

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Water and wastewater industry annual reestablishment of authorized range of return on common equity for water and wastewater utilities pursuant to Section 367.081(4)(f), F.S.

DOCKET NO. 020006-WS  
ORDER NO. PSC-02-0898-PAA-WS  
ISSUED: July 5, 2002

The following Commissioners participated in the disposition of this matter:

LILA A. JABER, Chairman  
J. TERRY DEASON  
BRAULIO L. BAEZ  
MICHAEL A. PALECKI  
RUDOLPH "RUDY" BRADLEY

NOTICE OF PROPOSED AGENCY ACTION  
ORDER ESTABLISHING AUTHORIZED RANGE OF RETURNS ON  
COMMON EQUITY FOR WATER AND WASTEWATER UTILITIES

BY THE COMMISSION:

NOTICE is hereby given by the Florida Public Service Commission that the action discussed herein is preliminary in nature and will become final unless a person whose interests are substantially affected files a petition for a formal proceeding, pursuant to Rule 25-22.029, Florida Administrative Code.

Section 367.081(4)(f), Florida Statutes, authorizes this Commission to establish, not less than once each year, a leverage formula to calculate a reasonable range of returns on equity for water and wastewater (WAW) utilities. In Docket No. 010006-WS, the Commission established the current leverage formula by Order No. PSC-01-2514-FOF-WS, issued on December 24, 2001. This Order utilizes the same leverage formula methodology, with updated financial data, as that set forth in Order No. PSC-01-2514-FOF-WS,

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using returns on equity from financial models based on an index of natural gas utilities. Accordingly, we approve the following leverage formula:

$$\text{Return on Common Equity} = 9.65\% + 0.582/\text{Equity Ratio}$$

Where the Equity Ratio = Common Equity / (Common Equity + Preferred Equity + Long-Term and Short-Term Debt)

Range: 10.23% @ 100% equity to 11.10% @ 40% equity

We note that the leverage formula depends on the four basic assumptions listed below:

- 1) Business risk is similar for all WAW utilities.
- 2) The cost of equity is an exponential function of the equity ratio.
- 3) The marginal weighted average cost of investor capital is constant over the equity ratio range of 40% to 100%.
- 4) The cost rate at an assumed Moody's Baa3 bond rating, plus a 50 basis point private placement premium and a 50 basis point small utility premium, represents the average marginal cost of debt to a Florida WAW utility over an equity ratio range of 40% to 100%.

The leverage formula is assumed to be appropriate for the average Florida WAW utility.

The leverage formula relies on two return on equity (ROE) models and several adjustments for differences in risk and debt cost in order to conform the results of the models to the average Florida WAW utility. Both models include a four percent adjustment for flotation costs. The models are as follows:

- A Discounted Cash Flow (DCF) model applied to an index of natural gas utilities (NG) that have publicly traded stock and are followed by the Value Line Investment Survey (Value Line). The DCF model is an annual model and uses prospective growth rates.
- A Capital Asset Pricing Model (CAPM) using a market return for companies followed by Value Line, the average yield on the

Treasury's long-term bonds projected by the Blue Chip Financial Forecasts, and the average beta of the index of NG utilities. The market return is adjusted to assume a quarterly model by adding 20 basis points to the result.

The indicated returns of the above models are averaged and the resulting estimate is adjusted in the following manner:

- A bond yield differential of 40 basis points to reflect the difference in yields between an A/A2 rated bond, which is the average bond rating for the NG utility index, and a BBB-/Baa3 rated bond. Florida WAW utilities are assumed to be comparable to WAW companies with the lowest investment grade bond rating, which is Baa3. This adjustment compensates for the difference between the credit quality of "A" rated debt and the credit quality of the minimum investment grade rating.
- A private placement premium of 50 basis points is added to reflect the difference in yields on publicly traded debt and privately placed debt, which is illiquid. Investors require a premium for the lack of liquidity of privately placed debt.
- A small utility premium of 50 basis points is added to reflect that the average Florida WAW utility is too small to qualify for privately placed debt.

After the above adjustments are made, the resulting cost of equity estimate is included in the average capital structure for the NG utilities. The cost of equity is determined at a 40% equity ratio and the leverage formula is derived. The leverage formula derived using the current methodology with updated financial data is presented in Attachment 1.

As set forth in Section 367.081 (4)(f), Florida Statutes, the Commission shall use the current leverage formula for any utility "which otherwise would have no established rate of return on equity." In addition, we are utilizing the current leverage formula to reestablish the authorized ROE for all WAW utilities that currently have authorized ROEs. This update would not be done annually, only when there have been significant changes in the capital markets. We believe this action to be cost effective and

appropriate in order to avoid a piecemeal approach in updating authorized ROEs.

Pursuant to Section 367.011(2), Florida Statutes, the Commission has "exclusive jurisdiction over each utility with respect to its authority, service, and rates." Additionally, as set forth in Section 367.081(2)(a), Florida Statutes, the Commission can "either upon request or upon its own motion, fix rates." A utility's ROE is one factor that is used in determining rates. As a result, we have the authority to use the leverage formula set forth in this Order to reestablish the ROE for all WAW utilities that currently have an authorized ROE. Updating the ROEs of the WAW utilities will not change the rates currently charged to ratepayers.

Many WAW utilities currently have authorized ROEs that are outside the range of returns indicated by the leverage formula. Capital market conditions change continuously, and reestablishing the authorized ROE for all WAW utilities that currently have authorized ROEs reflects current capital market conditions. A utility's authorized ROE and range can affect excess earnings reviews (earnings surveillance), index and pass-through applications, and interim rates. Updating the WAW utilities' ROEs will bring many outdated ROEs in line with the current economic returns expected by today's investors. In addition, using an ROE based on current expected returns will limit the chance of overstating or understating the true economic cost to the utilities when the ROE is used for purposes other than setting rates.

The Commission regulates approximately 200 WAW utilities. Only 47% of these utilities have authorized ROEs. The leverage formula authorized by this Order will lower the ROE of an estimated 34% of the utilities with authorized ROEs. In addition, it will raise the ROE of an estimated 38% of utilities with authorized ROEs and leave 28% of the utilities with authorized ROEs unchanged. We note that this Commission adopted a similar approach for the gas industry. See Order No. PSC-93-1820-FOF-GU, issued December 22, 1993, in Docket No. 931098-GU; Order No. PSC-94-0249-FOF-GU, issued March 7, 1994, in Docket No. 931100-GU; and Order No. PSC-93-1772-FOF-GU, issued December 10, 1993, in Docket No. 931099-GU. This action was taken to reflect significant changes in capital market

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conditions and to bring those utilities' ROEs more in line with current market conditions.

For WAW utilities that have authorized ROEs, we hereby reestablish the authorized ROEs using the water and wastewater leverage formula authorized by this Order. The appropriate equity ratio for determining the new authorized ROE shall be the equity ratio that this Commission used to determine the utility's last authorized ROE. The appropriate range for the new authorized ROE is the ROE plus or minus 100 basis points.

Based on the foregoing, it is

ORDERED by the Florida Public Service Commission that the leverage formula methodology, summarized herein and in Attachment 1, used to calculate a range of returns on equity for water and wastewater utilities is hereby approved. It is further

ORDERED that Attachment 1 is herein incorporated by reference. It is further

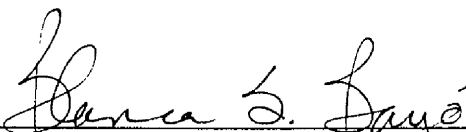
ORDERED that returns on common equity are hereby capped at 11.10 percent for all water and wastewater utilities with equity ratios of less than 40 percent in order to discourage imprudent financial risk. It is further

ORDERED that the leverage formula methodology approved in this Order shall be applied to all water and wastewater utilities that currently have an authorized return on equity. It is further

ORDERED that the provisions of this Order, issued as proposed agency action, shall become final and effective upon the issuance of a Consummating Order unless an appropriate petition, in the form provided by Rule 28-106.201, Florida Administrative Code, is received by the Director, Division of the Commission Clerk and Administrative Services, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, by the close of business on the date set forth in the "Notice of Further Proceedings" attached hereto. It is further

ORDERED that in the event this Order becomes final, this docket shall remain open to allow our staff to monitor the movement in capital costs and to readdress the reasonableness of the leverage formula as conditions warrant.

By ORDER of the Florida Public Service Commission this 5th day of July, 2002.



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BLANCA S. BAYÓ, Director  
Division of the Commission Clerk  
and Administrative Services

( S E A L )

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NOTICE OF FURTHER PROCEEDINGS OR JUDICIAL REVIEW

The Florida Public Service Commission is required by Section 120.569(1), Florida Statutes, to notify parties of any administrative hearing that is available under Section 120.57, Florida Statutes, as well as the procedures and time limits that apply. This notice should not be construed to mean all requests for an administrative hearing will be granted or result in the relief sought.

Mediation may be available on a case-by-case basis. If mediation is conducted, it does not affect a substantially interested person's right to a hearing.

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The action proposed herein is preliminary in nature. Any person whose substantial interests are affected by the action proposed by this order may file a petition for a formal proceeding, in the form provided by Rule 28-106.201, Florida Administrative Code. This petition must be received by the Director, Division of the Commission Clerk and Administrative Services, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, by the close of business on July 26, 2002.

In the absence of such a petition, this order shall become final and effective upon the issuance of a Consummating Order.

Any objection or protest filed in this/these docket(s) before the issuance date of this order is considered abandoned unless it satisfies the foregoing conditions and is renewed within the specified protest period.

**SUMMARY OF RESULTS**

Leverage Formula Update

	<u>Updated Results</u>	<u>Currently in Effect</u>
(A) CAPM ROE for Natural Gas Index	8.93%	9.08%
(B) DCF ROE for Natural Gas Index	<u>10.13%</u>	<u>10.81%</u>
AVERAGE	9.53%	9.95%
Bond Yield Differential	.40%	.25%
Private Placement Premium	.50%	.50%
Small-Utility Risk Premium	.50%	.50%
Adjustment to Reflect Required Equity		
Return at a 40% Equity Ratio	<u>.17%</u>	<u>.15%</u>
Cost of Equity for Average Florida WAW		
Utility at a 40% Equity Ratio	<u>11.10%</u>	<u>11.34%</u>

2001 Leverage Formula (Currently in Effect)

Return on Common Equity	=	9.10% + .896/ER
Range of Returns on Equity	=	10.00% - 11.34%

2002 Leverage Formula (Recommended)

Return on Common Equity	=	9.65% + .582/ER
Range of Returns on Equity	=	10.23% - 11.10%



Marginal Cost of Investor Capital  
Average Water and Wastewater Utility

<u>Capital Component</u>	<u>Ratio</u>	<u>Marginal Cost Rate</u>	<u>Weighted Marginal Cost Rate</u>
Common Equity	45.46%	10.93%	4.97%
Total Debt	<u>54.54%</u>	9.65% *	<u>5.26%</u>
	100.00%		10.23%

A 40% equity ratio is the floor for calculating the required return on common equity. The return on equity at a 40% equity ratio is  $9.65\% + 0.582/.40 = 11.10\%$

Marginal Cost of Investor Capital  
Average Water & Wastewater Utility at 40% Equity Ratio

<u>Capital Component</u>	<u>Ratio</u>	<u>Marginal Cost Rate</u>	<u>Weighted Marginal Cost Rate</u>
Common Equity	40.00%	11.10%	4.44%
Total Debt	<u>60.00%</u>	9.65% *	<u>5.79%</u>
	100.00%		10.23%

Where: ER = Equity Ratio = Common Equity / (Common Equity + Preferred Equity + Long-Term Debt + Short-Term Debt)

\* Assumed Baa3 rate for April 2002 plus a 50 basis point private placement premium and a 50 basis point small utility risk premium.

Source: Moody's Credit Perspectives

ANNUAL DISCOUNTED CASH FLOW MODEL

INDEX COMPANY	MOODY'S NATURAL GAS INDEX						APRIL						
	DIV0	DIV1	DIV2	DIV3	DIV4	EPS4	ROE4	GR1-4	GR4+	HI-PR	LO-PR	AVER-PR	
AGL RESOURCES	1 08	1 08	1 11	1 13	1 16	2 10	12 50	1 0241	1 0560	24 340	22 800	23 570	
ATMOS ENERGY	1 18	1 21	1 25	1 30	1 35	2 20	14 00	1 0372	1 0541	24 550	23 440	23 995	
CASCADE NATURAL GAS	0 96	0 96	0 97	0 97	0 98	2 00	15 00	1 0069	1 0765	22 500	20 200	21 350	
LACLEDE GAS	1 36	1 38	1 40	1 43	1 45	2 25	12 00	1 0166	1 0427	24 880	23 300	24 090	
NICOR, INC.	1 84	1 94	2 04	2 14	2 24	4 40	21 50	1 0491	1 1055	49 000	44 990	46 995	
NORTHWEST NATURAL GAS	1 26	1 28	1 30	1 33	1 35	2 50	11 00	1 0179	1 0506	30 300	27 600	28 950	
PIEDMONT NATURAL GAS	1 60	1 68	1 73	1 77	1 82	2 90	12 50	1 0270	1 0466	37 950	35 000	36 475	
SOUTHWEST GAS	0 82	0 82	0 84	0 86	0 88	1 95	8 00	1 0238	1 0439	24 990	22 600	23 795	
WGL HOLDINGS	1 28	1 30	1 32	1 33	1 35	2 65	12 50	1 0127	1 0613	27 950	26 250	27 100	
AVERAGE	1 2644	1 2944	1 3278	1 3622	1 3978	2 55	13 2222	1 0239	1 0597			28 480	

S&P STOCK GUIDE MAY 2002 with April Stock Prices

Stock Price w/four Percent Flotation Costs	27.3408	Annual	10.13%	ROE					
		1 1550	1 0742	1 0005	0 9321	0 8757	22 3033		
		27 3408							

\$27.34 = April 2002 average stock price with a 4% flotation cost.

10.13% = Cost of equity required to match the current stock price with the expected cash flows.

Sources:

1. Stock Prices - S&P Stock Guide, May 2002 Edition.
2. DPS, EPS, ROE - Value Line Edition 3, March 22, 2002.

Capital Asset Pricing Model Cost of Equity for  
Water and Wastewater Industry

CAPM analysis formula

$$K = RF + \text{Beta}(\text{MR} - \text{RF})$$

$$K = \text{Investor's required rate of return}$$

$$\text{RF} = \text{Risk-free rate (Blue Chip forecast for  
Long-term Treasury bond)}$$

$$\text{Beta} = \text{Measure of industry-specific risk (Average  
for water utilities followed by Value Line)}$$

$$\text{MR} = \text{Market return (Value Line Investment Survey  
For Windows, May 2002)}$$

$$\underline{8.93\%} = 6.00\% + .59(10.64\% - 6.00\%) + .20\%$$

**Note:** We calculated the market return using an annual DCF model for a large number of dividend paying stocks followed by Value Line. For April 2002 stock prices, the result was 10.44%. We have added 20 basis points to allow for the quarterly compounding of dividends. The resulting market return is 10.64%. We have also added 20 basis points to the CAPM result to allow for a four-percent flotation cost.

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BOND YIELD DIFFERENTIALS  
 Public Utility Long Term Bond Yield Averages  
 Source: Moody's Credit Perspectives

UPDATED: 05/20/2002

120 Month Average -	0 1982		0 1982		0 0472		0 0472		0 0472		0 0989		0 0989		0 0989		0 0989		
MONTH/YEAR	Aaa	SPREAD	Aa1	SPREAD	Aa2	SPREAD	Aa3	SPREAD	A1	SPREAD	A2	SPREAD	A3	SPREAD	Baa1	SPREAD	Baa2	SPREAD	Baa3
Apr-2002	3.69	3.69	3.69	7.38	0.06	7.44	0.06	7.51	0.06	7.57	0.23	7.80	0.23	8.02	0.23	8.25	0.23	8.48	
Mar-2002	3.71	3.71	3.71	7.42	0.11	7.53	0.11	7.65	0.11	7.76	0.19	7.95	0.19	8.13	0.19	8.32	0.19	8.51	
Feb-2002	3.57	3.57	3.57	7.14	0.13	7.27	0.13	7.41	0.13	7.54	0.21	7.75	0.21	7.97	0.21	8.18	0.21	8.39	
Jan-2002	3.64	3.64	3.64	7.28	0.13	7.41	0.13	7.53	0.13	7.66	0.16	7.82	0.16	7.97	0.16	8.13	0.16	8.29	
Dec-2001	7.53	0.00	7.53	0.00	7.53	0.10	7.63	0.10	7.73	0.10	7.83	0.15	7.98	0.15	8.12	0.15	8.27	0.15	8.42
Nov-2001	7.45	0.00	7.45	0.00	7.45	0.04	7.49	0.04	7.53	0.04	7.57	0.13	7.70	0.13	7.83	0.13	7.96	0.13	8.09
Oct-2001	7.45	0.01	7.46	0.01	7.47	0.05	7.52	0.05	7.58	0.05	7.63	0.13	7.76	0.13	7.89	0.13	8.02	0.13	8.15
Sep-2001	7.52	0.02	7.54	0.02	7.55	0.07	7.62	0.07	7.68	0.07	7.75	0.12	7.87	0.12	8.00	0.12	8.12	0.12	8.24
Aug-2001	7.36	0.01	7.38	0.01	7.39	0.07	7.46	0.07	7.52	0.07	7.59	0.12	7.71	0.12	7.83	0.12	7.95	0.12	8.07
Jul-2001	7.46	0.04	7.51	0.04	7.55	0.08	7.63	0.08	7.70	0.08	7.78	0.09	7.87	0.09	7.96	0.09	8.05	0.09	8.14
Jun-2001	7.50	0.06	7.56	0.06	7.62	0.08	7.70	0.08	7.77	0.08	7.85	0.06	7.91	0.06	7.96	0.06	8.02	0.06	8.08
May-2001	7.61	0.09	7.70	0.09	7.79	0.07	7.86	0.07	7.92	0.07	7.99	0.04	8.03	0.04	8.07	0.04	8.11	0.04	8.15
Apr-2001	7.53	0.09	7.63	0.09	7.72	0.07	7.79	0.07	7.87	0.07	7.94	0.04	7.98	0.04	8.02	0.04	8.06	0.04	8.10
Mar-2001	7.31	0.10	7.41	0.10	7.51	0.06	7.57	0.06	7.62	0.06	7.68	0.06	7.74	0.06	7.79	0.06	7.85	0.06	7.91
Feb-2001	7.46	0.08	7.54	0.08	7.62	0.04	7.66	0.04	7.70	0.04	7.74	0.07	7.81	0.07	7.87	0.07	7.94	0.07	8.01
Jan-2001	7.53	0.10	7.63	0.10	7.73	0.02	7.75	0.02	7.78	0.02	7.80	0.06	7.86	0.06	7.93	0.06	7.99	0.06	8.05
Dec-2000	7.51	0.14	7.65	0.14	7.79	0.02	7.81	0.02	7.82	0.02	7.84	0.06	7.90	0.06	7.95	0.06	8.01	0.06	8.07
Nov-2000	7.71	0.16	7.87	0.16	8.03	0.03	8.06	0.03	8.08	0.03	8.11	0.05	8.16	0.05	8.20	0.05	8.25	0.05	8.30
Oct-2000	7.80	0.14	7.94	0.14	8.08	0.02	8.10	0.02	8.12	0.02	8.14	0.05	8.19	0.05	8.24	0.05	8.29	0.05	8.34
Sep-2000	7.95	0.08	8.03	0.08	8.11	0.04	8.15	0.04	8.19	0.04	8.23	0.03	8.26	0.03	8.29	0.03	8.32	0.03	8.35
Aug-2000	7.89	0.03	7.92	0.03	7.95	0.06	8.01	0.06	8.07	0.06	8.13	0.04	8.17	0.04	8.21	0.04	8.25	0.04	8.29
Jul-2000	8.00	0.05	8.05	0.05	8.10	0.05	8.15	0.05	8.20	0.05	8.25	0.03	8.28	0.03	8.30	0.03	8.33	0.03	8.36
Jun-2000	7.96	0.07	8.03	0.07	8.10	0.09	8.19	0.09	8.27	0.09	8.36	0.04	8.40	0.04	8.43	0.04	8.47	0.04	8.51
May-2000	8.22	0.11	8.33	0.11	8.44	0.09	8.53	0.09	8.61	0.09	8.70	0.05	8.75	0.05	8.81	0.05	8.86	0.05	8.91
Apr-2000	7.95	0.11	8.06	0.11	8.17	0.06	8.23	0.06	8.29	0.06	8.35	0.02	8.37	0.02	8.38	0.02	8.40	0.02	8.42
Mar-2000	7.87	0.06	7.93	0.06	7.99	0.10	8.09	0.10	8.18	0.10	8.28	0.04	8.32	0.04	8.36	0.04	8.40	0.04	8.44
Feb-2000	7.82	0.09	7.91	0.09	7.99	0.09	8.08	0.09	8.16	0.09	8.25	0.03	8.28	0.03	8.30	0.03	8.33	0.03	8.36
Jan-2000	7.95	0.11	8.06	0.11	8.17	0.06	8.23	0.06	8.29	0.06	8.35	0.02	8.37	0.02	8.38	0.02	8.40	0.02	8.42
Dec-1999	7.74	0.13	7.87	0.13	8.00	0.05	8.05	0.05	8.09	0.05	8.14	0.05	8.19	0.05	8.23	0.05	8.28	0.05	8.33
Nov-1999	7.56	0.13	7.69	0.13	7.82	0.04	7.86	0.04	7.90	0.04	7.94	0.06	8.00	0.06	8.06	0.06	8.12	0.06	8.18
Oct-1999	7.73	0.11	7.85	0.11	7.96	0.03	7.99	0.03	8.03	0.03	8.06	0.09	8.15	0.09	8.23	0.09	8.32	0.09	8.41
Sep-1999	7.55	0.14	7.69	0.14	7.82	0.04	7.86	0.04	7.89	0.04	7.93	0.09	8.02	0.09	8.10	0.09	8.19	0.09	8.28
Aug-1999	7.54	0.14	7.68	0.14	7.82	0.03	7.85	0.03	7.88	0.03	7.91	0.08	7.99	0.08	8.08	0.08	8.16	0.08	8.24
Jul-1999	7.34	0.14	7.48	0.14	7.62	0.03	7.65	0.03	7.68	0.03	7.71	0.09	7.80	0.09	7.88	0.09	7.97	0.09	8.06
Jun-1999	7.37	0.15	7.52	0.15	7.67	0.02	7.69	0.02	7.72	0.02	7.74	0.10	7.84	0.10	7.93	0.10	8.03	0.10	8.13
May-1999	7.09	0.15	7.24	0.15	7.38	0.03	7.41	0.03	7.44	0.03	7.47	0.09	7.56	0.09	7.65	0.09	7.74	0.09	7.83
Apr-1999	6.80	0.16	6.96	0.16	7.11	0.04	7.15	0.04	7.18	0.04	7.22	0.10	7.32	0.10	7.41	0.10	7.51	0.10	7.61
Mar-1999	6.78	0.17	6.95	0.17	7.11	0.05	7.16	0.05	7.21	0.05	7.26	0.10	7.36	0.10	7.45	0.10	7.55	0.10	7.65
Feb-1999	6.56	0.19	6.75	0.19	6.94	0.05	6.99	0.05	7.04	0.05	7.09	0.11	7.20	0.11	7.30	0.11	7.41	0.11	7.52
Jan-1999	6.41	0.21	6.62	0.21	6.82	0.05	6.87	0.05	6.92	0.05	6.97	0.11	7.08	0.11	7.19	0.11	7.30	0.11	7.41

Source: Moody's Credit Perspectives, May 20, 2002

12/31/01 Equity Ratios of Natural Gas Utilities

Value Line Listed Gas Utilities	Bond Rating	% of Gas Rev.	V/L Market Capital (billions)	Equity Ratio	Value Line Beta
AGL RESOURCES	A-	76%	1.30	35%	0.60
ATMOS ENERGY	A-	96%	0.95	46%	0.55
CASCADE NATURAL GAS	BBB+	100%	0.23	44%	0.55
LACLEDE GAS	A+	93%	0.45	43%	0.55
NICOR, INC.	AA	83%	2.00	53%	0.60
NORTHWEST NAT. GAS	A	98%	0.68	49%	0.60
PIEDMONT NAT. GAS	A	86%	1.10	52%	0.60
SOUTHWEST GAS CORP.	BBB-	86%	0.78	36%	0.65
WGL HOLDINGS	AA-	100%	1.30	52%	0.60
Average:	A			45.46%	0.59

Source:  
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