SENATE STAFF ANALYSIS AND ECONOMIC IMPACT STATEMENT

(This document is based only on the provisions contained in the legislation as of the latest date listed below.)

Date: March 31, 1998 Revised: 4/15/98

Subject: Water and Wastewater Systems Regulation by the Florida Public Service Commission

	Analyst	Staff Director	Reference	Action
1.	Matthews	Guthrie	RI	Fav/2 amendments
2.				
3.				
4.				
5.				

I. Summary:

This bill amends the Water and Wastewater System Regulatory Law. It prohibits the Florida Public Service Commission from imputing (deducting) future contributions-in-aid-of-contribution against a utility's property investment in its margin reserve allowance, construes the term "used and useful in public service" to allow for a 5-year margin reserve period unless otherwise justified, and requires the commission to approve rates allowing for the recovery of certain prudently incurred environmental compliance costs.

This bill substantially amends the following section of the Florida Statutes: 367.081.

II. Present Situation:

Under chapter 367, F.S., the Florida Public Service Commission (PSC) exercises exclusive jurisdiction over the economic regulation of investor-owned and private water and wastewater utilities, with the exception of those utilities that are regulated by counties that opted to retain regulatory jurisdiction. The PSC regulates 351 water and wastewater utility companies with 1,327 systems in 37 counties, serving approximately 8-10% of Florida's population.

Like other regulated monopolies, water and wastewater utilities are allowed recovery or offset of certain investment costs and other expenses through rates. However, unlike other utilities, water and wastewater utilities typically have smaller customer bases over which to spread investments costs and expenses, resulting in higher rate levels per ratepayer.

Under rate-of-return regulation, a utility may only charge rates that have been approved by the PSC, with the exception of the price index adjustment and pass-through adjustment provisions that allow a utility to adjust its rates without hearing or other formal PSC action. *See*

s. 367.081, F.S. Even counties that have "opted out" of PSC jurisdiction are required to adopt certain rate setting provisions in s. 367.081, F.S. *See* s. 367.171(6) & (8), F.S.

The rates established by the PSC must be "just, reasonable and compensatory and not unfairly discriminating." See s. 367.081(2)(a), F.S. The PSC must consider the cost of providing service including the utility's expenses, depreciation, working-capital needs, and a fair return on the investment that is "used and useful in the public service." *See* s. 367.081(2)(a), F.S. Rate base is the investment base upon which a utility is allowed to earn a fair return. The components used for determining a utility's rate base include: plant and land used and useful in the public service, contributions-in-aid-of-construction(CIAC), accumulated depreciation, accumulated amortization of CIAC, and working capital.

1. Property Used and Useful in the Public Service

When considering the recovery of property investment in a rate case proceeding, the PSC determines how much increase in capacity can be appropriately charged to current customers versus how much should be charged to future customers. The PSC applies the concept of "used and useful in the public service" to characterize investments in water and wastewater utility plant capacity for which existing customers should bear the cost. *See* s.367.081(2), F.S. Plant that is not used and useful is not included in the rate base. However, PSC does provide an Allowance for Funds Prudently Invested (AFPI), which enables a utility to recover costs such as accumulated depreciation, depreciation expense, and property taxes on plant that is not used and useful. However, AFPI is based on estimated collections rather than actual receipts, which makes recovery on the investment somewhat uncertain.

In determining what amount of plant is "used and useful", the PSC makes an allowance for margin reserve or projected growth. The PSC defines "margin reserve" as the amount of plant capacity needed to preserve and protect the ability of utility facilities to serve existing and future customers in an economically feasible manner that will preclude a deterioration in quality of service and prevent adverse environmental and health effects.

Another factor that affects the used and useful calculation is the practice of imputing contributions-in-aid-of-construction (CIAC). CIAC are contributions of property or in kind cash (e.g., hook-up or connection fees, or developer-donated water and sewer lines) made or given by a customer, a government agency or other entity to a utility for connection to defray the cost of the facilities. *See* s. 367.021(3), F.S. Since current law does not allow a utility to earn a return on plant facility funded by CIAC, such contributions are treated as an offset to the cost of plant in determining rate base. *See* s. 367.081(2)(a), F.S. Imputing CIAC on the allowed margin reserve reduces the reserve by the projected CIAC that existing or future customers are expected to pay, which may eliminate some or all investment in margin reserve from being counted in the rate base. Thus the utility bears the risk that future customers (and future CIAC) may not materialize.

Until recently, the PSC applied a non-rule policy to allow for a presumptively valid 12-month margin reserve for collection and distribution pipes and lines, and an 18-month margin reserve for

water source and treatment facilities and wastewater treatment and effluent disposal facilities, unless a longer period was otherwise justified. It also was PSC policy to impute 100% of the CIAC. Longer margin reserve periods could be allowed based on the growth rate in the number of equivalent residential connections (ERCs), the time needed to meet the guidelines of the DEP for planning, designing, and construction of plant expansion. and the technical and economic options available for sizing increments of plant expansion. DEP requires a minimum horizon of five years for planning, designing, permitting and constructing utility treatment plant expansions. See DEP Rule 62-600.405, F.A.C. There is no DEP rule mandating a minimum growth period for distribution and collection lines.

The industry has long argued that the PSC's non-rule policies governing margin reserve and CIAC are inconsistent with state environmental law and regulations. In 1996, the Florida Waterworks Association and the Florida Water Services Corporation, (FWA, et al.) petitioned for rulemaking. FWA proposed a rule to expand the margin reserve time period to 5 years, unless otherwise justified, to preclude the imputation of CIAC against the allowance for margin reserve, and to permit full recovery of reclaimed water reuse facilities as 100% used and useful. *See In re Petition to Adopt Rules on Margin Reserve and Imputation of Contributions-In-Aid of Construction on Margin Reserve Calculation,* PSC Docket #96-0258-WS. In June 1996, without addressing the reclaimed water reuse facilities policy issue, the PSC voted instead to publish its own proposed rule codifying its existing non-rule policies governing margin reserve and imputation of CIAC.

The petitioners challenged the proposed rule but abated the appeal pending an evidentiary hearing conducted by the Commission. *See Florida Waterworks Association (FWA) v. Florida Public Service Commission (FPSC), Florida Water Services Corporation (FWSC) v. FPSC, FWSC v. FPSC v. Office of the Public Counsel,* Case No. 96-3809RP and 96-3949RP. After the evidentiary hearing, PSC staff recommended a modified proposed rule to include only a 5-year margin reserve period for potable water and wastewater treatment and disposal facilities, including reclaimed water reuse facilities, and no imputation of CIAC. In June 1997, the PSC rejected staff recommendation and voted to proceed with its initial proposed rule, modified to reduce the CIAC imputation from 100% to 50%. The Florida Waterworks Association again challenged the revised proposed rule. *See FWA, et al. v. FPSC, and Office of Public Counsel v. FPSC,* Case No. 97-3480RP and 97-3481RP.

On March 2, 1998, the Division of Administrative Hearings (DOAH) issued its ruling that the proposed rules constitutes an unauthorized delegation of legislative authority based on the grounds set forth in s. 120.52(8)(a)-(g) of the 1996 Administrative Procedures Act. DOAH held that the PSC exceeded its rulemaking authority and materially failed to follow applicable rulemaking procedures or requirements in ch. 120, F.S. DOAH also found that the proposed rules:

- are not supported by competent substantial evidence,

- contravene legislative intent in s. 367.111, F.S., that a utility's obligation to serve and provide safe, efficient and sufficient service be in accordance with the state's environmental regulations and policies set forth in chapters 373 and 403, F.S.,

- are inconsistent with statutory objectives to allow utilities to earn a return on their investment (s. 367.081(2)), to recover fully prudent costs attendant with re-use projects and studies (see ss. 367.0817(3) and 403.064(10), F.S.), to satisfy concurrency requirements for purposes of the state's growth management laws, and to encourage development of alternative supplies of water under chapter 373, F.S.,

- do not meet the requirements of s. 120.541, F.S., by failing to address adequately estimated regulatory costs or consider less costly alternatives,

- fail to establish adequate guidelines for affected parties, and

- pose potential environmental and public health problems by constraining utilities to operate near or at capacity rather than to build economies of scale facilities which meet environmental standards, reduce overhead costs, and provide for long-term cost containment.

The commission voted to appeal the decision, which will result in an automatic stay of the administrative order.

2. Environmental Compliance Costs

A utility can recover or offset certain other environmental compliance costs in a rate case by proving that the costs were reasonable and prudent investments. Section 367.081(4)(b), F.S., allows a utility to pass through to customers rate adjustments reflecting certain expenses over which the utility has no control, such as purchased water or sewage treatment, purchased power from electricity suppliers, ad valorem tax increases, water quality testing requirements mandated by the Department of Environmental Regulation (DEP) and the federal Environmental Protection Agency, and regulatory fees increases.

Currently, the PSC is not bound by the decisions and orders of an environmental regulatory agency upon a utility, but the PSC considers and allows a utility to recover these environmental compliance costs by passing them on to customers *unless* the underlying compliance action taken by the utility to meet the environmental requirement was not specifically mandated by DEP. According to PSC staff, requests for recovery of reasonably and prudently incurred environmental compliance costs from DEP or other environmental regulatory agencies are rarely denied by the PSC.

Over the years, water and wastewater utilities have incurred increasing costs and have needed additional time to comply with expanding state and federal environmental regulatory agency requirements. In varying degrees, the DEP, the water management districts (WMDs), the federal Environmental Protection Agency (EPA) or other local regulatory agencies all require utilities to

secure a variety of permits, construct and operate certain facilities, and install pollution control devices. Moreover, the PSC may actually reduce a utility's return on equity if a utility has failed to meet environmental regulatory and statutory standards as prescribed by DEP and WMDs. *See* 367.111(2), F.S. However, unlike municipal water and wastewater utilities, privately-owned and operated utilities cannot receive federal monies or tax exempt financing to assist them in complying with environmental requirements.

Under part VI of Chapter 403, F.S., DEP regulates the permitting, construction and operation of water supply and treatment and wastewater treatment, reuse and disposal facilities. DEP also is charged with administering the State Revolving Loan Fund (SRLF) program established to loan or grant funds to utilities for water facility construction improvements. Eligibility for SRLF funds is conditioned in part on a cost-effectiveness evaluation of a utility facility's improvement to serve a minimum 5-year growth and capacity. Under parts I and II of Chapter 373, F.S., WMDs regulate Florida's water resources, develop plans to meet existing and future water supply needs for the next 20 years, and issue consumptive use permits. WMD's permit criteria and supply plans similarly consider a minimum 5-year growth period.

Although these environmental regulatory costs compound the costs of producing, delivering, treating and disposing water, the impact on customers is oftentimes neither fully considered nor fully understood. One of the ongoing debates relates to cost recovery in ratemaking proceedings based on whether a cost is associated with environmental compliance requirements or attributable to plant expansion needed to serve growth.

III. Effect of Proposed Changes:

This bill amends s. 367.081, F.S. , relating to rate-setting in rate case proceedings. It precludes the PSC from imputing (deducting) prospective future contributions-in-aid-of-construction against the utility's investment in property determined to be used and useful in the public service. It requires the PSC to consider utility property "used and useful in the public service" if it is needed to serve current or future customers up to 5 years after the entry of a final order on a rate request. If the utility presents clear and convincing evidence to justify a growth in capacity period longer than 5 years, the PSC must consider such property used and useful. Unlike current law, which makes a distinction in growth periods for treatment plants versus distribution and collection lines, the bill uniformly applies the same growth periods for all "used and useful property."

The bill also expands the scope of a utility's recovery of "environmental compliance costs" in its rates to include all reasonable expenses and a fair return on any prudent investments incurred in complying with environmental requirements or conditions from specified environmental regulatory authorities (United States Environmental Protection Agency, DEP, WMDs, and any other governmental entity with similar regulatory jurisdiction). Allowances for funds prudently invested or similar charges are not to be included in the rates. The bill eliminates the PSC's discretion to deny recovery of environmental compliance costs expended by the utilities in response to permitting and enforcement regulations by the environmental regulatory agencies.

The bill also deletes the current requirement that the PSC consider the investment of the utility in property within a "reasonable time in the future, unless extended by the commission, 24 months from the end of the historical test period used to set final rates."

IV. Constitutional Issues:

A. Municipality/County Mandates Restrictions:

None.

B. Public Records/Open Meetings Issues:

None.

C. Trust Funds Restrictions:

None.

V. Economic Impact and Fiscal Note:

A. Tax/Fee Issues:

None.

B. Private Sector Impact:

This bill will impact investor-owned water and wastewater utilities within PSC jurisdictional counties but also in nonjurisdictional (opt-out) counties that are required by law to apply most of the rate-setting provisions in s. 367.081, F.S. This bill may result in an immediate short-term rate increase for customers of some investor-owned and operated utilities. The magnitude of rate increases on each customer will depend on the extent of planned future development and the number of customers already served by the utility. Any rate increase would still require a rate case petition and approval by the PSC. PSC staff generally concurs with industry projections of rate increases less than 2% for 85% of the systems under PSC jurisdiction based on an historical application of the bill to actual rate cases. However higher increases would occur for a few systems.

The immediate rate impact may be offset by long-term benefits to customers resulting from economies of scale, longer range planning, and fewer rate case filings. The bill also will provide a financial incentive and certainty to a utility that prudently incurs certain environmental compliance costs and plans and constructs plant additions in longer increments.

C. Government Sector Impact:

None.

VI. Technical Deficiencies:

None.

VII. Related Issues:

SB 1034 is similar to CS/HB 3185, which passed out of the House on March 17, 1998, and is now in this committee.

An amendment to replace "the word "it" on page 1, line 31, with the phrase "the commission" would make SB 1034 identical to CS/HB 3185.

Measuring the margin reserve period from the "expected date of the commission's entry of a final order on a rate request" (see page 2, lines 13-14 and 17-19) may result in margin reserve periods, considerably longer than 5 years. PSC staff has suggested an amendment to replace that language to specify that the margin reserve period begins "after the end of the test year."

VIII. Amendments:

#1 by Regulated Industries:
Replaces the word "it" with the phrase "the commission."

#2 by Regulated Industries:
Strikes everything after the enacting clause and establishes "The Investor-owned and Private Water and Wastewater Study Panel," to review the issue of rate adjustment.

Section 1: Sets forth legislative finding that the impact of margin reserve allowances and expanded recovery of environmental costs by investor-owned and private water and wastewater utilities necessitate review and public hearing. Requires the panel to review the need for rate adjustment legislation, analyze infrastructure and future growth needs of water and wastewater utilities, economic impact of policy changes to margin reserve allowances and environmental compliance cost recovery in the economic regulation of water and wastewater utilities.

Section 2: Establishes a 9-member panel to consist of: one representative appointed by the Senate and one representative appointed by the House of Representatives, one representative from the Attorney General's Office, two representatives from water and wastewater utilities, one member from the Public Service Commission, one staff member of a water and wastewater utility, one representative of the American Association of Retired Persons, and one representative from a county that opted out of PSC jurisdiction. With the exception of the first two members, all others are to be appointed by the Governor.

Section 3: Requires the panel to hold at least three public hearings in various locations in the state for purposes of seeking public input and comment. Provides for reimbursement of travel expenses and per diem costs for panel members which is to be funded out of the Public Service Commission budget.

Section 4: Requires the panel to report to the Governor and the Legislature by January 15, 1999, on recommendations for proposed legislation.

Section 5: Provides an effective date upon becoming law. (WITH TITLE AMENDMENT)