BEFORE THE PUBLIC SERVICE COMMISSION
OF THE STATE OF DELAWARE

IN THE MATTER OF THE PETITION OF UNITED WATER DELAWARE INC. FOR APPROVAL OF ACCOUNTING TREATMENT TO DEFER AN EXTRAORDINARY INDUSTRIAL REVENUE LOSS (FILED MAY 7, 2010)	))))))	PSC DOCKET NO. 10-171

ORDER NO. 7838

This 21st day of September, 2010, the Commission determines and Orders the following:

1. On May 7, 2010, United Water Delaware Inc. ("United" or the "Company") filed a "Petition of United Water Delaware Inc. for Approval of Accounting Treatment to Defer an Extraordinary Industrial Revenue Loss" (the "Petition"). By the Petition, United seeks Commission approval to track and defer a loss in revenue associated with a reduction in water usage at the Delaware City Refinery (the "Refinery"), formerly owned by Valero Energy Corporation ("Valero"). The Commission denied the Petition at its regularly scheduled Commission meeting on August 17, 2010 (4-1; Com. Winslow voting nay). This is the Commission's Order setting forth its decision denying the Petition.

BACKGROUND

2. In September 2009, the Commission approved a settlement of the Company's most recent base rate case. *See* PSC Docket No. 09-60 (PSC Order No. 7637). The settlement provided United with $1.7 million of its requested $3,477,637 in additional annual revenue. (*See* Settlement Agreement (attached to Order No. 7637), ¶2). The

settlement also provided for a stipulated 10% return on common equity ("ROE"). (*Id.*).

3. United claimed that within two months of approval of the settlement of the rate case it became aware that Valero was curtailing business at the Refinery. (Petition, ¶6). Using actual figures from January through April, United calculated $852,722 in projected 2010 revenue for Valero. (*Id.*, ¶7). According to United, this represented an extraordinary decline in projected revenues from the $1,901,352 that "was determined" for Valero in the rate case. (Petition, ¶5).[1] In support of its claim that the loss is extraordinary, United asserted that the decline constituted a 55% decrease in the amount assumed for Valero and a 4.2% decrease in total revenue. (*See Id.*, ¶¶6-7).[2]

4. The Company recognized that the loss was, and would continue to be, mitigated by a corresponding reduction in taxes and variable production costs for power and chemicals. (*Id.*, ¶8). The Company estimated a total savings of $241,524 from the shutdown. (*See id.*, Ex. B). The Company claimed that the anticipated lost revenue would not be offset by an increase in revenue from other customers.

[1] As is typical, the parties did not settle all of the disputed issues, but rather agreed upon a total revenue requirement, an increase in revenue, and an ROE. Accordingly, the Commission did not make any findings regarding the issues that may or may not have been disputed among the parties, including revenue requirements for specific customers. Thus, United's allusions to the contrary, this "black-box" settlement did not include any *Commission determination* regarding an appropriate revenue requirement for the Refinery.

[2] The approved total revenue requirement from the rate case was $25,170,674. *See* Settlement Agreement, ¶ 1. A reduction in revenue of $1,048,810 ($1,901,532 claimed for Valero less the projected 2010 revenue of $852,722) is approximately 4.166% of that amount.

(*See id.*, ¶9 and Ex. C). The Company calculated an estimated ROE of 8.77% due to the estimated loss of Valero. (*Id.*, ¶10).

5. Although the Company claimed that it was not currently seeking ratemaking treatment, it indicated that it will seek to recoup the lost revenue in the next rate case, which it plans to file in the first half of 2011. (*Id.*, ¶ 13).

6. Commission staff ("Staff") filed an objection to the Petition, arguing primarily that United's Petition requested retroactive ratemaking. Staff also noted that any deficiency in revenues could be addressed in United's planned rate case. The Division of the Public Advocate (the "DPA") joined in Staff's objection, reiterating that United's request violated the fundamental ratemaking principle that rates are set prospectively.

7. United filed a reply to the objections (the "Reply"), asserting that it was seeking accounting treatment only, not ratemaking treatment – retroactive or prospective – and therefore the Commission need not decide whether its request sought retroactive ratemaking. (*See* Reply, ¶4). United claimed, however, that even if it was seeking ratemaking treatment, there was no violation of the retroactive ratemaking prohibition because its anticipated loss revenue was both "extraordinary" and "nonrecurring" and therefore fell within an exception to the retroactive ratemaking prohibition. (*Id.* at ¶¶ 6-10).

8. United also updated the projections contained in its Petition to include actual figures from May and June. As updated, United's estimated 2010 revenue for Valero is $619,608 (or a

$1,281,924 loss), representing an estimated 5.1% total revenue loss and an ROE of 8.49%. (*See* Reply, ¶ 2, Exs. A and D). United's updated savings in variable costs for power and chemicals, as well as avoided tax liability, now totals $295,206. (*Id.*, Ex. B).

9. As stated above, the Commission heard argument on the matter during its meeting on August 17, 2010 and voted to deny relief.

DISCUSSION

10. Before addressing whether United's Petition seeks approval of prohibited retroactive ratemaking, it is helpful to reiterate certain basic utility rate-making principles. One fundamental rule is that, generally, rates are set prospectively and may not be designed to recoup past losses. *See Public Service Commission v. Diamond State Telephone Co.*, 468 A.2d 1285, 1298 (Del. 1955) ("A pervasive and fundamental rule underlying the utility rate-making process is that 'rates are exclusively prospective in application and that future rates may not be designed to recoup past losses' in the absence of express legislative authority.") (citations omitted). "The rationale for this principal is that the Commission acts in a legislative capacity in exercising its rate making authority; that rate making orders have statutory effect; and, that, as such, they are subject to the rules ordinarily applied in statutory construction. *Diamond State*, 468 A.2d at 1298-99 (citations omitted); *see also Matter of the Application of Diamond State Telephone Co.*, 113 A.2d 437, 442 (Del. 1955) ("The fixing of rates which a public utility will be permitted to charge is generally considered to be a legislative act."); *Matter of the Pet. of Elizabethtown Water Co. for an Increase in Rates*, 527

A.2d 354, 360 (N.J. 1987) ("By its nature legislative action operates prospectively and not retroactively."); *Popowsky v. Pennsylvania Public Utilities Commission*, 642 A.2d 648, 650 (Pa. Cmwlth. Ct. 1994) ("Ratemaking, by its nature, is prospective.").

11. In setting prospective rates, the "the normal ratemaking method followed is one which equates revenue requirement (or cost of service) with the total of: operating expenses, depreciation, taxes and a reasonable rate of return allowance on the utility's investment in rate base." *Matter of the Application of Artesian Water Company, Inc. for an Increase in Water Rates*, Findings, Order and Opinion No. 3274 (PSC Docket No. 90-10) (May 28, 1991), 1991 Del. PSC Lexis 12, *18 (Del. P.S.C.). The rates set afford a utility a "*reasonable prospective opportunity* to meet the revenue requirement developed from this regulatory equation." *Id.*

12. Like most jurisdictions, rates in Delaware are based upon a "test period" level of revenues and operating expenses, which may be adjusted for certain known and measureable changes. Under our regulations, a "test period" is a period consisting of "twelve months ending at the end of a reporting quarter utilized by the utility to support its request for relief." *See* Section 1.2.2.1 of the Minimum Filing Requirements for All Regulated Companies Subject to the Jurisdiction of the Public Service Commission ("MFRs"), 26 Del. Admin. C. §1002-1.2.2.1. Major Utilities, such as United, may choose an historic test period or partially projected (up to nine months

projected) test period. *See* MFR, §1.2.2.1.[3] In either case, comparing revenues and expenses from the same period is crucial, as it ensures adherence to the matching principle – that "the relationship of rate base, revenues and expenses be within the same time frame when we are setting just and reasonable rates for the future." *Matter of the Diamond State Telephone Co's Application for a Rate Increase*, Order No. 3713 (Docket No. 92-47), 1993 Del. LEXIS 22, *9 (Del. P.S.C.).

13. Retroactive ratemaking runs counter to these fundamental principles because it seeks the "imposition on future rates of a surcharge to recover a utility's past losses from past services." *Diamond State*, 468 A.2d at 1298. Thus, for instance, in the *Artesian* case, we held that the prohibition against retroactive ratemaking barred Artesian from recovering the difference between its actual rate case expense and what was estimated in its previous rate case. 1991 Del. PSC Lexis 12, *18. We noted that the "rate setting process provides no guarantee that a utility will recover all of its actual expenses from its ratepayers." *Id.* at *19. As the Commission explained, the "proposition that a utility should recover on a dollar-for-dollar basis each and every expense misses the test year/test period process and conflicts with the fundamental prohibition against retroactive ratemaking in Delaware." *Id.*

[3] Major utilities are also required to provide financial and operating data for an historical "test year," which must include the actual per books results of operation for a 12-month period at the end of a reporting quarter. The test year must end no later than seven months prior to the filing of a rate application, but no sooner than one month after the final closing of the test year. MFR §1.2.1. The test period may be the same as the test year. MFR §1.2.2.1.

14. The rule against retroactive ratemaking cuts both ways. For instance, the New Jersey Supreme Court held that it was impermissible retroactive ratemaking for the New Jersey Board of Public Utilities to hold a rate increase in abeyance in order to offset previous overearnings. *Matter of the Pet. of Elizabethtown Water Co. for an Increase in Rates*, 527 A.2d 354, 360-61 (N.J. 1987). Noting that ratemaking is a legislative and prospective, the Court observed:

> Customers are constantly being added and dropped by a utility. Those who have paid their utility bills have a right to expect that they will not be surcharged for the same service at a later date. New customers should not be called on to pay a present surcharge for service rendered prior to their becoming customers.
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> * * *
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> Projecting revenue, costs, and debt-service – along with rates they produce – is invariably an inexact science. Economic factors beyond the utility's control may reduce or increase revenues from the levels anticipated. The rates may prove to be too high or too low. But as this Court has noted, that 'is a risk of the business.'

Id. at 361-62 (citations and internal quotations omitted).

15. Although not specifically discussing retroactive ratemaking, the New York Commission rejected a request for recovery of lost earnings made by a company eventually acquired by United's parent company. In *Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of the New Rochelle Water Company,* Case 29201, 1986 N.Y. P.U.C. Lexis 207 (May 5, 1986), New Rochelle Water Company requested a three-year amortization of $901,049 in lost revenue caused by drought restrictions. The company claimed that the

lost revenue was analogous to an extraordinary expense or property loss. The hearing examiner recommended denial of the requested recovery, explaining:

> The basic distinction [between recovery of extraordinary expenses or property loss and recovery of lost revenue] is that a ratepayer benefit or public interest is the underlying (if not always explicit) rationale for extraordinary expense or property loss treatment because the recoupment authorized is in contemplation of and directly related to the future or continued adequate provision of utility service at just and reasonable rates. For example, extraordinary storm damage expense cited by the Company is allowed to be recovered over time not only because of the financial effect on the utility's earnings, but because service restoration costs are incurred for the direct benefit of the utility's customers…. Thus, while in such instances, the allowance seeks to indemnify the utility or its stockholders for a prior event, a direct ratepayer benefit is nonetheless intended. Such benefit is consistent with the public interest because of the potential effect of (non-recoupment for) that event on utility service to be rendered either in the future or in the near term period which rates are being set…. Moreover, New Rochelle overlooks – in essentially characterizing the two prior years of revenue overcollections to which Staff points as either irrelevant, non-comparable or overstated – that just as its stockholders derive the exclusive benefit of any such overcollections as a quid pro quo for its business risks, the risk of unforeseen revenue shortfalls is theirs exclusively, except possibly where the loss is catastrophic to the extent that the utility's ability to render safe and adequate service is likely to be impaired.

New Rochelle, 1986 N.Y. PUC Lexis at *15 (footnotes omitted). The N.Y. Commission upheld the hearing examiner's rejection of the requested allowance, stating that "'deferred ratemaking recognition of unanticipated losses or expenses is an extraordinary remedy that is reserved for cases where a compelling financial need is

demonstrated.'" *Proceeding on Motion of the Commission as to the Rates, Charges, Rules and Regulations of the New Rochelle Water Company,* Case 29201, 1986 N.Y. P.U.C. Lexis 41 (Jul. 31, 1986).

16. United urges the Commission to ignore the fact that any request for actual recovery of the lost revenue due to the Refinery shutdown might constitute retroactive ratemaking, simply because it is not – at this time – actually requesting recovery. It states that all it "is seeking is accounting treatment that will enable all interested parties to track the impact of the Refinery shut down on [United] and put them in a position on [sic] the next rate case to have an accurate accounting and sufficient facts to determine the appropriate ratemaking treatment at that time." (Reply, ¶5). The issue is not that simple.

17. Just because a utility is not seeking actual recovery of an expense (here lost revenue) in seeking approval of deferred accounting treatment does not mean that the Commission applies no standard. Indeed, in a matter involving a previous United request for deferred accounting (there, an expense) we stated that we should exercise our authority to approval deferrals "sparingly" and only where "necessary." *See Matter of the Application of United Water Delaware for an Increase in Water Rates and Other Tariff Changes*, PSC Order 4383 (PSC Docket No. 96-164) (1/7/97), 1997 Del. PSC Lexis 98, *6 (Del. P.S.C). There, United claimed that it learned of a proposed increase in bulk rates charged by the Chester Water Authority (the "CWA") shortly after it filed a petition to increase base rates. The proposed CWA increase was subject to approval in Pennsylvania, and, if

approved, would have increased United's purchased water expense by $101,494, $44,454 of which would have been incurred by United during the 60-day period United's proposed rate increase was suspended by the Commission under 26 *Del. C.* §306(a)(1).[4] United then filed a petition seeking deferred accounting for what it characterized as an unanticipated increase in its purchased water expense and the amortization of the increased amount as recoverable expenses for ratemaking purposes. *Id.* at *2. Staff and the DPA objected, pointing out that United could adjust its test period purchased water expense for a known and measurable change if the CWA's proposed increase was approved in Pennsylvania. Both objected to the request for deferred accounting and amortization of the $44,454 incurred in the suspension period, since the amount "was not so large as to threaten real financial harm to the utility." *Id.* at 3.

18. The Commission, in a unanimous vote, agreed with the objections and denied deferred accounting and amortization of the increased expense. First, the Commission noted that

> Ratemaking is normally forward-looking: a utility's rates are set for the future based upon an analysis of historical revenues and expenses during a test year or a portion of a test period, with adjustments for annualizations,

[4] 26 *Del. C.* §306(a)(1) authorizes the Commission to suspend a proposed increase in rates within sixty days of the filing of a petition for a rate change for a period not to exceed seven months. Utilities are, in turn, permitted to implement a certain percentage of a requested increase sixty days after filing the petition by posting a bond. Thus, typically, there is a 60-day period following a rate case filing where the utility is permitted no increase – referred to as a "suspension period."

> normalizations, and known and measureable changes. As such the ratemaking procedure does not look to adjust for past losses or gains to either the utility or consumers.

Id. at *4. The Commission recognized, however, that

> the Commission may, in some instances, authorize the deferral of costs not included in previously approved rates for consideration in a subsequent rate case. However, because such deferred accounting treatment goes against traditional principles of ratemaking, the Commission believes that this authority should be exercised *sparingly* and only in situations where it is *necessary*.

Id. at *5 (emphasis added). In a footnote, we elaborated that "deferred accounting orders tend to be single-issue focusing on isolated expenses without scrutiny of other fluctuations." *Id.* We noted that "such ratemaking treatment asking for deferral of costs from one period to a subsequent rate case challenges the matching principle which normally seeks to insure a matched review of both costs and revenue for an indentified period of time." *Id.* With those principles in mind, we concluded that, while the amount of money paid by United during the suspension period was not "trivial," United had failed to demonstrate that its failure to recover such amounts would "seriously threaten the financial integrity of the utility or is not the type of shareholder risk accounted for in other ways in the ratemaking formula." *Id.* at *6.

19. While United's estimated approximately $1 million net revenue loss from the shutdown of the Refinery is not trivial (indeed, it greatly exceeds the $44,454 at issue in *Application of United*), United has failed to allege in this case, much less demonstrate, that that revenue loss will seriously threaten its financial integrity. To

the contrary, the Company greatly downplayed any impact that the Commission's decision on its Petition may have. For instance, counsel for United asserted during argument that the requested accounting treatment for United "would have no impact on the financial statement of the parent company" and that "the amount at issue here is not material at that level." (Aug. 17, 2010, Hearing Trans., pp. 20 and 23). In any event, there does not appear to be any serious threat to United's financial integrity, nor does its anticipated loss appear to be "so catastrophic to the extent that the utility's ability to render safe and adequate service is likely to be impaired." *New Rochelle*, 1986 N.Y. PUC Lexis at *15 (footnotes omitted). United's own projections show that it may earn a 8.5% ROE, compared to the 10% that it was *permitted an opportunity to earn* in its last rate case. In this present economy, such a return can hardly be considered a serious threat to financial integrity.

20. In denying recovery of United's request for deferred accounting, we are also mindful of applicable accounting standards. As the Company conceded during argument, its request for deferred accounting is a request for the establishment for a regulatory asset. The recording of a regulatory asset under applicable accounting standards presupposes that it is "probable" or "likely" that the regulator will allow recovery of that asset in rates at some future date. For instance, the Uniform System of Accounts for Class A Water Utilities, established by the National Association of Regulatory Commissioners ("NARUC"), defines "regulatory assets and liabilities," in part, as:

> assets and liabilities that result from rate actions of regulatory agencies. Regulatory assets and liabilities arise from specific revenues, expenses, gains or losses that would have been included in one period under the general requirements of the Uniform System of Accounts but for it being *probable* that[:] (1) such items will be included in a different period(s) for purposes of developing the rates the utility is authorized to charge for its utility services….

Uniform System of Accounts, Definition 27 (emphasis added).[5] Regulatory assets are to be included in Uniform System of Account 186.3, which states in part "A" that "[t]his account shall include the amounts of regulatory-created assets, not included in other accounts, resulting from the ratemaking actions of regulatory agencies." Part "B" then describes the amounts that should be included in the regulatory asset account, mimicking the definition quoted above, again emphasizing that future recovery be "probable." Uniform System of Accounts, Account 186.3.

21. Similarly, Financial Accounting Standards ("FAS") No. 71 (now codified as 980-10), established by the Financial Accounting Standards Board ("FASB") to provide guidance in preparing financial

[5] United is required to file annual financial statements based upon the accounts set out in the Uniform System of Accounts. 26 Del. Admin. C. §2001 (Minimum Standards Governing Service Provided by Water Companies), §2.4.8.; *see also* 26 *Del. C.* §208 (authorizing the Commission to prescribe systems of accounts and records to be kept by public utilities and to classify utilities and prescribe a system of accounts and records for each class.).

statements for public companies, sets forth a similar definition – and treatment – of regulatory assets. FAS71 states:

> 9. Rate actions of a regulator can provide *reasonable assurance* of the existence of an asset. An enterprise shall capitalize all or part of an incurred cost that would otherwise be charged to expense if both of the following criteria are met:
>
> a. It is *probable* that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable cost for rate-making purposes.
>
> b. Based on available evidence, the future revenue will be provided to permit recovery of the previously incurred cost rather than to provide for expected levels of similar future costs. If the revenue will be provided through an automatic rate-adjustment clause, this criterion requires that the regulator's intent be to permit recovery of the previously incurred cost.

FASB 71, §9 (emphasis added).

22. By seeking, and then recording, the revenue loss from the Refinery shutdown as a "regulatory asset", United would be indicating to the financial community that such a loss is an asset that it "probably" will recover in the future, here, in its next rate case, which it plans to file next year. The Commission will not, and need not, make any determination of the appropriateness of recording the anticipated lost revenue as a regulatory asset, where, as here, the Commission is not itself convinced of the asset's "probable" recovery. To the contrary, as discussed during our deliberations in this matter, far from being probable that United will recover this amount, it is, in fact, unlikely.

23. The cases cited by United in support of its claim that even if it were seeking ratemaking treatment, its request would fall within an exception to the prohibition against retroactive ratemaking, are not on point. The two Chesapeake Utilities cases, *Matter of the Application of the Delaware Div. of Chesapeake Utilities Co.*, 1995 Del. PSC LEXIS 164 (Del. P.S.C.), *Matter of the Application of Chesapeake Utilities Co.*, 1986 Del. P.S.C. LEXIS 6 (Del. P.S.C.), are base rate case decisions and did not involve the issue or retroactive ratemaking. The primary issue in those cases was whether environmental clean-up costs should be considered normal operating expenses. In *Integrated Resource Planning*, 2006 WL 4535235 (Del. P.S.C. Aug. 8 2006), we ordered that Delmarva Power & Light be permitted to defer and recover costs incurred in connection with the IRP process; however, the statute requiring Delmarva to engage in the IRP process *required* the Commission to allow such recovery. *See* 26 *Del. C.* §1007(c)(1)d ("The costs that DP&L incurs in developing and submitting its IRPs shall be included and recovered in DP&L's distribution rates."). Finally, the two *PPL Electric Utilities* decisions are likewise unhelpful to United. Both cases allowed deferral of expenses incurred by PPL Electric in repairs associated with Hurricane Isabel and significant ice and snow storms. In both of those decisions, the Pennsylvania P.U.C. emphasized that the authorization for deferred accounting was no assurance of future rate recovery. *PPL Electric Utilities Corp*, 2005 WL 2217432, *5 (Pa P.U.C.); *PPL Electric Utilities Corp*, 2004 WL 578733 (Pa P.U.C.). Apparently, PPL required regulatory approval of deferred accounting in

those cases because applicable FERC accounting rules require state regulatory approval of deferrals of items that constitute less than 5% of income. *PPL Electric*, 2004 WL 2217432, *2; *PPL Electric*, 2005 WL 2217432, *4. Here, unlike those cases, United has failed to show why Commission approval is required for it to defer the lost revenue other than the fact that it wants to establish a regulatory asset, which, again, *is an assurance of future recovery*. This, we will not allow.

NOW THEREFORE, IT IS ORDERED BY THE AFFIRMATIVE VOTE OF NOT FEWER THAN THREE COMMISSIONERS:

For the foregoing reasons, the Commission hereby denies the Petition of United Water Delaware Inc. for Approval of Accounting Treatment to Defer an Extraordinary Industrial Revenue Loss, filed May 7, 2010 (4-1; Com. Winslow voting nay).

BY ORDER OF THE COMMISSION:

/s/ Arnetta McRae
Chair

/s/ Joann T. Conaway
Commissioner

/s/ Jaymes B. Lester
Commissioner

/s/ Dallas Conaway
Commissioner

/s/ Jeffrey J. Clark
Commissioner

ATTEST:

/s/ Alisa Carrow Bentley
Secretary