State of Florida

Public Service Commission

CAPITAL CIRCLE OFFICE CENTER 2540 SHUMARD OAK BOULEVARD
TALLAHASSEE, FLORIDA 32399-0850

RECEIVED-FPSC
02 MAR -6 AM 10:30
COMMISSION CLERK

-M-E-M-O-R-A-N-D-U-M-

DATE: MARCH 7, 2002

TO: DIRECTOR, DIVISION OF THE COMMISSION CLERK & ADMINISTRATIVE SERVICES (BAYÓ)

FROM: DIVISION OF ECONOMIC REGULATION (COSTNER, FITCH, EDWARDS)
OFFICE OF THE GENERAL COUNSEL (GERVASI)

RE: DOCKET NO. 020045-WU - INVESTIGATION OF OVEREARNINGS FOR MORNINGSIDE UTILITIES, INC. IN OSCEOLA COUNTY.
COUNTY: OSCEOLA

AGENDA: 03/19/02 - REGULAR AGENDA - PROPOSED AGENCY ACTION/ EXCEPT FOR ISSUES 10 AND 11 - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\ECR\WP\020045.RCM.WPD

Table of Contents

CASE BACKGROUND

Morningside Utility, Inc., (Morningside or utility) is a Class C water utility located in Osceola County. The utility provides water service to approximately 218 residential customers who utilize septic tanks for waste disposal. The Commission acquired jurisdiction over Osceola County on October 12, 1959. Although the utility was established in 1983 by Schoofield Properties, the Commission was unaware of its existence until 1997.

On May 28, 1997, the utility filed its application for an original certificate pursuant to Section 367.045, Florida Statutes. The utility was granted operating Certificate No. 595-W, pursuant to Order No. PSC-97-1211-FOF-WU, issued October 7, 1997, in Docket No. 970636-WU. Mr. George Devillers purchased the utility in 1988 from Schoolfield Properties.

On March 30, 1998, Morningside applied for a staff assisted rate case (SARC) pursuant to Section 367.0814, Florida Statutes. By Order No. PSC-98-1585-FOF-WU, issued November 25, 1998, in Docket No. 980445-WU, the Commission approved rate base, expenses, and rates for this utility.

On February 27, 1999, Mr. George DeVillers transferred majority organizational control of the utility to the present owner, Mr. Gary K. Turner. By Order No. PSC-99-1753-FOF-WU, issued September 7, 1999, in Docket No. 990248-WU, the Commission granted the transfer of majority organizational control.

A review of the utility's 2000 annual report showed possible overearnings. Therefore, an investigation of possible overearnings was initiated and a staff audit of the utility's records was performed. Staff selected a historical test year ending December 31, 2000.

Based on staff's analysis contained in this recommendation, the utility is overearning and revenues should be decreased by an annual amount of $14,664 (14.40%). The utility's test year revenue is $101,854, and test year operating expenses are $82,483. This results in an operating income of $19,371 for the test year.

The Commission has jurisdiction pursuant to Section 367.081, Florida Statutes.

ISSUE 1: What percentage of the utility's water treatment system and distribution system is used and useful?

RECOMMENDATION: Staff recommends that both the water treatment plant and distribution system be considered 100% used and useful. (EDWARDS)

STAFF ANALYSIS: The utility records for the test year were utilized to calculate the used and useful percentage. Currently, the utility's and the Department of Environmental Protection's (DEP) records indicate that the system is operating properly.

Water Treatment System

The water treatment plant has a firm reliable capacity of 0.189 mgd and the minimum size of this plant was mandated by DEP. Generally, the Commission's practice has been to determine the used and useful percentage by adding the growth allowance and the fire flow requirement to the five maximum days average flow and subtracting any excess unaccounted for water which produces the flows that are then divided by the plant capacity. In accordance with the formula method for calculating used and useful, this water treatment plant would be considered 73% used and useful. However, this utility has extenuating circumstances, in that it is surrounded on all four sides of its service area by the service areas of other utilities. Since the utility is surrounded on all four sides, eliminating the opportunity for future growth, the normal method of calculating used and useful should not be applied.

In Order No. PSC-98-1585-FOF-WU, the utility's last SARC, this Commission acknowledged that implementing the standard formula method of calculating used and useful was not applicable for this utility. The Commission reasoned as follows:

> A strict used and useful calculation based on actual flow data and rated capacity would result in the water treatment plant being considered 17% used and useful. However, because of the small size of this utility and limits to potential growth, we find it appropriate that an alternate method of calculating used and useful based on current customers versus customers in the service area at built out be used. Using this method results in the water treatment plant being 80% used and useful.

After applying this alternate method of calculation previously approved by this Commission and because the service area is surrounded on all four sides by the service areas of other utilities, staff recommends that the water treatment plant is 100% used and useful.

Water Distribution System

The utility's customer base is residential, and in this case lots are equal to equivalent residential customers (ERCs). Currently, this water distribution system has the potential to physically serve an estimated 230 ERCs (one ERCs = one connection). The standard ERCs to ERCs formula method of calculating used and useful should be implemented.

In Order No. PSC-98-1585-FOF-WU, the Commission acknowledged that the distribution system was built out, and therefore approved a used and useful percentage of 100%. At that time, the system was considered built out, with 175 connections although physically the distribution system could handle 188 connections at total built out. On March 3, 1999, Morningside applied to the Commission for an Amendment to Certificate, to extend its territory boundaries. By Order No. PSC-99-1810-FOF-WU, issued September 20, 1999, in Docket No. 990247-WU, the Commission approved the application to include additional teritory, and this added 42 new lots to the utility's service territory.

Currently, all 230 available connections are occupied with mobile homes that are connected to the main distribution system. Hence, this system remains 100% used and useful. In addition, the utility's surrounded service area restricts further growth.

Summary

Currently, based on the above and most recent data, staff recommends that the water treatment plant and the distribution system should be considered 100% used and useful.

ISSUE 2: What is the appropriate average test year rate base for this utility?

RECOMMENDATION: The appropriate average test year rate base for Morningside is $52,103. (COSTNER, FITCH)

STAFF ANALYSIS: The utility's rate base was last established in Order No. PSC-98-1585-FOF-WU, the utility's last SARC. Staff has selected a test year ended December 31, 2000, for this rate case. Rate base components, established in Order No. PSC-98-1585-FOF-WU, have been updated through December 31, 2000, using information obtained from staff's audit and engineering reports. A discussion of each rate base component follows:

Utility Plant-in-Service (UPIS): The utility recorded UPIS of $142,718 for the test year ended December 31, 2000.

According to Audit Exception No. 2, the utility did not reconcile its UPIS account balances to amounts approved in Order No. PSC-98-1585-FOF-WU. Therefore, staff has made an adjustment to increase UPIS by $20,526 to reconcile UPIS to the Commission approved UPIS balance for the year ended November 25, 1998.

Audit Exception No. 2, also noted that the utility did not record several items of plant. These items were purchased and installed for use before the test year end and should be included in the test year UPIS balance. Therefore, staff has made an adjustment to increase UPIS for unrecorded plant as follows:

Account	Description	Amount
307	Switch	$135
320	Regulator, Chlorinator, and Valve	$1,029
334	Meter	$496
	Total	$1,660

Audit Exception No. 2, further noted that the utility incorrectly capitalized telephone and cellular phone service during the test year. Telephone service is an expense item and should not be capitalized. Therefore, staff has made an adjustment to reclassify $458 from UPIS to miscellaneous expense Account No. 675.

Staff made an adjustment to decrease UPIS by $2,593 to reflect an averaging adjustment.

The utility provided staff with two items of plant that were placed in service after the test year. The first item was the installation of a chlorine vacuum monitor ($716), which was required by DEP. The utility also replaced a well pump that was struck by lightning ($4,000). Therefore, staff has made an adjustment to increase UPIS by $4,716 ($716 + $4,000) for pro forma plant additions. Staff then made an adjustment to decrease UPIS by $2,358 to reflect an averaging adjustment on pro forma plant.

With the above described adjustments, staff recommends a UPIS balance of $164,211.

Contributions-in-Aid-of-Construction: The utility recorded CIAC of $0 for the test year ended December 31, 2000.

According to Audit Exception No. 3, the utility did not reconcile its CIAC balance to the CIAC balance approved in Order No. PSC-98-1585-FOF-WU. Staff made the CIAC reconciliation by increasing CIAC by $109,800. This increase reconcilies the CIAC balance with the CIAC balance approved in Order No. PSC-98-1585-FOF-WU.

According to Audit Exception No. 4, the utility incorrectly recorded service availability charges as revenues. Service availability charges are considered contributions to plant and should be recorded as CIAC. Therefore, staff increased CIAC by $7,095 to reclassify service availability charges from the revenue account. Audit Exception No. 3 also noted the utility did not record service availability charges associated with new customer connections since the utility's last rate case. Therefore, staff increased CIAC by $25,715 to include the CIAC that should have been recorded based on the utility's service availability charges.

Staff also decreased CIAC by $4,515 to reflect an averaging adjustment. Staff's recommended CIAC balance is $138,095.

Accumulated Depreciation: The utility recorded a balance for accumulated depreciation of $81,088 for the test year.

Staff recalculated accumulated depreciation based on the depreciation rates provided in Rule 25-30.140, Florida

Administrative Code. Staff increased accumulated depreciation by $2,004 to reconcile test year accumulated depreciation to staff's calculated accumulated depreciation per Rule 25-30.140, Florida Administrative Code. Staff decreased accumulated depreciation by $4,313 to reflect an averaging adjustment.

With the above described adjustments, staff's recommended accumulated depreciation is $138,095.

Amortization of CIAC: The utility did not record an amount in this account for the test year. According to Audit Exception No. 3, the utility did not reconcile its amortization of CIAC balance to the amortization of CIAC balance approved in Order No. PSC-98-1585-FOF-WU. Therefore, staff increased CIAC amortization by $43,214 to reconcile with the amortization of CIAC balance approved in Order No. PSC-98-1585-FOF-WU.

Staff recalculated amortization of CIAC based on composite depreciation rates. Staff increased CIAC amortization by $17,989 to reflect staff's calculated amortization. Staff then decreased CIAC amortization by $3,582 to reflect an averaging adjustment.

With these described adjustments, staff's recommended CIAC amortization balance is $57,621.

Working Capital Allowance: Working Capital is defined as the investor-supplied funds necessary to meet operating expenses or going-concern requirements of the utility. Consistent with Rule 25-30.433(2), Florida Administrative Code, staff recommends that the one-eighth of the O&M expense formula approach be used for calculating working capital allowance. Applying that formula, staff recommends a working capital allowance of $9,145 (based on O&M of $73,162). Staff has increased working capital allowance by $9,145 to include one-eighth of staff's recommended O&M expenses.

Rate Base Summary: Based on the foregoing, staff's adjustments to the utility's rate base results in a recommended rate base of $52,103.

Rate base is shown on Schedule No. 1-A. Specific adjustments are shown on Schedule No. 1-B.

COST OF CAPITAL

ISSUE 3: What is the appropriate rate of return on equity and the appropriate overall rate of return for this utility?

RECOMMENDATION: The appropriate rate of return on equity is 11.34% with a range of 10.34% - 12.34%. The appropriate overall rate of return for the utility is 10.30%. (COSTNER, FITCH)

STAFF ANALYSIS: According to staff's audit, the utility recorded the following items in capital structure: common stock of $500, retained earnings of $2,063, paid-in-capital of $85,197, total long term debt of $183,181, and customer deposits of $5,742.

The utility's $183,181 of long term debt consists of three debt instruments. According to Audit Exception No. 8, the balances recorded by the utility did not reflect the actual balances per the debt agreements as of December 31, 2000. Therefore, staff reduced total long-term debt by $8,871 to reflect the actual balances per the debt agreements. Specific adjustments are shown on Schedule No. 2. The weighted average cost of total long-term debt is 9.91%.

Using the current leverage formula approved by Order No. PSC-01-2514-FOF-WS, issued December 24, 2001, in Docket No. 010006-WS, the appropriate rate of return on equity for all capital structures with an equity ratio of less than 40% is 11.34%. Since the utility's capital structure is 32.77% equity, the rate of return on equity is 11.34% with a range of 10.34% - 12.34%.

The utility's capital structure has been reconciled with staff's recommended rate base. Staff's recommended return on equity is 11.34% with a range of 10.34% - 12.34%, and an overall rate of return of 10.30%.

The return on equity and overall rate of return are shown on Schedule No. 2.

ISSUE 4: What is the appropriate test year operating revenue?

RECOMMENDATION: The appropriate test year operating revenue should be $101,854. (COSTNER, FITCH)

STAFF ANALYSIS: The utility recorded $108,520 for its operating revenue for the test year. According to Audit Exception No. 4, the utility improperly recorded service availability charges in this account during the test year. Service availability charges are considered contributions to plant and should be recorded as CIAC. Therefore, staff reclassified $7,095 (meter installation fees of $665 and system capacity charges of $6,430) from the revenue account to CIAC.

Staff has recalculated revenues based on the billing analysis and the tariffed rates in effect at the end of the test year. This recalculation resulted in a test year revenue increase of $429 made to annualize test year revenues per the utility's tariffed rates and information contained in the billing analysis. Based on the above adjustments, staff recommended test year revenue is $101,854.

Staff's adjusted test year revenue is shown on Schedule No. 3-A. The related adjustments are shown on Schedule No. 3-B.

ISSUE 5: What is the appropriate amount of operating expense?

STAFF RECOMMENDATION: The appropriate amount of operating expenses for this utility is $81,823. (COSTNER, FITCH)

STAFF ANALYSIS: The utility recorded operating expenses of $77,891 during the test year. As previously discussed, the utility's rates and expenses were last approved in Order No. PSC-98-1585-FOF-WU. Staff compared the expenses approved in the utility's last rate case with the expenses recorded or requested for the test year. Staff identified three accounts (601, 603, and 675) in which there was a substantial increase in expense or requested expense since the last rate case. By letter dated September 27, 2001, staff requested that the utility justify the increase in expenses. The utility provided staff with explanations for the increased expenses by letter dated October 23, 2001.

The utility provided the auditor with access to all invoices, canceled checks, and other utility records to verify its O&M and taxes other than income expense for the 12-month period ended December 31, 2000. Using the documents provided by the utility, the staff auditor determined the appropriate operating expenses for the test year and a breakdown of expenses by account class. Adjustments have been made to reflect the appropriate annual operating expenses that are required for utility operations on a going forward basis.

Operations and Maintenance Expenses (O&M)

Salaries and Wages-Employees-(601) and Salaries and Wages-Officers (603) - The utility recorded $823 for salaried employees and $30,660 for salaried officers during the test year. In Audit Disclosure No. 2, the utility requested pro forma expenses of $18,720 for the president, $20,800 for the vice president, and $6,240 for a casual laborer. Staff compared the duties of the president and the vice president with the duties described in the utility's last rate case. The duties of the president were identical to the duties described for the salaried employee in the last rate case and the duties of the vice president were identical to the duties described for the salaried officer in the last rate case. Therefore, staff believes that the appropriate amount for salaries and wages is the amount approved in the last rate case adjusted for inflation.

By letter dated September 27, 2001, staff requested that the utility justify in writing the reasons for its requested increase beyond the salaries approved in the last rate case. The utility's response cited the change in ownership to be the primary reason for the increase. The utility stated that the new owners were different people with different skills and dedication to the utility and customers. Staff does not believe that an increase in salaries based merely on a change in ownership is reasonable.

It is the intent of staff, when bringing a SARC recommendation before the Commission, that the recommended expenses are sufficient to operate a utility on a going forward basis. Staff believes that if the duties are performed properly then good customer service will follow. The utility cites increased customer satisfaction since the new owners obtained the utility and staff commends the new owners for their efforts to increase customer service; however, staff believes that the previous Commission-approved balance for salaries is sufficient to meet the customer service needs.

The utility also requested $6,240 for a casual laborer. The utility incurred $4,908 during the test year for maintenance expenses that would fall under the duties of a casual laborer. The casual laborer is a related party (the owner's son). It has been Commission practice that related party transactions should be viewed at arms length. However, the utility contracted these repairs out rather than hire a casual laborer. Because the utility was able to do so for less than the requested amount for a casual laborer, staff has not increased this account for the requested casual laborer.

For the above reasons, staff believes that the appropriate amount for salaries and wages employees and salaries and wages officers should be the balances approved in the utility's last rate case adjusted for inflation. Therefore, staff increased Account No. 601 (Salaries and Wages-Employees) by $31,297 and decreased Account No. 603 (Salaries and Wages-Officer) by $26,847 to reflect Salaries and Wages-employees expense of $32,120 and Salaries and Wages-Officers expense of $3,813, the previously approved Commission balances adjusted for inflation.

<u>Purchased Power Expense- (615)</u> - The utility recorded $2,864 in this account for the test year. According to Audit Exception No. 5, the utility recorded an out of period electric bill of $236. Because this expense was incurred outside of the test year, it

should be removed from test year expenses. Therefore, staff decreased purchased power expense by $236 to remove the out of period electric bill.

Materials and Supplies- (620) - The utility recorded $3,171 in this account for the test year. The utility provided staff with a breakdown of miscellaneous expenses. This breakdown included $1,045 for postage and billing supplies. Postage and billing supplies should be recorded in Account No. 620 Materials and Supplies. Therefore, staff increased Account No. 620 (Materials and Supplies) by $1,045 to reclassify billing supplies from Account No. 675 (Miscellaneous expense) to the materials and supplies account.

Contracted Services-Professional-(631) - The utility recorded $4,925 in this account for the test year. In the utility's last rate case, the Commission approved an allowance of $1,300 to set up the utility's books in order to conform with the NARUC USOA. The Commission also ordered that this expense should be amortized over five years. Since the five-year period has not passed, staff increased contracted services-professional by $260 ($1,300 ÷ 5 years) to reflect the NARUC set up cost approved in the last rate case.

Contractual Services Other-(636) - The utility did not record an amount in this account for the test year. According to Audit Disclosure No. 1, the utility did not record unpaid invoices in the amount of $4,908 for casual labor. Although the utility did not pay the invoices during the test year, the expenses related to the casual laborer were incurred by the utility during the test year. Under accrual accounting, expenses are recognized when incurred. Therefore, staff increased this account by $4,908 to include the unpaid invoices incurred during the test year.

Rents- (640) - The utility did not record an amount in this account during the test year. The utility does have an office and the Commission approved $1,200 for rent in the utility's last rate case. Therefore, staff increased this account by $1,231 to reflect office rent approved in the last rate case adjusted for inflation.

Insurance Expense- (655) - The utility recorded $5,609 in this account during the test year. Staff has annualized the insurance expense based on the policies contained in the audit work papers. Staff decreased this account by $1,164 to reflect annualized insurance expenses based on the insurance policies contained in the audit work papers.

Regulatory Commission Expense-(655) - The utility did not record an amount in this account during the test year. In the utility's last rate case, the Commission approved rate case expense of $1,788 to be amortized over four years. Since the four-year period has not expired, staff increased regulatory commission expense by $447 ($1,788 ÷ 4 years) to include the previously approved rate case expense.

Bad Debt Expense- (670) - The utility recorded $445 in this account for the test year. The utility provided staff with a breakdown of miscellaneous expenses. This breakdown included an additional $445 for bad debt expense. Therefore, staff has made an adjustment to increase bad debt expense by $445 to reclassify bad debt expense from Account No. 675 (Miscellaneous expense) to the bad debt expense account.

Miscellaneous Expense-(675) - The utility recorded $12,296 for this expense during the test year. Staff requested justification for the increase in miscellaneous expense from $3,892 approved in the last rate case. The utility responded in a letter dated October 23, 2001, which cited expenses not classified correctly by the auditor and an increase in communication expense. The utility provided staff with a breakdown of miscellaneous expenses. Staff has made adjustments to reclassify $1,045 to Account No. 620, Materials and Supplies, and $445 to Account No. 670, Bad Debt Expense. These items are further discussed above.

The utility recorded $600 for an employee's IRA in this account during the test year. The NARUC Uniform System of Accounts (USOA) states that employee pensions and benefits shall include all accruals under pension plans to which the utility has irrevocably committed such funds and payments for employee accident, sickness, hospital and death benefits or insurance therefor. It also includes expenses for medical, educational, or recreational activities of employees. The Commission found in Order No. PSC-99-1883-PAA-SU, issued on September 21, 1999, in Docket No. 980242-SU, that an IRA does not fall into the category of an employee pension and benefit under the NARUC USOA. Therefore, staff has made an adjustment to decrease miscellaneous expense by $600 to remove the IRA contribution consistent with past Commission practice.

The utility recorded $5,646 for communication expense which included $3,855 for Nextel cell phone bills, $1,602 for the office phone, and $189 for a pager. Further, according to Audit Exception No. 2, the utility recorded $458 ($373 cell phone, $85 office phone) of communications expense in the UPIS. Telephone service is an expense item and should not be capitalized. Therefore, staff has made an adjustment to increase miscellaneous expense by $458 to reclassify communication expense from UPIS to the miscellaneous expense account. Staff believes that the cellular and office phone expenses are excessive. The utility uses Nextel cell phones with the two way digital communication. The utility uses two Nextel phones to take advantage of the two way digital communication feature. Staff searched the Nextel website for service plans and found that a service plan with 500 minutes was approximately $40 a month. Staff also believes that an appropriate amount for local office phone service would be between $30 and $40 per month. Staff believes that a monthly allowance of $140 is an appropriate amount for communication services. This would allow for the two Nextel phones, the office phone, and estimated taxes that are not listed under the Nextel plan. Therefore, staff decreased miscellaneous expense by $4,235 allowing annual communication service for the office and cell phone of $1,680 ($140 x 12 months).

Staff also decreased miscellaneous expense by $85 to remove entertainment expense. Staff further decreased miscellaneous expense by $704 to remove returned checks and by $200 to remove penalties assessed by the IRS. Based on the above adjustments, staff recommends miscellaneous expense of $5,440.

<u>Operation and Maintenance Expense (O&M Summary)</u> - Staff's total O&M adjustment is an increase of $4,530. Staff's recommended O&M expense is $73,162 for water. O&M expenses are shown on Schedule 3-B.

<u>Depreciation Expense</u> - The utility did not record depreciation expense for the test year. Depreciation expense has been calculated by staff using the rates prescribed by Rule 25-30.140, Florida Administrative Code. Staff has increased depreciation expense by $8,819 to reflect staff's calculated depreciation expense. Staff also calculated test year amortization of CIAC, using composite rates. Staff has decreased depreciation expense by $7,435 to reflect staff's calculated amortization of CIAC. Amortization of CIAC has a negative impact on depreciation expense. Staff's calculated net depreciation expense is $1,384.

Taxes Other Than Income - The utility recorded $9,259 in this account for the test year.

Staff has recalculated regulatory assessment fees (RAFs) based on staff's recommended test year revenue in Issue No. 4. Staff has increased this account by $440 to reflect RAFs based on the recommended test year revenues discussed in Issue No. 4. According to Audit Exception No. 6, the utility recorded $1,762 in out of period taxes. Because these taxes were incurred outside of the test year, these taxes should be removed from test year expenses. Therefore, staff has decreased this account by $1,762 to remove out of period taxes.

Income Tax - Because the utility is a Sub-chapter S corporation, the utility pays no income taxes.

Operating Revenues - Staff decreased revenues by $14,664 to reflect the decrease in revenue requirement discussed in Issue No. 6.

Taxes Other Than Income - Staff decreased taxes other than income to reflect RAFs of 4.5% on the decrease in revenues as discussed above.

Operating Expenses Summary - The result of staff's recommended adjustments to the audited test year operating expenses is an operating expense of $81,823.

Operating expenses are shown on Schedule No. 3-A. The related adjustments are shown on Schedule No. 3-B.

REVENUE REQUIREMENT

ISSUE 6: What is the appropriate revenue requirement?

RECOMMENDATION: The appropriate revenue requirement is $87,190. (COSTNER, FITCH)

STAFF ANALYSIS: The utility's revenues should be decreased by an annual amount of $14,664 (14.40%). This will allow the utility the opportunity to recover its expenses and earn a 10.30% return on its investment. The calculations are as follows:

	Water
Adjusted Rate Base	$52,103
Rate of Return	x .1030
Return on Rate of Return	$5,367
Adjusted O & M expense	$73,162
Depreciation expense (Net)	$1,384
Amortization	$0
Taxes Other Than Income	$7,277
Income Taxes	$0
Revenue Requirement	$87,190
Adjusted Test Year Revenues	$101,854
Percent Increase/(Decrease)	(14.40)%

Revenue requirements are shown on Schedule No. 3-A.

ISSUE 7: Did Morningside earn in excess of its authorized return on equity for the test year ended December 31, 2000?

RECOMMENDATION: Yes, the Commission should acknowledge that $14,664 of the utility's water revenue exceeds staff's recommended 11.34% return on equity. (COSTNER, FITCH)

STAFF ANALYSIS: Morningside's return on equity was set by the Commission in Order No. PSC-98-1585-FOF-WU to be 8.89%. The Commission set rates in this docket designed to recover expenses and the authorized return on rate base. However, since rates were last established the utility has grown by approximately 35 customers (19%). This growth was not anticipated in the last rate case and therefore was not accounted for in rates. The Commission also calculated a repression adjustment for this utility; however, the average customer use has remained virtually unchanged since the last rate case. Further, the Commission approved a late payment charge in the last rate case for this utility. The late payment charge, along with other miscellaneous service charges, accounts for $5,685 of the utility's test year revenues. This volume of miscellaneous service charge revenue was also not anticipated in the utility's last rate case.

Staff's adjusted test year figures show water revenues of $101,854 with operating expenses of $82,483 resulting in water operating income of $19,371, which translates to a 93.38% rate of return on equity. In Issue No. 3, staff recommends the Commission establish a new return on equity for this utility of 11.34%, based on the leverage formula approved in Order No. PSC-01-2514-FOF-WS, issued December 24, 2001, in Docket No. 010006-WS. The Commission should acknowledge that $14,664 of the utility's water revenue exceeds staff's recommended 11.34% return on equity. In Issue No. 8, staff recommends a reduction in utility rates to correct utility overearnings.

ISSUE 8: What are the appropriate rates for the system?

RECOMMENDATION: The approved rates should be designed to produce revenue of $81,505 excluding miscellaneous service charge revenue, as shown in the staff analysis. The approved rates should 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. The rates should not be implemented until notice has been received by the customers. The utility should provide proof of the date notice was given within 10 days after the date of the notice. (COSTNER, FITCH)

STAFF ANALYSIS: During the test year the utility provided service to approximately 218 residential customers. As discussed in Issue No. 7, the appropriate revenue requirement is $87,190. The utility recorded $5,685 of miscellaneous service charge revenues. Miscellaneous service charge revenues should be used to reduce revenue requirement recovered through rates. Staff has designed rates to cover $81,505, which is the total revenue requirement less miscellaneous service charges.

The utility currently has a base facility and gallonage charge rate structure. The Commission found in Order No. PSC-98-1585-FOF-WU (the utility's last rate case) that under the utility's current rate structure, the total average consumption per bill was 6,840 gallons which is below the 10,000 gallon threshold that determines whether a more aggressive conservation-oriented rate structure is appropriate. According to the billing analysis, test year average consumption per bill was 6,942 gallons. The Commission also found in the above order that although the utility had not implemented a conservation program, it appeared that its customers were voluntarily making efforts to conserve water because the water consumption for this utility was low.

The Commission further found that the current rate structure promotes conservation and is designed to provide equitable sharing by the rate payers of both the fixed and variable costs for providing service. The base facility charge is based on the concept of readiness to serve all customers connected to the system. This ensures that ratepayers pay their share of the fixed costs for providing service (through the base facility charge) and also pay their share of the variable costs of providing service (through the consumption or gallonage charge).

Staff has calculated rates based on the rate structure approved in Order No. PSC-98-1585-FOF-WU adjusted for the decrease in revenue requirement. Schedules of the utility's current rates and staff's recommended rates are as follows:

MONTHLY RATES - WATER

RESIDENTIAL AND GENERAL SERVICE

	Existing Rates	Staff's Recommended Rates
Base Facility Charge		
Meter Sizes		
5/8" x 3/4"	$15.47	$13.11
1"	$38.68	$32.78
1 ½"	$77.37	$65.57
2"	$123.79	$104.91
3"	$247.58	$209.83
4"	$386.84	$327.85
6"	$773.69	$655.71
Gallonage Charge		
Per 1,000 Gallons	$3.12	$2.64

Staff's recommended decrease in revenue requirements is $14,664 or approximately 14.40%. The service rates approved for the utility should be designed to produce revenues of $81,505, excluding miscellaneous service charge revenues. Because miscellaneous service charge revenue is cost based, staff recommends reducing the $14,664 of revenue requirement through service rates. Applying the $14,664 revenue requirement decrease to service revenues results in an actual decrease of 15.25% ($14,664/$81,505) to service revenues.

Approximately 7% ($5,685) of the revenue requirement is recovered through miscellaneous service charges and approximately 39% ($33,955) of the revenue requirement is recovered through the recommended base facility charge (BFC). The fixed costs are recovered through the BFC based on the number of factored ERCs. The remaining 54% ($47,550) are revenues collected through the consumption charge based on the number of gallons consumed.

If the Commission approves staff's recommendation, these rates should be effective for service rendered as of the stamped approval date on the tariff sheets provided customers have received notice. The tariff sheets will be approved upon staff's verification that the tariffs are consistent with the Commission's decision and the customer notice is adequate.

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 should be prorated based on the number of days in the billing cycle on and after the effective date of the new rates. In no event should the rates be effective for service rendered prior to the stamped approval date.

ISSUE 9: Should the utility's system capacity charge be revised, and if so, what is the appropriate system capacity charge?

RECOMMENDATION: Staff recommends that the utility's system capacity charge be discontinued. (COSTNER, FITCH)

STAFF ANALYSIS: Rule 25-30.580, Florida Administrative Code, sets contribution guidelines as follows:

> (1) The maximum amount of contributions-in-aid-of-construction, net of amortization, should not exceed 75% of the total original cost, net of accumulated depreciation, of the utility's facilities and plant when the facilities and plant are at their designed capacity; and
>
> (2) The minimum amount of contributions-in-aid-of-construction should not be less than the percentage of such facilities and plant that is represented by the water transmission and distribution and sewage collection systems.

The utility’s is currently 97% contributed. Based on the guidelines in Rule 25-30.580, Florida Administrative Code, the utility is over contributed.

The utility currently has a $600 tariffed system capacity charge. Collection of the system capacity charge is recorded as CIAC and reduces the rate base or utility investment. Staff believes that a contribution level higher than 75% reduces the invested interest of the owner and could lead to possible abandonments. Staff also believes that continued collection of the system capacity charge has and will continue to exacerbate the utility’s current overearnings.

For the foregoing reasons, staff recommends that the utility's system capacity charge be discontinued.

ISSUE 10: In the event of a protest of the Proposed Agency Action (PAA) Order, should any amount of annual water revenues be held subject to refund?

RECOMMENDATION: Yes. In the event of a protest of the PAA Order, the utility should be allowed to continue collecting existing rates as temporary rates. However, in order to protect utility customers from potential overearnings, the utility should hold $14,664 (15.25%) of annual service revenues subject to refund. (COSTNER, FITCH, GERVASI)

STAFF ANALYSIS: Staff's recommended test year revenues of $101,854 and operating expenses of $82,483 results in water operating income of $19,371, which reflects a 93.38% rate of return on equity. Staff has recommended a decrease of $14,664 (15.25%) in the utility's annual service revenue which would provide the utility an opportunity to earn an overall rate of return of 10.30%. In the event of a protest of the PAA Order, the utility should be allowed to continue collecting existing rates as temporary rates. However, in order to protect utility customers from potential overearnings, the utility should hold $14,664 (15.25%) of annual service revenues subject to refund.

ISSUE 11: In the event of a protest of the PAA Order, what is the appropriate security to guarantee the amount subject to refund?

RECOMMENDATION: The security should be in the form of a bond or letter of credit in the amount of $9,916. Alternatively, the utility could establish an escrow agreement with an independent financial institution. If security is provided through an escrow agreement, the utility should escrow 15.25% of its monthly service revenues as detailed in Issue No. 10. By no later than the twentieth day of each month, the utility should file a report showing the amount of revenues collected each month and the amount of revenues collected to date relating to the amount subject to refund. Should a refund be required, the refund should be with interest and undertaken in accordance with Rule 25-30.360, Florida Administrative Code.(GERVASI, COSTNER, FITCH)

STAFF ANALYSIS: Pursuant to Section 367.082, Florida Statutes, when revenues are held subject to refund, the utility is authorized to continue collecting the previously authorized rates. As recommended in Issue No. 10, the amount of potential overearnings in the water system is $14,664 on an annual basis. Assuming an eight-month time frame for staff to complete the hearing process, the potential refund amount would be $9,776. Interest, calculated in accordance with Rule 25-30.360, Florida Administrative Code, is $140, making the total $9,916, which should be collected under guarantee, subject to refund with interest.

The security should be in the form of a bond or letter of credit in the amount of $9,916. Alternatively, the utility could establish an escrow agreement with an independent financial institution.

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

1) The Commission denies the rate decrease; or

2) If the Commission approves the decrease, the utility shall refund the amount collected that is attributable to the decrease.

If the utility chooses a letter of credit as security, it should 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 the final Commission order is rendered, and the amount of refund, if any, is determined.

If security is provided through an escrow agreement, the utility should escrow 15.25% of its monthly revenues as detailed in Issue No. 10, and the following conditions should be part of the escrow agreement:

1) No funds 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 Commission Clerk and Administrative Services must be a signatory to the escrow agreement.

In no instance should the maintenance and administrative costs associated with any refund be borne by the customers. These costs are the responsibility of, and should be borne by, the utility. Also, by no later than the twentieth day of each month, the utility should file a report showing the amount of revenues collected each month and the amount of revenues collected to date relating to the amount subject to refund. Should a refund be required, the refund should be with interest and undertaken in accordance with Rule 25-30.360, Florida Administrative Code.

ISSUE 12: Should this docket be closed?

RECOMMENDATION: Yes. If no timely protest is received to the PAA issues upon expiration of the protest period, the Order will become final upon the issuance of the Consummating Order. In the event of a protest, the utility should be allowed to continue collecting existing rates as temporary rates, but the utility should hold annual revenues subject to refund, as set forth in Issue No. 10 of this recommendation. (GERVASI, COSTNER, FITCH)

STAFF ANALYSIS: If no timely protest is received to the PAA issues upon expiration of the protest period, the Order will become final upon the issuance of the Consummating Order. In the event of a protest, the utility should be allowed to continue collecting existing rates as temporary rates, but the utility should hold annual revenues subject to refund, as set forth in Issue No. 10 of this recommendation.

WATER TREATMENT PLANT - USED AND USEFUL DATA

Docket No. 020045-WU - MORNINGSIDE UTILITIES, INC.

1)	**Firm Reliable Capacity of Plant**	189,000	gallons per day
2)	**Average of 5 Highest Days From Maximum Month**	137,800	gallons per day
3)	**Average Daily Flow**	51,378	gallons per day
4)	**Fire Flow Capacity**	N|A	gallons per day
5)	**Growth**	0	gallons per day

a) Test year Customers in ERCs:

Begin	230
End	230
Average	230

(Use average number of customers)

b) Customer Growth in ERCs 0 ERCs

c) Statutory Growth Period 5 Years

(b)x(c)x [3\(a)]= gallons per day for growth

6) **Excessive Unaccounted for Water** gallons per day

a) Total Unaccounted for Water gallons per day

Percent of Average Daily Flow

b) Reasonable Amount gallons per day

(10% of average Daily Flow)

c) Excessive Amount gallons per day

USED AND USEFUL FORMULA

[(2)+(4)+(5)-(6)]/(1) = *73% Used and Useful

*Note: This percentage is a result of using the standard formula, which in this case is not applicable.

Attachment A page 2 of 2

WATER DISTRIBUTION SYSTEM - USED AND USEFUL DATA

Docket No. 020045-WU; MORNINGSIDE UTILITIES, INC.

1)	**Capacity of System** (Number of Potential Customers, ERCs or Lots Without Expansion)	230 connections
2)	**Test year connections**	
	a) Beginning of Test Year	230 connections
	b) End of Test Year	230 connections
	c) Average Test Year	230 connections
3)	**Growth**	230 connections
	a) customer growth in connections for last 5 years including Test Year using Regression Analysis	0 connections
	b) Statutory Growth Period	5 Years
	(a)x(b) = 0 connections allowed for growth	

USED AND USEFUL FORMULA

[(2)+(3)]/(1) = 100% Used and Useful

MORNINGSIDE UTILITIES, INC.
TEST YEAR ENDING 12/31/00
SCHEDULE OF WATER RATE BASE

SCHEDULE NO. 1-A
DOCKET NO. 020045-WU

DESCRIPTION	BALANCE PER UTILITY	STAFF ADJUST. TO UTIL. BAL.	BALANCE PER STAFF
1. UTILITY PLANT IN SERVICE	$142,718	$21,493	$164,211
2. LAND & LAND RIGHTS	38,000	$0	$38,000
3. NON-USED AND USEFUL COMPONENTS	0	$0	$0
4. CIAC	0	($138,095)	($138,095)
5. ACCUMULATED DEPRECIATION	(81,088)	$2,309	($78,779)
6. AMORTIZATION OF CIAC	0	$57,621	$57,621
7. WORKING CAPITAL ALLOWANCE	0	$9,145	$9,145
8. WATER RATE BASE	$99,630	($47,527)	$52,103

MORNINGSIDE UTILITIES, INC. TEST YEAR ENDING 12/31/00 ADJUSTMENTS TO RATE BASE	SCHEDULE NO. 1-B DOCKET NO. 020045-WU
	WATER
UTILITY PLANT IN SERVICE	
1. Adjust to plant balance per Order PSC-98-1585-FOF-WU	$20,526
2. Increase Act. 307 for switch	135
3. Increase Act. 320 for Regulator, Valve, and Chlorinator	1,029
4. Increase Act. 334 for Meter	496
5. Reclassify Miscellaneous Expense	(458)
6. Averaging Adjustment	(2,593)
7. ProForma plant	4,716
8. ProForma Avg. Adj.	(2,358)
Total	$21,493
CIAC	
1. To reflect Commission Order PSC-98-1585-FOF-WU	($109,800)
2. To reclassify from Revenue	(7,095)
3. To reflect unrecorded CIAC	(25,715)
4. Averaging Adjustment	4,515
Total	($138,095)
ACCUMULATED DEPRECIATION	
1. To reflect test year depreciation calculated per 25-30.140 FAC.	($2,004)
2. Averaging Adjustment	4,313
Total	$2,309
AMORTIZATION OF CIAC	
1. Adjust to balance per Commission Order 15124.	$43,214
2. To reflect accumulated amortization per 25-30.140 FAC.	17,989
3. Averaging Adjustment	(3,582)
Total	$57,621
WORKING CAPITAL ALLOWANCE	
1. To reflect 1/8 of test year O & M expenses.	$9,145

MORNINGSIDE UTILITIES, INC.
TEST YEAR ENDING 12/31/00
SCHEDULE OF CAPITAL STRUCTURE

SCHEDULE NO. 2
DOCKET NO. 020045-WU

CAPITAL COMPONENT	PER Utility	SPECIFIC ADJUST-MENTS	BALANCE BEFORE PRO RATA ADJUSTMENTS	PRO RATA ADJUST-MENTS	BALANCE PER STAFF	PERCENT OF TOTAL	COST	WEIGHTED COST
1. COMMON STOCK	$500	$0	$500					
2. RETAINED EARNINGS	2,063	0	2,063					
3. PAID IN CAPITAL	85,197	0	85,197					
4. OTHER COMMON EQUITY	0	0	0					
5. TOTAL COMMON EQUITY	$87,760	$0	87,760	(70,686)	17,074	32.77%	11.34%	3.72%
6. LONG TERM DEBT		0	0	0	0	0.00%	0.00%	0.00%
GEORGE DEVILLERS	145,452	(5,024)	140,428	(113,108)	27,320	52.44%	10.00%	5.24%
FORD CREDIT	7,420	(110)	7,310	(5,888)	1,422	2.73%	11.50%	0.31%
GARY TURNER	30,309	(3,737)	26,572	(21,402)	5,170	9.92%	9.00%	0.89%
TOTAL LONG TERM DEBT	183,181	(8,871)	174,310	(140,398)	33,912	65.09%		
7. CUSTOMER DEPOSITS	5,742	0	5,742	(4,625)	1,117	2.14%	6.00%	0.13%
8. TOTAL	$276,683	($8,871)	$267,812	($215,709)	$52,103	100.00%		10.30%

RANGE OF REASONABLENESS	LOW	HIGH
RETURN ON EQUITY	10.34%	12.34%
OVERALL RATE OF RETURN	9.97%	10.62%

MORNINGSIDE UTILITIES, INC.
TEST YEAR ENDING 12/31/00
SCHEDULE OF WATER OPERATING INCOME

SCHEDULE NO. 3-A
DOCKET NO. 020045-WU

	TEST YEAR PER UTILITY	STAFF ADJ. PER UTILITY	STAFF ADJUSTED TEST YEAR	ADJUST. FOR DECREASE	REVENUE REQUIREMENT
1. OPERATING REVENUES	$108,520	($6,666)	$101,854	($14,664) -14.40%	$87,190
OPERATING EXPENSES:					
2. OPERATION & MAINTENANCE	68,632	4,530	73,162	0	73,162
3. DEPRECIATION (NET)	0	1,384	1,384	0	1,384
4. AMORTIZATION	0	0	0	0	0
5. TAXES OTHER THAN INCOME	9,259	(1,322)	7,937	(660)	7,277
6. INCOME TAXES	0	0	0	0	0
7. TOTAL OPERATING EXPENSES	$77,891	$4,592	$82,483	($660)	$81,823
8. OPERATING INCOME/(LOSS)	$30,629		$19,371		$5,367
9. WATER RATE BASE	$99,630		$52,103		$52,103
10. RATE OF RETURN	30.74%		37.18%		10.30%
11. RETURN ON EQUITY	73.74%		93.38%		11.36%

MORNINGSIDE UTILITIES, INC. TEST YEAR ENDING 12/31/00 ADJUSTMENTS TO OPERATING INCOME	SCHEDULE NO. 3-B DOCKET NO. 020045-WU PAGE 1 OF 2
	WATER
OPERATING REVENUES	
1. Reclassify service availability charges to CIAC	($7,095)
2. Annualize Revenue	429
Subtotal	($6,666)
OPERATION AND MAINTENANCE EXPENSES	
1. Salaries and Wages - Employees (601)	
a. Reflect Salaries from previous Order adjusted for inflation	$31,297
2. Salaries and Wages - Officers (603)	
a. Reflect Officers Salaries from previous Order adjusted for inflation	($26,847)
3. Purchased Power (615)	
a. Removal of out-of-period power bill	($236)
4. Materials and Supplies (620)	
a. Reclassify for Billing supplies	$1,045
5. Contractual Services - Professional (632)	
a. To reflect Amortization of NARUC setup	$260
6. Contractual Services - Other (636)	
a. Increase for unpaid invoices	$4,908
7. Rents (640)	
a. To reflect rent of previous order	$1,231
8. Insurance Expenses (655)	
a. To reflect annualized monthly payment	($1,164)
9. Regulatory Commission Expense (665)	
a. To reflect Amortization of Rate Case Expense	$447
10. Bad debt Expense (670)	
a. Increase per Audit Exception No. 5	
b. Reclassify from Acct. 675 (Misc. exp.)	445
Total	$445
11. Miscellaneous Expense (675)	
a. Remove IRA contributions	(600)
b. Reclassify to Acct. 620	(1,045)
c. Reclassify to Acct. 670	(445)
d. Reclassify from plant for telephone expense	458
e. Removal of excessive telephone billing	(4,235)
f. To remove Entertainment Expense	($85)
g. Remove expense for returned checks	(704)
h. Remove IRS penalty	(200)
Total	($6,856)
TOTAL OPERATION & MAINTENANCE ADJUSTMENTS	$4,530

MORNINGSIDE UTILITIES, INC.
TEST YEAR ENDING 12/31/00
ADJUSTMENTS TO OPERATING INCOME

SCHEDULE NO. 3-B
DOCKET NO. 020045-WU
PAGE 2 OF 2

	WATER
DEPRECIATION EXPENSE	
1. To reflect test year depreciation calculated per 25-30.140, FAC.	$8,819
3. Test year amortization of CIAC.	(7,435)
Total	$1,384
TAXES OTHER THAN INCOME	
1. To include regulatory assessment fees on annualized revenue.	$440
2. Removal of out-of-period taxes	(1,762)
Total	($1,322)

MORNINGSIDE UTILITIES, INC.
TEST YEAR ENDING 12/31/00
ANALYSIS OF WATER OPERATION AND
MAINTENANCE EXPENSE

SCHEDULE NO. 3-C
DOCKET NO. 020045-WU

	TOTAL PER UTILITY	STAFF PER ADJUST.		TOTAL PER PER STAFF
(601) SALARIES AND WAGES - EMPLOYEES	823	31,297	[1]	32,120
(603) SALARIES AND WAGES - OFFICERS	30,660	(26,847)	[2]	3,813
(604) PENSIONS AND BENEFITS	0	0		0
(610) PURCHASED WATER	0	0		0
(615) PURCHASED POWER	2,864	(236)	[3]	2,628
(616) FUEL FOR POWER PRODUCTION	0	0		0
(618) CHEMICALS	1,754	0		1,754
(620) MATERIALS AND SUPPLIES	3,171	1,045	[4]	4,216
(630) CONTRACTUAL SERVICES - BILLING	0	0		0
(631) CONTRACTUAL SERVICES - PROFESSIONAL	4,925	260	[5]	5,185
(635) CONTRACTUAL SERVICES - TESTING	1,835	0		1,835
(636) CONTRACTUAL SERVICES - OTHER	0	4,908	[6]	4,908
(640) RENT	0	1,231	[7]	1,231
(650) TRANSPORTATION EXPENSE	4,250	0		4,250
(655) INSURANCE EXPENSE	5,609	(1,164)	[8]	4,445
(665) REGULATORY COMMISSION EXPENSE	0	447	[9]	447
(670) BAD DEBT EXPENSE	445	445	[10]	890
(675) MISCELLANEOUS EXPENSES	12,296	(6,856)	[11]	5,440
	68,632	4,530		73,162

RECOMMENDED RATE REDUCTION SCHEDULE

MORNINGSIDE UTILITIES, INC.
TEST YEAR ENDING 12/31/00

SCHEDULE NO. 4
DOCKET NO.
020045-WU

CALCULATION OF RATE REDUCTION AMOUNT

MONTHLY WATER RATES

RESIDENTIAL SERVICE BASE FACILITY CHARGE:		CURRENT RATES	RECOMMENDED RATES
Meter Size:			
5/8"X3/4"	$	15.47	13.11
1"		38.68	32.78
1-1/2"		77.37	65.57
2"		123.79	104.91
3"		247.58	209.83
4"		386.84	327.85
6"		773.69	655.71
RESIDENTIAL GALLONAGE CHARGE PER 1,000 GALLONS	$	3.12	2.64