rata reconciliation of ITCs. The court affirmed the Commission's decision without any discussion.

cc: All Attorneys
Marshall Willis
Bob Crouch

OPN1720.CTM

CORRECTED COPY 5/13/99

IN THE DISTRICT COURT OF APPEAL

FIRST DISTRICT, STATE OF FLORIDA

PALM COAST UTILITY CORPORATION,

Appellant,

v.

STATE OF FLORIDA, FLORIDA PUBLIC SERVICE COMMISSION,

Appellee.

NOT FINAL UNTIL TIME EXPIRES TO FILE MOTION FOR REHEARING AND DISPOSITION THEREOF IF FILED.

CASE NO.: 97-1720

MAY 11 1999

LEGAL DIVISION

Opinion filed May 10, 1999.

An appeal from an order of the Public Service Commission.

Arthur J. England, Jr. of Greenberg, Traurig, Hoffman, Lipoff, Rosen & Quentel, P.A., Miami, for Appellant.

B. Kenneth Gatlin and Wayne L. Schiefelbein of Gatlin, Schiefelbein & Cowdery, Tallahassee, for Appellant.

Robert D. Vandiver, General Counsel; Christiana T. Moore, Associate General Counsel, Tallahassee, for Appellee.

Albert J. Hadeed, County Attorney and Mary Elizabeth Kuenzel, Assistant County Attorney, Bunnell for Flagler County.

Jack Shreve, Public Counsel and Stephen C. Reilly, Office of Public Counsel, Tallahassee, for Citizens of The State of Florida.

Patrick K. Wiggins of Wiggins & Villacorta, P.A., Tallahassee, for Amicus Curiae.

PER CURIAM.

Palm Coast Utility Company (Palm Coast), which provides water and wastewater service to customers in Flagler County, appeals a final order of the Florida Public Service Commission which granted Palm Coast a rate increase in an amount

substantially less than requested by the utility. Palm Coast raises seven issues on appeal. For the reasons that follow, we reverse in part and affirm in part.

Used and Useful Property

Palm Coast argues that the Commission erred in determining various components of the utility's rate base. A regulated utility is entitled to an opportunity to earn a fair rate of return on its "rate base" - the capital prudently invested in the utility's facilities that "are used and useful in the public service." § 367.081(2)(a), Fla. Stat. (1995); Citizens v. Hawkins, 356 So. 2d 254, 256 (Fla. 1978). For each component of the utility's water and waste water system, the Commission is required to determine that portion which is "used and useful."

Lot count methodology. Palm Coast first contends that the Commission erred in utilizing a so-called "lot count" methodology in determining that portion of the Palm Coast's water transmission and distribution system and its wastewater gravity mains which are deemed used and useful in the public service. § 367.081(2)(a), Fla. Stat. (1995). The Commission acknowledges that the lot count methodology represented a departure from the methodology previously employed, in which used and useful plant was determined based upon the number of equivalent residential connections.

We recognize that the Commission is to be accorded "considerable discretion and latitude in the rate-fixing process," Gulf Power Co. v. Bevis, 296 So. 2d 482, 487 (Fla. 1974), and its determination of the applicable "used and useful" considerations should be given great weight since such considerations are infused with policy considerations for which the Commission has special responsibility and expertise. Citizens v. Florida Pub. Serv. /Comm'n, 488 So. 2d 112 (Fla. 1st DCA 1986). The Commission's discretion, however, is limited by chapter 120, Florida Statutes (Supp. 1996). As we observed in Southern States Utilities v. Florida Pub. Serv. Comm'n, 714 So. 2d 1046, 1057 (Fla. 1st DCA 1998),

> For the most part, the Legislature has committed used and useful calculations to the expertise and discretion of the [Public Service Commission]. . . . It is not for the reviewing court to dictate methodology or other policy with the PSC's "statutorily delimited sphere." As regards used and useful calculations, our concern thus far has been only that the PSC comply with the procedural requirements of the Administrative Procedure Act, chapter 120, Florida Statutes (1997), in making changes in policies governing these calculations. The PSC is, after all, subject to the Act.

(Citations omitted).

We note that when the order under review was entered, the Commission did not have the benefit of our decisions in Florida Cities Water Co. v. State, Pub. Serv. Comm'n, 705 So. 2d 620 (Fla. 1st DCA 1998), and Southern States. We stated in Florida

Cities Water, and reaffirmed in Southern States, that, under chapter 120, Florida Statutes (Supp. 1996), a shift in rate-making policy must be supported by expert testimony, documentary evidence or other evidence appropriate to the nature of the issue involved. See also Manasota-88, Inc v. Gardinier, Inc., 481 So. 2d 948, 950 (Fla. 1st DCA 1986). As was the case in Southern States and Florida Cities Water, we reverse and remand with directions that the Commission provide explanation, with record support, for the change in methodology in determining the used and useful portion of Palm Coast's water transmission and distribution mains and its wastewater gravity mains are used and useful in the public service. The record before us lacks an adequate basis for the change in methodology.

In so holding, however, we reject Palm Coast's suggestion that it was denied notice that the lot count methodology was an issue below. The prehearing order indicates that the staffs of both the Commission and the Office of the Public Counsel had proposed using the lot count methodology. This proposal was also explored in prehearing exhibits and pre-filed testimony. Thus, Palm Coast was on clear notice that this methodology would be considered by the Commission.

Fire Flow Allowance. Palm Coast also argues that the Commission erred when, in determining used and useful plant, it eliminated a fire flow allowance for the wells and water

treatment plant. We agree. When Palm Coast's rates were previously set by the Commission, an allowance for fire flow was included for the wells, water treatment, and storage facilities. Despite this previously granted allowance for the source of supply, the Commission refused to continue such an allowance because, "from an engineering design perspective" the allowance was not cost effective. Again, such a decision constituted a departure by the Commission from its previous treatment of Palm Coast, and such a departure is not justified on the record. Southern States, supra. Accordingly, we reverse and remand for further proceedings on this issue.

Annual Average Daily Flow. Similarly, Palm Coast argues that the Commission erred when it used an annual average daily flow, rather than a three-month average daily flow measurement, when calculating the used and useful portion of the wastewater treatment plant. The use of an annual average daily flow is another departure from the Commission's previous practices. The Commission has justified this departure by the fact that the Department of Environmental Protection, which issues the permit for operation of a wastewater treatment plant, had only recently begun stating the capacity of the plant in terms of annual average flow. Thus, argues the Commission, for the used and useful ratio to be stated in like terms, the amount of demand as measured by annual average flow. However, we have previously

held that the fact that the Department of Environmental Protection has changed the language used on its permits is an insufficient basis by itself for a departure from the previous methodology employed by the Commission. See Southern States, 714 So. 2d at 1056. Accordingly, we reverse and remand on this issue.

Margin Reserve

The Commission's rate making practices allow the inclusion of a margin reserve allowance in a utility's rate base. The margin reserve allowance enables the utility to expand its facilities in a prudent manner beyond current demand to meet short-term growth requirements while maintaining system reliability. "By allowing a margin reserve increment to the rate base, the Commission permits the utility to charge its existing customers a portion of the cost necessary to have service available for future customers." Rolling Oaks Utilities v. Florida Pub. Serv. Comm'n, 533 So. 2d 770, 773 (Fla. 1st DCA 1988).

Palm Coast argues that the Commission erred in allowing a margin reserve period of only eighteen months for its water and wastewater treatment plants and of only twelve months for its transmission lines. We affirm the Commission's allowance of an eighteen-month margin reserve period for the water treatment plant and the allowance of a twelve-month margin reserve period

for the transmission lines. Competent substantial evidence, including the testimony of Commission witness Amaya, supported this decision.

As to the Palm Coast wastewater treatment facility, however, witness Amaya testified that the margin reserve period should be three years, and a utility witness testified that the margin reserve period should be five years. The Commission allowed a margin reserve of only eighteen months, explaining, as follows:

> Our primary justification for allowing only an 18 month margin reserve period for plant is that the utility does not actually start accruing significant capital outlays until the plant is constructed. The utility has not presented any information which indicates that the construction period for its water or wastewater plants was greater than 18 months.

In establishing the margin reserve based only on the time required to construct a treatment facility, without considering the pre-construction period needed for design and permitting, the Commission departed from its prior practice. See, e.g., Florida Cities Water Co. (Golden Gate Division), 95 F.P.S.C. 6:136, 142 (1995). This departure from prior Commission practice was without record support. See generally Southern States, supra; Florida Cities Water, supra. Further, no competent, substantial evidence in the record supports an 18-month margin reserve period, if the complete design, permitting and construction time requirements are considered. While it might be possible to develop a margin reserve that reflects both the time required for

the complete design, permitting and construction of a plant and the fact that a substantial portion of the capital expenditures are not required until the construction work begins, that was not done here. We therefore reverse and remand for the determination of the margin reserve allowance for the wastewater treatment plant based upon the competent substantial evidence in the record.[1]

Imputed Contributions-in-aid-of-Construction

There is one final issue which merits discussion. Palm Coast has argued that the Commission erred in using proposed service utility charges in determining imputed contributions-in-aid-of-construction, because the actual service utility charges were known to the Commission as of November 1996, when the Commission entered an order approving Palm Coast's new charges. The Commission has argued that the new charges were not, strictly speaking, in the record of this case and therefore the Commission was not obliged to use them. We find the Commission's argument to be without merit. The Commission is certainly capable of taking notice of its own orders. Compare Mutual Ins. Rating

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[1]We note that the Commission policy and practice on margin reserve is the subject of Proposed Rule 25-30.341, which provides that one factor to consider when determining the period of margin reserve is "the time needed to meet the guidelines of the Department of Environmental Protection (DEP) for planning, designing, and construction of plant expansion." See Florida Pub. Serv. Comm'n v. Florida Waterworks Ass'n, Case No. 98-1280 (Fla. 1st DCA 1999) (reversing an order of the administrative law judge finding this proposed rule invalid).

Bureau v. Williams, 189 So. 2d 389 (Fla. 1st DCA 1966).

We affirm the remaining issues raised on appeal without discussion. Accordingly, the order under review is AFFIRMED in part, REVERSED in part, and REMANDED.

ERVIN, BENTON AND VAN NORTWICK, JJ., CONCUR.