DOCKET NO. 960258-WS
FWA RESPONSE TO EXHIBIT 7
"ANALYSIS OF MARGIN RESERVE, USED-AND-USEFUL ADJUSTMENTS, AND ALLOWANCE FOR FUNDS PRUDENTLY INVESTED"

PSC staff introduced the document Analysis of Margin Reserve, Used-and-Useful Adjustments, and Allowance for Funds Prudently Invested ("Analysis"), dated March 1990, as an exhibit during rulemaking hearings on Margin Reserve and Imputation of Contributions in Aid of Construction (Exh. 7). The following comments address the Analysis and its applicability to the rulemaking at hand.

The Analysis contains some interesting observations and data, but it is not relevant to rulemaking on margin reserve and imputation of CIAC because:

(1) It was not prepared for the purpose of evaluating proposed rules on margin reserve and imputation of CIAC,

(2) It is outdated.

The stated objective of the Analysis was "...to determine whether the concepts of AFPI, used-and-useful plant, and margin reserve are compatible when used collectively." The FWA does not dispute the overall conclusion that these concepts are compatible when used collectively. In fact, under the FWA's proposed rule on margin reserve and imputation of CIAC all three concepts would still be applied. We also agree with the final statement of the Analysis that, "questions such as whether AFPI will adversely affect an area's growth or whether AFPI cash flows will meet a utility's needs must await further observations of the concept's use in Florida." The FWA's Study of Margin Reserve and Imputation of CIAC explored the question of whether AFPI cash flow would meet a utility's needs and found that, as presently defined, it does not (Composite Exh. 1(9) DS-2). We do, however, dispute some of the assertions made in the Analysis.

Observations in the Analysis that are consistent with the FWA's position

The Analysis acknowledges and supports much of what has been presented by witnesses for the FWA in support of its proposed rule, including the following points:

(1) To fulfill its obligation to serve new customers within a reasonable time, a utility must anticipate and build for such demands in advance of the plant being needed (page 1-2).

(2) Twelve to eighteen months is not necessarily the optimum planning horizon between capacity additions (page 1-2).

(3) It is reasonable to build enough capacity to meet growth up to five years into the future (page 1-2). In fact, five years is considered by staff to be the standard time frame established by industry practice for designing and building additional capacity (page 2-18).

(4) When utility investors choose to build smaller plants to minimize the total capital at risk at any one time the result is usually higher costs in the long run (page 1-2).

(5) Used-and-useful calculations must be adjusted to accommodate facility requirements imposed by other governmental bodies (page 2-7).

(6) Included in the factors to be given consideration in determining the appropriate margin reserve is lead time for managerial decisions, engineering, construction and regulatory approvals (page 2-7).

(7) Existing customers are said to benefit from lower rates made possible by economies of scale in the larger plant (page 2-9).

(8) If utilities must absorb costs associated with nonused-and-useful plant, the utility may be more susceptible to financial problems caused by unforeseen repairs and improvements or increases in costs. This may lead to major repairs or fines and rate shock to future customers (page 3-5).

(9) If imputed CIAC netted against margin reserve is not added into nonused-and-useful plant and a return permitted through AFPI, the utility will never recover carrying costs on this portion of plant even though they were incurred prior to collecting CIAC (page 3-7).

(10) Recovery through AFPI rather than through current rates may increase cash flow problems experienced by some utility companies (e.g., where growth fails to occur or occurs late) (page 3-12).

(11) Responses provided to the survey of water and wastewater utilities shows consistency in positions advocated by Association members (chapter 4 and appendix A-1).

Observations in the Analysis that are not consistent with the FWA's position

A number of assertions are made in the Analysis which are not consistent with the findings of FWA's Study and a number of issues are not discussed at all. These are discussed briefly here.

Margin Reserve period

Although five years is acknowledged as the standard time frame that has been established by industry practice for designing and building additional capacity, the Analysis designates 12 to 18 months as the appropriate margin reserve period without presenting any evidence or argument to support this shorter period.

Definition of margin reserve vs. reserve margin

The Analysis presents several "common misinterpretations of margin reserve," apparently in an attempt to narrowly define margin reserve and differentiate it from reserve margin as applied to other regulated utilities. We contend that there is no difference in the intended concepts of margin reserve and reserve margin and that water and wastewater utilities should not be treated differently from other regulated utilities with regards to margin reserve.

Significance of margin reserve

The Analysis underplays the significance of margin reserve by concluding that under most circumstances current Commission policy would limit margin reserve in rate base to less than 5 percent and, therefore, most companies would suffer little detriment if AFPI were calculated on all nonused-and-useful plant and margin reserve was granted only in cases of special need. The reason the amount is less than 5 percent as calculated in the Analysis is because CIAC is imputed on margin reserve. The FWA's proposed rule would eliminate imputation of CIAC and this position is now supported by PSC staff. Financial models presented as a part of FWA's Study show that alternative margin reserve treatment can have a very significant financial impact on utilities.

Further, the Analysis ignores the fact that shifting recovery of margin reserve from current rates to AFPI would unfairly place all the risk associated with growth on the utility while current customers would receive all the benefits associated with economies of scale. AFPI is not a satisfactory substitute for current rates. It would be absurd to adopt a rule that is discriminatory and inconsistent with the environmental protection goals of the state on the unsupported premise that "most companies would suffer little detriment."

Impact on plant investment decisions

The Analysis states that it seems unlikely that the availability of margin reserve alone is the critical factor between a utility's building an undersized or an efficiently sized plant. We found that utilities do, in fact, consider PSC rate making policy in making plant investment decisions. Where rate recovery is unlikely, utilities are expanding in smaller increments and the result is that costs are greater to customers in both the short- and long-term.

Imputation of CIAC

The Analysis does not analyze or question the policy of imputing CIAC on margin reserve, but assumes it will be continued. The negative impacts of imputation of CIAC has been discussed in great detail in exhibits and testimony presented in support of the FWA's proposed rule.

AFPI

The Analysis states that AFPI was developed "to avoid penalizing utilities for building larger plants when larger plants may minimize total long-term costs to customers and to avoid unduly burdening current customers with costs of excess capacity." And further, "AFPI is intended to remove disincentives to build larger facilities." We found that AFPI has not succeeded in providing such incentives. In fact, utilities are choosing to expand plants in relatively small increments in response to used-and-useful and margin reserve policies of the PSC.