

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Application for staff- ) DOCKET NO. 950641-WU  
assisted rate case in Palm Beach ) ORDER NO. PSC-96-0357-FOF-WU  
County by Lake Osborne Utilities ) ISSUED: March 13, 1996  
Company, Inc. )  
\_\_\_\_\_ )

The following Commissioners participated in the disposition of this matter:

SUSAN F. CLARK, Chairman  
J. TERRY DEASON  
JOE GARCIA  
JULIA L. JOHNSON  
DIANE K. KIESLING

ORDER GRANTING TEMPORARY RATES IN THE EVENT OF A PROTEST  
AND  
NOTICE OF PROPOSED AGENCY ACTION  
ORDER IMPLEMENTING USE OF OPERATING RATIO METHODOLOGY  
ESTABLISHING THRESHOLD CRITERIA FOR APPLICABILITY OF  
OPERATING RATIO METHODOLOGY  
AND  
APPROVING INCREASED RATES AND CHARGES

BY THE COMMISSION:

NOTICE IS HEREBY GIVEN by the Florida Public Service Commission that the action discussed herein is preliminary in nature except for our granting of temporary rates in the event of a protest, and ordering Lake Osborne Utilities Company, Inc. to maintain its books and records in conformity with the 1984 NARUC Uniform System of Accounts, 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.

BACKGROUND

Lake Osborne Utilities Company, Inc. (LOU or utility) is a Class C water utility operating in Palm Beach County. The system serves approximately 464 customers. In October, 1972, the Commission granted a transfer of Certificate No. 53-W from Joseph D. Farish, Jr., d/b/a Lake Osborne Utility Company, to Lake Osborne Utilities Company, Inc. On November 5, 1974, the utility connected its existing distribution system to the City of Lake Worth Water Authority. At this time, the utility ceased operating its own water treatment facility. The utility has had two general rate increases, one in 1974 (Order No. 6164) and the other in 1983

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(Order No. 11967). The utility has also had several index increases (in 1978, 1991, 1992, 1993 and 1994).

On June 13, 1995, the utility applied for the instant staff assisted rate case and included in its application a request for an emergency rate increase. By Order No. PSC-95-1037-FOF-WU, issued August 21, 1995, the request for emergency rate relief was approved.

We have audited the utility's records for compliance with Commission rules and orders and have determined all components necessary for rate setting. We have conducted an engineering field investigation of the utility's water plant and the service area. A customer meeting was held in the service area on November 8, 1995.

We selected an historical test year ended June 30, 1995. During that period, the utility's books reflected unaudited operating revenues of \$91,571 for water. The utility recorded unaudited net operating losses of \$56,650.

This utility is within the South Florida Water Management District (SFWMD) and is operating under the consumptive use permit granted to the City of Lake Worth Water Utility as a bulk customer. LOU is in a "defined critical water supply problem area." SFWMD and the City of Lake Worth Water Utility have been notified that the utility has filed for a change in rates.

#### OPERATING RATIO METHODOLOGY

We have decided that rates shall be determined for this utility by an operating margin rather than by the traditional rate base method. Rule 25-30.456, Florida Administrative Code, on alternative rate setting, effectively allows for the operating ratio method. We are implementing this methodology for the first time herein.

#### Authority to Implement on Commission's Own Motion

Section 367.0814(7), Florida Statutes, provides that the Commission may by rule establish standards and procedures for setting rates and charges of small utilities using criteria other than those set forth in Sections 367.081(1), (2) and (3), Florida Statutes. Rule 25-30.456, Florida Administrative Code, provides, in part, as an alternative to a staff assisted rate case as described in Rule 25-30.455, Florida Administrative Code, that water utilities whose total gross annual operating revenues are

\$150,000 or less per water or wastewater system may petition the Commission for Staff assistance in alternative rate setting.

The utility did not petition the Commission for alternative rate setting under the aforementioned rule. Nevertheless, we find that we have the authority to employ the operating ratio method upon our own motion. Pursuant to Section 367.0814(3), Florida Statutes, the provisions of Sections 367.081(1), (2) and (3), Florida Statutes, shall apply in staff assisted rate cases. Section 367.081(2)(a), Florida Statutes, provides, in part, that the Commission, either upon request or upon its own motion, shall set just, reasonable and compensatory rates. Further, Section 367.121, Florida Statutes, states that "[i]n the exercise of its jurisdiction, the Commission shall have power to prescribe fair and reasonable rates and charges." Chapter 367, Florida Statutes, does not contain an express prohibition against the Commission setting rates upon its own motion. Specifically, the Legislature did not limit the Commission to the use of rate base regulation in its authority to set rates upon its own motion. In fact, the Legislature has given us the exclusive authority over rates. See Section 367.011(2), Florida Statutes. Accordingly, we find that, upon our own motion, we have the authority to employ non-rate base forms of regulation for Class C utilities as contemplated in Rule 25-30.456, Florida Administrative Code.

#### History of Operating Ratio Methodology

By implementing Section 367.0814, Florida Statutes, we believe the Legislature recognized that the segment of the water and wastewater industry comprised of Class C utilities is significantly different from the remainder of regulated utilities. Subsequently, the Legislature augmented the statute by including language permitting the Commission to implement other than rate base regulation under that statutory authority provided the Commission promulgated rules to cover it. In implementing Rule 25-30.456, Florida Administrative Code, the Commission established an alternative to the traditional staff assisted rate case. Section 12 of the Rule provides that the "Commission shall, for the purposes of determining the amount of rate increase, if any, compare the operation and maintenance expenses (O&M) of the utility to test year operation revenues."

Rule 25-30.456, Florida Administrative Code, was designed to address a different issue other than that of small or negative rate base. The rule was tailored to provide a more timely response than a traditional staff assisted rate case; that is, to provide rate relief within 90 days. Additionally, the existing rule limits the amount of the increase allowed to 50% of existing revenues.

#### Impact of Operating Ratio Method on CIAC

Our Staff has researched whether the customer's contribution-contributions-in-aid-of-construction- (CIAC) is properly recognized in the operating ratio method. Although the perception may be that the operating ratio method ignores CIAC, our analyses in Schedule 5 indicate just the opposite. CIAC contribution levels of 0%, 75% and 100% were analyzed for two different sized utilities, one serving 150 customers and the other serving 500 customers. Under traditional rate base regulation, a comparison of monthly bills at 0% CIAC versus 75% CIAC shows significantly lower rates when the customer pays CIAC. This benefit of CIAC remains in the form of lower depreciation expense and net operating income even if an operating ratio method is implemented in a later year. Assuming a fully "built out" utility at inception and a 75% CIAC level, the operating ratio method would not be implemented until the 13th year for both utilities. Thereafter, the operating ratio method would produce moderately higher rates. Even when assuming a 100% CIAC level and implementing the operating ratio method in the first year, the operating ratio method rates are significantly lower than rate base rates under the 0% CIAC scenario. This shows that the customers retain much of the benefit of CIAC under operating ratio method rates. It is also interesting to note that operating ratio method rates at the 100% CIAC level, although higher than rate base rates at that level, are lower than rate base rates at the 75% CIAC level. In conclusion, the benefits of CIAC to the customer are neither ignored nor nullified when the operating ratio method is implemented.

#### Impact of Operating Ratio Method on Rate of Return

Another perception or concern is that the operating ratio method will unjustly enrich the utility owner through an excessive rate of return. This perception is understandable given the preoccupation with rate base regulation; however, it fails to recognize the transition in risk that occurs when rate base falls below the level of O&M expense. Low or nonexistent rate base does not eliminate the need for an adequate margin to maintain viability in the face of uncertainty. The operating ratio method recognizes that a major issue for small utilities is cash flow, therefore, the operating ratio method focuses more on cash flow than on investment. For a variety of reasons, as noted above, many Class C utilities are owned and operated by individuals that have very little of their own investment in the assets of the utility. This, however, does not eliminate the risk of owning and operating the utility, nor does it reduce the need to provide a sufficient cash flow to the utility to allow the utility to operate.

The issues facing LOU and others in similar circumstances are those of cash flow and, equally as important, inadequate margin to allow for capital replacement and the inability to sustain significant unanticipated expenses such as line breaks, pump failures, etc. As a practical matter, these needs continue in the absence of a return component due to lack of rate base. We believe the operating ratio method may provide a mechanism to address this issue.

#### Use of Operating Ratio Method for Qualified Class C Utilities

For the reasons discussed herein, we shall consider approving the application of Rule 25-30.456, Florida Administrative Code, for any qualified Class C utility that it may benefit. Our staff shall recommend an evaluation of the effectiveness of the operating ratio method in approximately 24 months. During the 24 month period, we shall conduct biannual evaluations of each utility, including an audit of the utility's expenses and a site visit by a member of our engineering staff. At the conclusion of the two year period, our staff shall make an evaluation and recommendation as to whether a rule revision or a new rule is appropriate to clarify qualification criteria and make other necessary changes.

#### Criteria for Determining Use of Operating Ratio Method

There are many factors involved in deciding whether or not to set revenue requirement using the operating ratio method. We do not believe it is necessary or possible to identify every situation that may arise affecting this decision. We therefore find it necessary to grant a great deal of flexibility within the criteria during the evaluation period. This will require a regulatory focus that does not rest solely on capital cost recovery.

Assuming that a utility is charged with the responsibility to provide safe and reliable service to its customers, the goal of ratemaking is to provide the funds needed to meet that objective. The question is whether or not traditional rate base regulation will enable the utility to meet its responsibilities. The answer to this question requires an assessment of the utility's cash flow needs. Unfortunately, in this industry, and for small utilities in particular, the appropriate cash flow level can be extremely difficult to quantify. What is known is that a utility, like any other business, needs an adequate margin of revenues over expenses in order to remain viable.

Without an evaluation of the facts specific to the case, it will be difficult to determine whether or not a utility should qualify for the operating ratio method. We shall perform an

initial screening of utilities using the following threshold criteria. Utilities failing to pass this initial screening will not be eligible for the operating ratio method.

#### Threshold Criteria

##### Whether utility's O&M expenses equal or exceed rate base

Because the operating ratio method substitutes O&M for rate base in calculating the rate of return, a utility generally would not benefit from the operating ratio method if rate base exceeds O&M. Moreover, the premise of the operating ratio method is that the decision of whether or not to use it depends on the determination of where the primary risk resides, in capital related costs or in operating expenses. If the utility's capital exceeds its expenses, the assumption is that covering capital costs represents the primary risk and the rate base method should be used.

##### Whether the utility is expected to become a Class B in the foreseeable future

Chapter 367.0814(7), Florida Statutes, presently permits alternative forms of regulation to Class C utilities only. Allowing the operating ratio method for a utility on the verge of becoming a Class B might subject the utility to overearnings action and rate reductions when Class B status is reached. If we find that a utility will reach Class B status in the foreseeable future, within approximately the next five years, it will be ineligible for the operating ratio method. We will determine potential Class B utilities by analyzing revenue and growth levels.

If a utility qualifies for operating ratio method consideration under the above threshold criteria, other factors, such as the ones that follow, shall be considered in determining eligibility for the operating ratio method. These factors are not all-inclusive; others may arise as specific circumstances of a particular utility are revealed.

#### Other Factors

##### Quality of service and condition of plant

Poor condition of plant and/or unsatisfactory quality may be due to a variety of factors such as age of the system, poor maintenance, neglect or malfeasance. These factors shall necessarily disqualify the utility from the operating ratio method. Rather, they highlight the need for an adequate revenue stream to

properly test and treat the water and maintain/renovate the system. In those cases where the owner has contributed to the system's decline, it may be appropriate to pursue certificate revocation and/or an escrow of operating ratio method funds when improvements are needed to restore the utility system.

Whether the utility is developer owned

Being developer owned shall not, in itself, disqualify a utility from the operating ratio method. However, if a developer owned utility is in the early stages of growth, it may be inappropriate to grant the operating ratio. Other factors to consider would be the rate of customer growth, the developer's financial condition (sources of developer funds), the utility's financial and operational condition, government mandated improvements and/or other unanticipated expenses. The level of CIAC collected or plant written off for tax purposes shall also be considered. Rather than setting the criteria in stone at this point, the eligibility of developer owned utilities shall be determined on a case-by-case basis.

Whether the utility operates treatment facilities or is simply a distribution and/or collection system

The issue is whether or not purchased water or wastewater costs should be excluded in the computation of the operating margin. The question may come down to the actual dollar amount of the operating margin that would result under either scenario. It should be noted that even purchase treatment costs have an element of risk due to regulatory lag and pass-through frequency limitations. If excluding certain costs produces too small of a operating margin to provide safe and reliable service, it may be appropriate to include these costs. This shall be determined on a case-by-case basis.

These criteria allow some flexibility so that the individual circumstances of the utility can be evaluated. The key issue continues to be identifying the utility's operational and capital needs and applying the appropriate regulatory framework to meet them.

RATE OF RETURN (MARGIN)

The key element in the operating ratio methodology is the rate of return or margin that should be allowed. The purpose of the return is to provide an appropriate margin to pay any debt interest and to cover revenue and expense variances. The margin is obtained

by multiplying operation and maintenance expense by the margin percent, or rate of return.

There appears to be no legal or economic guidance in the determination of an operating ratio. This explains why a number of states use widely different margins. In essence, each of the margins used by these states could be considered arbitrary. California uses a rate of return factor between 14 and 20 percent. North Carolina uses a margin based on the five year U.S. Treasury Notes plus 3 percent for risk. South Carolina margin ranges from break even to 12 percent, depending on the utility's request. Kentucky has been using a margin of roughly 12 percent for over sixteen years. Kentucky also allows dollar-for-dollar coverage for short-term interest. Pennsylvania permits a ratio of between 20 and 25 percent in calculating the operating margin. Michigan allows a margin based on an average rate of return authorized for all industries.

Since there is a lack of economic guidance on developing an operating ratio method rate of return, we believe that it would be a futile and unwarranted exercise to try to establish a precise return applicable to all small utilities. The important question is not what the return percentage should be, but what level of operating margin will allow the utility to provide safe and reliable service and remain a viable entity. The answer to this question requires a great deal of judgment based upon the particular circumstances of the utility. For this reason, we find it appropriate to establish a guideline margin of 10%. This margin shall be used unless a utility's unique circumstances justifies the use of a greater or lesser margin.

It may be appropriate, for example, to apply a margin greater than 10% in the case of a fully depreciated system where there would be an expectation of greater than average volatility in repair and maintenance costs. If this system has only \$5,000 in operation and maintenance expense, a 10% margin (\$500) may be inadequate. The cost of permit renewals or line and pump repairs usually exceed that amount. The circumstances of other utilities may dictate the granting of a margin less than 10%. We find it appropriate that the margin remain flexible and that we make our findings on a case-by-case basis.

Therefore, we find that during the two year evaluation period, a margin of 10% shall be used unless unique circumstances justify the use of a greater or lesser margin. We also find it is reasonable and prudent to limit the dollar amount of margin until more experience is gained. Therefore, we find it appropriate to cap operating margin at \$10,000.



APPLICATION OF OPERATING RATIO METHOD TO LAKE OSBORNE

As discussed earlier, there are many factors involved in deciding whether to implement an operating ratio method. The following illustrates how Lake Osborne Utilities Company, Inc. fits these criteria:

Threshold Criteria

Whether utility's operation and maintenance expenses exceed rate base

In the instant case, the rate base is substantially lower than the level of operation and maintenance expense. Based on the audit report, the rate base for the test year was \$17,446. Test year operation and maintenance expense was \$95,091. Even without the inclusion of purchased water costs (\$58,169), the O&M is twice the level of rate base. Considering the argument that the operating ratio method is designed to recognize that a majority of corporate risk originates from operating expense versus capital cost, we find that this utility satisfies the criteria that utility O&M is significantly greater than rate base. Low rate base in this case is the result of depreciation (system age) and plant retirements. As this utility is at full capacity and there are no anticipated plant additions, other than repairs, we do not find that the level of rate base will materially increase.

Strict adherence to rate base regulation for this utility will fail to recognize the transition in risk from rate base to operating expense. As an analysis of the O&M for this utility indicates, expenses greatly outweigh the level of rate base. We find that the risk for this utility has shifted from capital costs to operating expense.

Whether the utility is expected to become a Class B in the foreseeable future

According to Chapter 367.0814(7), Florida Statutes, the alternative forms of regulation being considered in this case apply to Class C utilities only. To allow operating ratio method for a utility on the verge of becoming a Class B could subject the utility to overearnings action and rate reductions when Class B status is reached. As this utility is at full capacity and the proposed revenue requirement is substantially below the threshold level for Class B status (\$150,000 per system), we find that this utility will not become a Class B utility in the foreseeable future.

Other Factors

Quality of service and condition of plant

As mentioned earlier, the poor condition of plant and/or unsatisfactory quality can be due to a variety of factors such as age of the system, poor maintenance, neglect or malfeasance. These factors shall not necessarily disqualify the utility from the operating ratio method, rather, they point to the need for an adequate revenue stream to properly test and treat the water and maintain/renovate the system. While this system has not experienced problems with quality of service, due to the advanced age of the delivery system and the makeup of the lines (asbestos cement) we find that this utility can look forward to increased costs related to upkeep and repairs.

Whether the utility is developer owned

The owner of this utility is not a developer. The owner does not anticipate making any additions to the system except for repairs and renovations.

Whether the utility operates treatment facilities or is simply a distribution and/or collection system

This criteria involves the issue of whether purchased water or wastewater costs should be excluded in computing the operating margin. This utility is a purchased water system, and as such, we have calculated the operating ratio method without consideration of the purchased water costs, because we find that a conservative approach is appropriate in the initial implementation of the operating ratio methodology.

In conclusion, we find that this filing meets the aforementioned criteria and that the revenue requirement shall be decided based on the operating ratio methodology. In the interest of recognizing the true risk factors that effect this utility and to provide some assurance of safe and reliable service at an aging utility, we find it is in the best interest of the ratepayers to determine the revenue requirement based on operating ratio method.

QUALITY OF SERVICE

The Staff engineer's on site investigation indicates that the system is being properly operated and maintained. The customer meeting was held on the evening of November 8, 1995. At this meeting, three customers spoke of quality of service problems. One customer made a general statement that the service was marginal but

satisfactory, with no specific problems mentioned. Another customer mentioned that some meters were not read monthly, resulting in several months of lowered payments with a sudden, unexpected large payment and that some meters were not on the owner's property. It was this customer's belief that some meters were inaccessible, perhaps covered with a bushes. Still another customer believed that the requirement for the fire hydrants to be flushed once a year was not being accomplished. It was further stated by this customer, that the fire plugs were not being properly maintained.

Our engineer's review determined that, at least for the past two years when new personnel took over the function of meter reading as well as the general "on site" management of the system, the meters have been read monthly. During this time, however, several meters have been found to be inoperative after two or more monthly readings would indicate a problem, and these meters were replaced. This would have allowed two or more months of lowered charges, then a higher one, but the customer benefitted in these cases because the meters were reading low for those months preceding the correct reading. We find that each meter is read monthly at this time. This does not contradict the customer's remarks that covered the distant past as far back as 1972.

As for the flushing out of the fire hydrants, the utility confirms that not only are they flushed annually by the fire department, but often when the system's chlorine residual is approaching the outer limits. During such conditions, the utility will flush out portions of the system, using the fire plugs as the flushing point. Finally, the complaint that the fire plugs are not maintained in a proper manner has some merit. One fire hydrant has a leak of such dimension and location that it can only be corrected by the replacement of the hydrant. The utility is seeking estimates for a replacement at this time and has promised to replace it in the near future.

Considering all of these factors, we find the quality of service provided by this utility to be satisfactory.

#### RATE BASE

Our calculation of the appropriate rate base and adjustments to rate base for the purpose of this proceeding is depicted on Schedule Nos. 1 and 1-A. Those adjustments which are self explanatory or which are essentially mechanical in nature are reflected on that schedule without further discussion in the body of this Order. The major adjustments are discussed below.

## Used & Useful Plant

### Water Distribution Plant

Billing records indicate that 464 of the total 465 connections are in service. As stated earlier, we find that the system is at full capacity, and any further development will require construction by the utility. We therefore, find that the water distribution system is 100 percent used and useful.

### Test Year Rate Base

The appropriate components of the utility rate base include depreciable plant in service, CIAC, accumulated depreciation, accumulated amortization of CIAC, and working capital allowance. Plant, depreciation, and CIAC balances were determined through the Staff audit and an original cost study was done by the Staff engineer. Further adjustments are necessary to reflect test year changes, used and useful levels, and pro forma plant. A discussion of each applicable component follows:

#### Plant in Service

##### Distribution System

On November 5, 1974, the City of Lake Worth began providing water to the utility via a metered 6 inch main. During 1976 the Lake Osborne Utilities Company, Inc., retired, disassembled and removed the water treatment plant on site at Lake Osborne Estates. The utility maintained ownership of the distribution system. To date, the distribution system constitutes the whole of the Lake Osborne Utilities Company, Inc. The distribution system consists of 1,334 feet of 8 inch pipe, 21,210 feet of 6 inch, 5,280 feet of 4 inch, 900 feet of 3 inch and 150 feet of 2 inch pipe, all cement asbestos.

The water distribution system was inspected during the engineer's evaluation and seemed to be working satisfactorily. At the time of the field investigation, no construction work was in progress.

We have reduced plant by \$245 to reclassify testing expense from plant in service, increased plant by \$346 for meter purchases that were misclassified as repairs expense and have made an adjustment of negative \$39,222 to agree current records with amounts reported in Commission Order No. 11967 and not booked by the utility. We find that plant in service totals \$118,323.

Land

The utility has no land ownership interest.

Plant Held For Future Use

Since we have found that the water distribution system is 100% used and useful, we have made no adjustment for non-used and useful plant.

Contributions-in-Aid-of-Construction

We have reviewed the CIAC balances have been reviewed and find them to be accurately stated at negative \$19,903.

Accumulated Depreciation

Consistent with Rule 25-30.140, Florida Administrative Code, we have calculated accumulated depreciation using the prescribed rates. We reduced accumulated depreciation by \$5,812 to reflect these rates and a net correction of \$11,748 has been made to account for the correction in plant in service made in accordance with Commission Order No. 11967. We find that the accumulated depreciation balance is negative \$103,688.

Accumulated Amortization

We calculated accumulated amortization of CIAC using the prescribed rates contained in Rule 25-30.140, Florida Administrative Code. An adjustment of \$896 has been made to agree booked balances with these prescribed rates. We find that amortization of CIAC totals \$10,828.

Working Capital Allowance

Consistent with Rule 25-30.443, Florida Administrative Code, the one-eighth of operation and maintenance expense formula approach shall be used for calculating working capital allowance. Applying that formula, we find that working capital allowance totals \$11,886, based on operation and maintenance expense of \$95,091.

Rate Base Summary

Based on the foregoing, we find that the appropriate balance of LOU rate base is \$17,446.

### COST OF CAPITAL

We have already established a rate of return or margin of 10% which focuses upon O&M when applying operating ratio method. A rate of return on equity is, therefore, inapplicable.

### NET OPERATING INCOME

Our calculation of net operating income is depicted on Schedules No. 3 and 3-A. Our adjustments are itemized on Schedule No. 3-B. Those adjustments which are self-explanatory or which are essentially mechanical in nature are reflected on that schedule without further discussion in the body of this Order. The major adjustments are discussed below.

### Test Year Operating Revenue

The LOU water system recorded revenues of \$91,571 during the test period. Based on a review of the test year billing analysis we have made a reduction of \$458 to agree utility revenues with production totals and an increase of \$3,017 to account for the annualization of current rate levels.

### Calculation of Revenue Requirement Using Operating Ratio Method

The objective of using an operating ratio in establishing revenue requirement is to provide a utility sufficient cash flow to meet its financial, operational and regulatory obligations. Since for low rate base utilities the principal risk resides in operating costs rather than capital related costs, the focus shifts from investment (rate base) to operating expense. With an operating ratio approach, rate base is essentially ignored in order to provide a sufficient "cushion" of revenues above operating expenses to enable the utility to meet its obligations.

Under traditional return on rate base regulation the revenue requirement is calculated as follows:

$$RR = O\&M + D + OT + IT + r(RB)$$

where: RR = revenue requirement;

O&M = operating and maintenance expense;

D = depreciation expense;

OT = other taxes (RAFTs, payroll taxes, property taxes, etc.);

IT = income tax;  
r = rate of return, and  
RB = rate base.

The return on rate base method and the operating ratio method contain essentially the same elements for determining revenue requirement. What differs is that the operating ratio method calculates the return component (margin) on operation and maintenance expenses instead of on rate base. Thus, the revenue requirement using an operating ratio shall be calculated as:

$$RR = O\&M + D + OT + IT + r(O\&M)$$

where all variables are defined as before.

The operating ratio approach is similar to the return on rate base approach in that it uses the rate of return component to provide a margin of revenues above operating expenses (operating margin). We find that this approach shall improve the financial and operational viability of low rate base utilities by providing internal funds to protect against adverse revenue and expense fluctuations.

#### Test Year Operating Expense

The utility recorded operating expense of \$148,221. The components of these expenses include operation and maintenance expenses, depreciation expense (net of related amortization of CIAC), and taxes other than income taxes.

The utility's test year operating expenses have been traced to invoices. Adjustments have been made to reflect unrecorded test year expenses and to reflect recommended allowances for plant operations.

#### Operation and Maintenance Expenses (O & M)

The utility charged \$143,951 to water O & M during the test year. Explanations of the utility's recorded expenses and Staff's recommended allowances follow:

- 1) Salaries and Wages - Employees - All expenditures for inhouse personnel are accounted for in contractual services.
- 2) Salaries and Wages - Officers - All expenditures for inhouse personnel are accounted for in contractual services.

3) Sludge Removal Expense - Not applicable.

4) Purchased Water - The utility recorded purchased water expense of \$58,215 during the test year. We have reduced this amount by \$46 to reclassify bank service charges for a revised total of \$58,169.

5) Chemicals - The utility is a bulk water customer of the City of Lake Worth Water Utility, and as such, does not incur any chemical expense.

6) Materials and Supplies - The utility recorded materials and supplies expense of \$1,015. Having reviewed this expense, we find this amount appropriate.

7) Contractual Services - The utility recorded contractual service expense of \$77,683 during the test year. We have made adjustments to a) reclass testing expense from plant in service of \$245, b) to reclassify repair expense to meter purchase in the amount of \$346, c) adjust the management fee to \$15,000 by reducing overall costs by \$43,500, d) reduce meter reading costs by \$750 to amount actually paid, e) annualize meter reading, phone, postage and testing expense by \$326, f) reclassify testing costs from miscellaneous expense by \$30, g) eliminate out of period accounting costs of negative \$3,395, h) accrue accounting fees not reflected in the test year of \$2,714 and I) adjust contract labor by \$15. Based on these audit adjustments, we find that contractual expense totals \$33,023. The components of these contractual services are detailed as follows:

Contractual Services

Management Fee	\$15,000	Contract Salaries	\$ 12,275
		Computer Rent	1,002
		Office Rent	386
		Electric	600
		Water & Sewer	120
		Insurance	120
		Janitorial	17
		Photocopy	240
		Fax	240
			<u>\$ 15,000</u>

Meter Reading	
/Contract Labor	5,935
Repairs	1,907
Contract Accounting	8,529
Telephone	522
Postage	1,130
Total	<u>\$33,023</u>



We have reduced water contractual services by \$44,660. We find total water contractual expense and water testing expense of \$33,023 and \$1,242, respectively.

8) Rents - The utility included the rent expense in the management fee. We find no adjustment necessary.

9) Transportation Expenses - The utility included the transportation expense in the management fee. We find no adjustment necessary.

10) Insurance Expense - The utility included the insurance expense in the management fee. We find no adjustment necessary.

11) Regulatory Commission Expense - The utility recorded no regulatory Commission expense for the test year. We have made an adjustment of \$1,500 to include an amortized portion of the instant rate case filing fee and related expenses. We find regulatory Commission expense totals \$1,500.

12) Miscellaneous Expense - The utility recorded \$5,753 of miscellaneous expenses. We have made adjustments to a) reclassify bank charges from purchased water expense of \$46, b) to reclassify miscellaneous testing expense to contractual services of \$30 and c) reflect a reclassification of regulatory assessment fees to taxes other than income in the amount of (\$5,670). Based on these adjustments, we find that total miscellaneous expense of \$99 is appropriate.

#### Operation and Maintenance Expenses (O & M) Summary

Total LOU operation and maintenance adjustments are negative \$48,860. We find it appropriate to allow a total operation and maintenance expense of \$95,091.

#### Depreciation Expense (Net of Amortization of CIAC)

We made an adjustment of \$3,847 to depreciation expense to agree with NARUC approved rates. We also reduced CIAC amortization by \$647 to agree with approved rates. We find that depreciation expense for the test period, net of amortization of CIAC, is \$3,200.

#### Taxes Other Than Income Tax

The utility recorded \$4,270 of taxes other than income. We have made an adjustment to 1) reclassify regulatory assessment fees from miscellaneous expense of \$5,670 and 2) reduce the level of

taxes other than income tax by \$5,564 to the level of regulatory assessment fees for the test period, \$4,236, along with miscellaneous taxes of \$140, for a total for taxes other than income of \$4,376.

#### Operating Revenue

We have adjusted revenues by \$12,804 to reflect the increase in revenue required to cover utility expense and allow a rate of return on investment.

#### Taxes Other Than Income Tax

We have increased this expense by \$576 to reflect the regulatory assessment fee of 4.5% on the increase in revenue, as discussed further in this Order.

#### Operating Expense Summary

The foregoing adjustments to the utility's test year operating expenses results in approved operating expense of \$103,243.

#### REVENUE REQUIREMENT

We find that the appropriate annual increase in revenue is \$12,804 (14%). The revenue requirement and resulting annual increase is shown on Schedule No. 3A.

#### RATES AND CHARGES

During the test year, LOU provided water service to approximately 464 residential customers. We have calculated a base facility/gallonage charge for water customers based on test year data. The base facility/gallonage charge rate structure is the preferred rate structure because it is designed to provide for the equitable sharing by the ratepayers of both the fixed and variable costs of providing service. The base facility charge is based upon the concept of readiness to serve all customers connected to the system. This ensures that ratepayers pay their share of the costs of providing service (through the consumption or gallonage charge) and also pay their share of the fixed costs of providing service (through the base facility charge).

Approximately 21% (or \$22,844) of the water revenue requirement is associated with the fixed costs of providing service. Fixed costs shall be recovered through the base facility charge based on annualized number of factored ERCs. The remaining 79% (or \$84,091) of the water revenue requirement represents the

consumption charge based on the estimated number of gallons consumed during the test period.

Schedules of the utility's existing rates and our approved rates follow:

Lake Osborne Utilities Company, Inc.

WATER RATES

OPERATING RATIO

RESIDENTIAL MULTI-RESIDENTIAL, AND GENERAL SERVICE

<u>Meter Size</u>	<u>Base Facility Charge</u>	
	<u>Existing Rate</u>	<u>Approved Rate</u>
5/8" x 3/4"	\$ 2.78	\$ 4.00
3/4"	N/A	5.99
1"	6.98	9.99
1-1/2"	13.96	19.98
2"	22.34	31.96
3"	44.68	63.92
4"	69.81	99.88
6"	139.59	199.75
Gallage Charge Per 1,000 gallons	\$ 1.75	\$ 1.91

The rates shall be effective for service rendered on or after the stamped approval date on the tariff sheets provided the customers have received notice. The tariff sheets shall be approved upon Staff's verification that the tariffs are consistent with the Commission's decision, that the customer notice is adequate, and that any required security has been provided. The utility shall provide proof of the date notice was given no more than (or within) 10 days after the date of the notice.

If the effective date of the new rates falls within a regular billing cycle, the initial bills at the new rate may be prorated. The old charge shall be prorated based on the number of days in the billing cycle before the effective date of the new rates. The new charge shall be prorated based on the number of days in the billing cycle on or after the effective date of the new rates.

In no event shall the rates be effective for service rendered prior to the stamped approval date.

STATUTORY RATE REDUCTION AND RECOVERY PERIOD

Section 367.0816, Florida Statutes requires that the rates be reduced immediately following the expiration of the four year period by the amount of the rate case expense previously included in the rates. The reduction will reflect the removal of revenues associated with the amortization of rate case expense and the gross-up for regulatory assessment fees. This amount is \$1,568. The reduction in revenues will result in the rates shown on Schedule No. 4.

The utility shall be required to file revised tariff sheets no later than one month prior to the actual date of the required rate reduction. The utility also shall be required to file a proposed customer notice setting forth the lower rates and the reason for the reduction.

If the utility files this reduction in conjunction with a price index or pass-through rate adjustment, separate data shall be filed for the price index and/or pass-through increase or decrease and the reduction in the rates due to the amortized rate case expense.

TEMPORARY RATES IN THE EVENT OF A PROTEST

This Order approves an increase in water rates for LOU. A timely protest might delay what may be a justified rate increase resulting in an unrecoverable loss of revenue to the utility. Therefore, in the event of a protest filed by a party other than the utility, we hereby authorize the utility to collect the rates approved herein on a temporary basis, subject to refund, provided the utility first furnishes and has approved by Commission staff, adequate security for a potential refund and a copy of the proposed customer notice. The security shall be in the form of a bond or letter of credit in the amount of \$8,857. Alternatively, the utility may establish an escrow agreement with an independent financial institution.

If the utility chooses a bond as security, the bond shall contain wording to the effect that it will be terminated only under the following conditions:

- 1) The Commission approves the rate increase; or

- 2) If the Commission denies the increase, the utility shall refund the amount collected that is attributable to the increase.

If the utility chooses a letter of credit as a security, it shall contain the following conditions:

- 1) The letter of credit is irrevocable for the period it is in effect.
- 2) The letter of credit will be in effect until final Commission order is rendered, either approving or denying the rate increase.

If security is provided through an escrow agreement, the following conditions shall be part of the agreement:

- 1) No refunds in the escrow account may be withdrawn by the utility without the express approval of the Commission.
- 2) The escrow account shall be an interest bearing account.
- 3) If a refund to the customers is required, all interest earned by the escrow account shall be distributed to the customers.
- 4) If a refund to the customers is not required, the interest earned by the escrow account shall revert to the utility.
- 5) All information on the escrow account shall be available from the holder of the escrow account to a Commission representative at all times.
- 6) The amount of revenue subject to refund shall be deposited in the escrow account within seven days of receipt.
- 7) This escrow account is established by the direction of the Florida Public Service Commission for the purpose(s) set forth in its order requiring such account. Pursuant to Cosentino v. Elson, 263 So.2d 253 (Fla. 3d DCA 1972), escrow accounts are not subject to garnishments.
- 8) The Director of Records and Reporting must be a signatory to the escrow agreement.

In no instance shall the maintenance and administrative costs associated with the refund be borne by the customers. These costs are the responsibility of, and shall be borne by, the utility. Irrespective of the form of security chosen by the utility, an account of all monies received as result of the rate increase shall be maintained by the utility. This account must specify by whom and on whose behalf such monies were paid. If a refund is ultimately required, it shall be paid with interest calculated pursuant to Rule 25-30.360(4), Florida Administrative Code.

The utility shall maintain a record of the amount of the bond, and the amount of revenues that are subject to refund. In addition, after the increased rates are in effect, the utility shall file reports with the Division of Water and Wastewater no later than 20 days after each monthly billing. These reports shall indicate the amount of revenue collected under the increased rates.

MAINTENANCE OF BOOKS AND RECORDS WITH 1984 NARUC  
UNIFORM SYSTEM OF ACCOUNTS (USOA)

During the test year, the utility's books were not maintained in conformity with the USOA.

Paragraph (1) of Rule 25-30.115, Florida Administrative Code, entitled "Uniform System of Accounts for Water and Sewer Utilities", states:

- 1) Water and Sewer Utilities shall, effective January 1, 1986, maintain its [sic] accounts and records in conformity with the 1984 NARUC Uniform System of Accounts adopted by the National Association of Regulatory Utility Commissioners.

We find the utility has the expertise necessary to convert and maintain the utility's records in conformity with Rule 25-30.115, Florida Administrative Code. Therefore, the utility shall be required to maintain its books and records in conformity with the 1984 NARUC Uniform System of Accounts. If a protest is not received within twenty-one days of the issue date of this Order, no further action will be required and this docket shall be closed.

Based on the foregoing, it is

ORDERED by the Florida Public Service Commission that Lake Osborne Utilities Company, Inc.'s application for increased water rates is hereby approved as set forth in the body of this Order. It is further

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ORDERED that each of the findings made in the body of this Order is hereby approved in every respect. It is further

ORDERED that all matters contained in the schedules attached hereto are incorporated herein by reference. It is further

ORDERED that the operating ratio method shall be applied pursuant to Section 367.0814(8), Florida Statutes, and Rule 25-30.456, Florida Administrative Code, to Lake Osborne Utilities, Inc. It is further

ORDERED that during the next twenty-four months, Commission staff shall conduct biannual evaluations of Lake Osborne Utilities Company, Inc., including an audit of the utility's expenses and a site visit by a member of the Commission engineering staff. It is further

ORDERED that the criteria established for determining the applicability of the operating ratio, as set forth in the body of this Order, shall be utilized when determining whether to apply the operating ratio method to other Class C utilities. It is further

ORDERED that during the next twenty-four months, a ten (10) percent margin shall be used when implementing the operating ratio method unless unusual circumstances justify the use of a greater or lesser margin. In no event shall the operating margin be higher than \$10,000. It is further

ORDERED that at the end of the twenty-four month period, Commission staff shall make an evaluation and recommendation as to whether a rule revision or a new rule is appropriate to clarify qualification criteria and make other necessary changes for, applying the operating ratio method. It is further

ORDERED that Lake Osborne Utilities Company, Inc., is hereby authorized to charge the new rates and charges as set forth in the body of this Order. It is further

ORDERED that Lake Osborne Utilities Company, Inc.'s rates and charges shall be effective for service rendered on or after the stamped approval date on the tariff sheet pursuant to Rule 25-30.475(1), Florida Administrative Code, provided that the customers have received proper notice. It is further

ORDERED that Lake Osborne Utilities Company, Inc. shall provide proof that the customers have received notice within ten days of the date of the notice. It is further

ORDERED that in the event of a protest by any substantially affected person other than the utility, Lake Osborne Utilities Company, Inc., is authorized to collect the rates approved on a temporary basis, subject to refund in accordance with Rule 25-30.360, Florida Administrative Code, provided that Lake Osborne Utilities Company, Inc., first furnishes and has approved by Commission staff, adequate security for any potential refund and a proposed customer notice. It is further

ORDERED that, prior to its implementation of the rates and charges approved herein, Lake Osborne Utilities Company, Inc., shall submit and have approved revised tariff pages. The revised tariff pages will be approved upon our staff's verification that the pages are consistent with our decision herein, that the protest period has expired, and that the customer notice is adequate and that any required security has been provided. It is further

ORDERED that the rates shall be reduced at the end of the four-year rate case expense amortization period, consistent with our decision herein. The utility shall file revised tariff sheets no later than one month prior to the actual date of the reduction and shall file a customer notice. It is further

ORDERED that prior to its implementation of the rates and charges approved herein, Lake Osborne Utilities Company, Inc., shall submit and have approved a bond or letter of credit in the amount of \$8,857 as a guarantee of any potential refund of revenues collected on a temporary basis. Alternatively, the utility may establish an escrow account with an independent financial institution. It is further

ORDERED that Lake Osborne Utilities Company, Inc., shall submit monthly reports as set forth in the body of this Order. It is further

ORDERED that the provisions of this Order except for the granting of temporary rates in the event of a protest, and the requirement that Lake Osborne Utilities Company, Inc. maintain its books and records in conformance with the 1984 NARUC USOA, are issued as proposed agency action and shall become final unless an appropriate petition in the form provided by Rule 25-22.029, Florida Administrative Code, is received by the Director, Division of Records and Reporting, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, by the close of business on the date set forth in the "Notice of Further Proceedings or Judicial Review" attached hereto. It is further

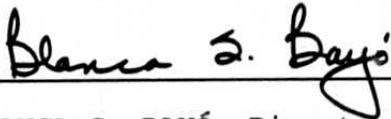


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ORDERED that Lake Osborne Utilities Company, Inc. shall maintain its books and records in conformity with the 1984 NARUC USOA. It is further

ORDERED that if no timely protest is received from a substantially affected person, within twenty-one days of the issuance of this Order, this docket shall be closed.

By ORDER of the Florida Public Service Commission, this 13th day of March, 1996.

  
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BLANCA S. BAYÓ, Director  
Division of Records and Reporting

( S E A L )

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**DISSENTS**

Commissioner Joe A. Garcia dissents from the majority opinion in this docket without opinion.

Commissioner J. Terry Deason dissents from the majority decision to implement this departure from cost based ratesetting in this Proposed Agency Action rate case order. In addition to the substantive concerns that I have with this new policy change, I have a fundamental concern with implementing policy in a proposal that may not be tested by a hearing. Ratecase expense for very small utilities is a serious concern for anyone who would contemplate protesting the order. An intervenor such as the Public Counsel who might have no objection to the rate levels proposed but who might also object to the application of this new method would have to weigh causing the few customers of the utility to pay higher rate case expense against the benefits of any challenge to the new policy. Rule 25-30.455(1) (the conventional SARC rule) recognizes that rate case expense is recoverable. Because Rule 25-30.456(17) (the alternative SARC rule) allows a utility to opt under the conventional ratesetting SARC method in the event of a protest, this possibility is one that a potential protestor would

have to consider. What makes this case even more awkward in this regard is that the staff -- not the utility -- requested the alternative method. At this time I do not reach the question of whether proposal by the staff is proper under the statute or rule.

I am concerned that this departure from cost based ratesetting is being undertaken without full consideration of the ramifications that it may have on our regulation of what continues to be a monopoly service for customers. None of the issues raised in this docket were discussed in the development of the rule allowing alternative ratesetting in a SARC case. The rule merely allows it; it does not address when and under what circumstances it's appropriate.

My principal concern is whether cutting over to an operating ratio ignores ratebase levels that may be relatively small for a reason. Take CIAC for example. The staff presented an analysis of the impact on CIAC levels that did not satisfy me that all benefits of CIAC paid by the customer or on the customers' behalf are adequately recognized in flash-cutting to an operating ratio methodology. Prepayments of utility costs in the form of hook-up charges, service availability charges, main extension charges, etc., whether paid directly by the customer or on his behalf by the developer, may create legal or perceptual obligations by the utility. These obligations should not be brushed aside easily. It occurs to me that the perception that the customer is "losing" something by not having CIAC considered in the ratesetting equation is not dispelled by our analysis or the circumstances of this case.

There are other concerns that I have with this approach that I feel it is necessary to mention. Because we are attempting to develop incipient policy, there are no rules or procedures on what would happen if the utility decided that it wanted to insist on its constitutional rights to have rates based on costs -- if those rates would generate a higher revenue stream. Such a change could come about due to a change in ownership, capitalization or additions of ratebase. Would it be fair to allow the best of both worlds to the utility? Furthermore, how does this impact our policy of seeking to encourage equity investment and, hence, a sense of ownership and responsibility by the owners? It does not seem like there is a countervailing concern that would outweigh promotion of this existing policy. Viability is apparently not a concern with this particular utility. Service quality was deemed by the staff to be good.

Having raised these concerns, I would like to take this opportunity to commend staff for their efforts in working on this case. I recognize that some of my concerns were addressed. For

example, the concern expressed about the theoretical basis for including depreciation expense in the ratio, was resolved by its removal. Additionally, the utility/developer affiliation "screen" addresses another concern that I have in utilizing the operating ratio approach. I think these protections are proper steps toward developing a conservative approach towards any departure from cost based ratesetting for utilities that are monopolies no matter how small they may be. Regardless, I must emphasize that I do not favor this departure at this time.

NOTICE OF FURTHER PROCEEDINGS OR JUDICIAL REVIEW

The Florida Public Service Commission is required by Section 120.59(4), Florida Statutes, to notify parties of any administrative hearing or judicial review of Commission orders that is available under Sections 120.57 or 120.68, 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 or judicial review will be granted or result in the relief sought.

As identified in the body of this order, our action proposed herein except for our granting temporary rates in the event of a protest, and the requirement that the utility maintain its books and records in conformance with the 1984 NARUC USOA, is preliminary in nature and will not become effective or final, except as provided by Rule 25-22.029, Florida Administrative Code. Any person whose substantial interests are affected by the action proposed by this order may file a petition for a formal proceeding, as provided by Rule 25-22.029(4), Florida Administrative Code, in the form provided by Rule 25-22.036(7)(a) and (f), Florida Administrative Code. This petition must be received by the Director, Division of Records and Reporting, at 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, by the close of business on April 3, 1996. In the absence of such a petition, this order shall become effective on the date subsequent to the above date as provided by Rule 25-22.029(6), Florida Administrative Code.

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

If the relevant portion of this order becomes final and effective on the date described above, any party adversely affected may request judicial review by the Florida Supreme Court in the case of an electric, gas or telephone utility or by the First

District Court of Appeal in the case of a water or wastewater utility by filing a notice of appeal with the Director, Division of Records and Reporting and filing a copy of the notice of appeal and the filing fee with the appropriate court. This filing must be completed within thirty (30) days of the effective date of this order, pursuant to Rule 9.110, Florida Rules of Appellate Procedure. The notice of appeal must be in the form specified in Rule 9.900(a), Florida Rules of Appellate Procedure.

Any party adversely affected by the Commission's final action in this matter may request: (1) reconsideration of the decision by filing a motion for reconsideration with the Director, Division of Records and Reporting within fifteen (15) days of the issuance of this order in the form prescribed by Rule 25-22.060, Florida Administrative Code; or (2) judicial review by the Florida Supreme Court in the case of an electric, gas or telephone utility or the First District Court of Appeal in the case of a water or wastewater utility by filing a notice of appeal with the Director, Division of Records and Reporting and filing a copy of the notice of appeal and the filing fee with the appropriate court. This filing must be completed within thirty (30) days after the issuance of this order, pursuant to Rule 9.110, Florida Rules of Appellate Procedure. The notice of appeal must be in the form specified in Rule 9.900(a), Florida Rules of Appellate Procedure.