

FLORIDA PUBLIC SERVICE COMMISSION
Capital Circle Office Center, 2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

MEMORANDUM

MARCH 7, 1996

TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYO)

FROM: DIVISION OF WATER & WASTEWATER (MERCHANT) *PAM*
DIVISION OF AUDITING AND FINANCIAL ANALYSIS (DAVIS, *AF*
LESTER) *Q*
DIVISION OF LEGAL SERVICES (VACCARO) *QV* *YES* *ARC* *ALM*

RE: DOCKET NO. 960234-WS - GULF UTILITIES COMPANY -
INVESTIGATION OF RATES OF GULF UTILITY COMPANY IN LEE
COUNTY FOR POSSIBLE OVEREARNINGS
COUNTY: LEE

AGENDA: 3/19/96 - REGULAR AGENDA - DECISION ON SETTING REVENUES
SUBJECT TO REFUND - ON ISSUE 1 INTERESTED PERSONS MAY
PARTICIPATE - ON ISSUES 2 AND 3 PARTICIPATION IS LIMITED
TO COMMISSIONERS AND STAFF

CRITICAL DATES: NONE

LOCATION OF FILE: I:\PSC\AFA\WP\960234WS.ACM

CASE BACKGROUND

Gulf Utility Company (Gulf or the utility) is a Class A utility providing water and wastewater service for approximately 6,529 water and 2,070 wastewater customers in Lee County which is within a Water Caution Area. For the test period ending June 30, 1995, the utility reported water operating revenues of \$2,089,347 and a net operating income of \$557,814. Wastewater operating revenues were \$1,042,151, with a net operating income of \$133,046.

The utility's 1994 annual report indicated that Gulf's water system was earning an overall rate of return of 24.08%. Staff requested an audit of the utility's books. Based on the results of staff's audit of the year ending June 30, 1995, the utility is earning 150.92% on its equity capital. Staff is recommending that a docket be opened for a formal investigation of potential overearnings.

Gulf's last rate case was finalized on July 1, 1991, in Order No. 24735, Docket No. 900718-WU. In that order, rate base was set and an overall rate of return of 13.11% was approved.

DOCUMENT NUMBER-DATE

02808 MAR-7/96

FPSC-RECORDS/REPORTING

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DISCUSSION OF ISSUES

ISSUE 1: Should the Commission initiate an overearnings investigation of Gulf Utility Company?

RECOMMENDATION: Yes. The Commission should initiate an investigation of the composition and level of water rates to determine potential overearnings. Water and wastewater rate base should also be established since both were last set by the Commission as of July 1, 1991. (DAVIS)

STAFF ANALYSIS: Based on a desk audit of the 1994 Annual Report for Gulf Utility Company, staff began an informal investigation into potential overearnings. The 1994 Annual Report indicated that Gulf's water system was earning an achieved overall rate of return of 24.08%. Staff requested an audit of the utility's books for the test year ended June 30, 1995. Staff's audit indicated that the water system was earning an overall rate of return of 19.52%. Based on this, staff believes that this docket should be opened to investigate the potential overearnings of the utility. Furthermore, staff believes that water and wastewater rate base should be established since both were last set by the Commission as of July 1, 1991.

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ISSUE 2: Should any amount of annual water revenues be held subject to refund?

RECOMMENDATION: Yes. Gulf Utility Company should hold annual water revenues of \$353,492 subject to refund. No wastewater revenues should be held subject to refund. The following amounts are recommended: (DAVIS)

	<u>Total Revenues</u>	<u>Amount Subject To Refund</u>	<u>% Subject To Refund</u>
Water	\$2,089,347	\$353,492	16.92%

STAFF ANALYSIS: Staff believes that Gulf's water system may be overearning. Our preliminary analysis, also reveals that the wastewater system is not earning its overall rate of return. After staff has completed its investigation, we will be able to determine if the utility is, in fact, overearning.

RATE BASE

Utility Plant in Service/Accumulated Depreciation

The last rate order contained an adjustment to water plant to adjust for the cost of a Lexus automobile. The adjustment in Order No. 24735 reduced plant by \$20,721 and reduced accumulated depreciation by \$9,648. Audit Exception No. 1 notes that these adjustments are not booked. Consistent with Section 367.082(2)(b), Florida Statutes, for interim refund purposes, the adjustments from this order should be booked. The amount removed is 72% of the cost of the vehicle. Therefore, accumulated depreciation and depreciation expense are also being adjusted at 72% of the total amount. Accumulated depreciation is \$15,822. One half is allocated to each water and wastewater. Depreciation expense was computed at 16.67% of the \$20,721 and allocated to equally to water and wastewater, (1,726) each.

The following adjustment is included in staff's adjusted rate base:

NON-UTILITY RECEIVABLE	8,350	
ACCUMULATED DEPRECIATION WATER	7,911	
ACCUMULATED DEPRECIATION WASTEWATER	7,911	
WATER PLANT		10,360
WASTEWATER PLANT		10,360
WATER DEPRECIATION EXPENSE		1,726
WASTEWATER DEPRECIATION EXPENSE		1,726

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Working Capital

Section 367.082(5)(b)1, Florida Statutes requires that, in calculating interim rates, adjustments be made consistent with those in the utility's last rate proceeding. Consistent with the treatment allowed in Gulf's last rate proceeding, in Order No. 24735, staff has calculated working capital using the formula method. The staff auditor used the balance sheet method to calculate a working capital allowance of \$308,293 for water and \$145,079 for wastewater. Based on staff's preliminary review and the use of the formula method, staff recommends a working capital allowance of \$147,065 for water and \$82,565 for wastewater.

Rate base for interim purposes, as adjusted by staff, is \$2,152,968 and \$2,868,619 for water and wastewater, respectively. (Attachment A, Schedule 1)

COST OF CAPITAL

In Order No. 24735 Gulf's return on equity was established at 13.11%, with a range of 12.11% to 14.11%. Consistent with Section 367.082(2)(b), Florida Statutes, the appropriate rate of return on equity for interim refund purposes is calculated using the maximum of the range of the last authorized rate of return on equity. Using the high-end of the range to calculate any potential overearnings, staff has established an overall rate of return of 9.82% for interim purposes. (Attachment A, Schedule 2)

NET OPERATING INCOME

In addition to the rate base adjustments to adjust the cost of the Lexus consistent with the last rate case (Audit Exception No. 1), transportation expenses should be adjusted to remove \$5,082 (\$3,524 water and \$1,558 wastewater) of expenses related to the repair of the Lexus in the test year.

According to the NARUC chart of accounts, charitable contributions are to be charged to account 426, a below the line account. The utility has included \$1,210 (\$839 water and \$371 wastewater) of charitable contributions in accounts 675.8 and 775.8, miscellaneous expenses. These expenses should be reclassified and not included in NOI.

Staff has also calculated income tax expense for the test year. Income tax expense should show \$143,639 for water and a negative \$45,804 for wastewater.

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Interim Net Operating Income, as adjusted by staff is \$420,264 for the water system and \$182,505 for the wastewater system. (Attachment A, Schedule 3)

REVENUE REQUIREMENT

Water operating revenues as adjusted by staff total \$2,089,347 and net operating income is \$420,264. This represents a 19.52% overall rate of return. Staff's calculation indicates a revenue requirement of \$1,735,855 for the interim test year, representing an annual decrease of \$353,492. Accordingly, 16.92% of test year water revenues should be held subject to refund pending the final determination by the Commission. The wastewater system is earning an overall rate of return of 6.36% on an annual basis which is less than the minimum range on the overall rate of return. Accordingly, no adjustments are necessary to wastewater. (Attachment A, Schedule 3)

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ISSUE 3: What is the appropriate security to guarantee the amount subject to refund?

RECOMMENDATION: A surety bond, letter of credit, or escrow agreement in the amount of \$179,203 should be accepted as security.
(DAVIS, LESTER)

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 2, the amount of potential overearnings in the water system is \$353,492 on an annual basis. Assuming a 6-month time frame, the potential refund amount is \$176,746. Interest, calculated in accordance with Rule 25-30.360, is \$2,457, making the total \$179,203, which should be collected under guarantee, subject to refund with interest.

The Division of Auditing and Financial Analysis has advised that Gulf Utility Company does not qualify for a corporate undertaking. Based on staff's financial analysis, the utility has adequate liquidity and is profitable. However, the utility has an extremely low equity ratio and inadequate interest coverage, and its combined net income for the past three years is less than the amount under consideration. Therefore, staff believes that the utility cannot support the necessary corporate undertaking. It should secure revenue subject to refund with a surety bond, letter of credit, or escrow agreement.

This brief financial analysis is only appropriate for deciding if the utility can support a corporate undertaking in the amount proposed and should not be considered a finding regarding staff's position on other issues in the earnings investigation.

Also, by no later than the twentieth (20) 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.

In no instance should maintenance and administrative costs associated with any refund be borne by the customers. The costs are the responsibility of, and should be borne by, the utility.

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ATTACHMENT A
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GULF UTILITY COMPANY
 SCHEDULE OF WATER RATE BASE
 TEST YEAR ENDED 6/30/95

SCHEDULE NO. 1-A
 DOCKET NO. 960234-WS

COMPONENT	TEST YEAR PER AUDIT	AUDIT ADJUSTMENTS	BALANCE PER AUDIT	STAFF ADJUSTMENTS	STAFF ADJ. AVERAGE BALANCE
1 UTILITY PLANT IN SERVICE	\$14,802,926	\$ (10,361)	\$14,792,565	\$ 0	\$14,792,565
2 LAND & LAND RIGHTS	200,160	0	200,160	0	200,160
3 NON-USED & USEFUL COMPONENTS	(681,728)	0	(681,728)	0	(681,728)
4 ACCUMULATED DEPRECIATION	(3,368,641)	7,611	(3,360,730)	0	(3,360,730)
5 CIAC	(11,114,615)	0	(11,114,615)	0	(11,114,615)
6 AMORTIZATION OF CIAC	2,381,645	0	2,381,645	0	2,381,645
7 ADVANCES FOR CONSTRUCTION	(21,394)	0	(21,394)	0	(21,394)
8 WORKING CAPITAL ALLOWANCE	<u>308,293</u>	<u>(181,228)</u>	<u>147,065</u>	<u>0</u>	<u>147,065</u>
WATER RATE BASE	<u>\$ 2,216,646</u>	<u>\$ (163,676)</u>	<u>\$ 2,152,969</u>	<u>\$ 0</u>	<u>\$ 2,152,969</u>

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GULF UTILITY COMPANY
 SCHEDULE OF WASTEWATER RATE BASE
 TEST YEAR ENDED 8/30/85

SCHEDULE NO. 1-B
 DOCKET NO. _____-WS

COMPONENT	TEST YEAR PER AUDIT	AUDIT ADJUSTMENTS	BALANCE PER AUDIT	STAFF ADJUSTMENTS	STAFF ADJ. AVERAGE BALANCE
1 UTILITY PLANT IN SERVICE	\$11,218,644	\$ (10,360)	\$11,208,284	\$ 0	\$11,208,284
2 LAND	473,487	0	473,487	0	473,487
3 NON-USED & USEFUL COMPONENTS	0	0	0	0	0
4 ACCUMULATED DEPRECIATION	(2,382,387)	7,911	(2,374,456)	0	(2,374,456)
5 CIAC	(8,088,847)	0	(8,088,847)	0	(8,088,847)
6 AMORTIZATION OF CIAC	1,567,806	0	1,567,806	0	1,567,806
7 ADVANCES FOR CONSTRUCTION	0	0	0	0	0
8 WORKING CAPITAL ALLOWANCE	<u>145,079</u>	<u>(82,514)</u>	<u>82,565</u>	<u>0</u>	<u>82,565</u>
WASTEWATER RATE BASE	<u>\$ 2,822,582</u>	<u>\$ (64,963)</u>	<u>\$ 2,858,619</u>	<u>\$ 0</u>	<u>\$ 2,858,619</u>

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GULF UTILITY COMPANY
 CAPITAL STRUCTURE
 TEST YEAR ENDED 6/30/85

SCHEDULE NO. 2
 DOCKET NO. 960234-WS

PER AUDIT	TOTAL CAPITAL	SPECIFIC ADJUSTMENTS	PRO RATA ADJUSTMENTS	CAPITAL RECONCILED TO RATE BASE	RATIO	COST WEIGHTED RATE	WEIGHTED COST
LONG TERM DEBT	\$ 9,885,000	0	\$ (5,847,747)	\$ 4,247,253	84.58%	10.34%	8.75%
SHORT-TERM DEBT	75,360	0	(43,012)	32,348	0.64%	11.72%	0.08%
PREFERRED STOCK	0	0	0	0	0.00%	0.00%	0.00%
COMMON EQUITY	776,813	0	(433,719)	343,194	6.83%	13.11%	0.90%
CUSTOMER DEPOSITS	185,564	0	(101,958)	83,606	1.66%	6.21%	0.10%
DEFERRED INCOME TAXES	720,088	0	(404,800)	315,288	6.28%	0.00%	0.00%
DEFERRED ITC'S-WTD COST	0	0	0	0	0.00%	0.00%	0.00%
OTHER	0	0	0	0	0.00%	0.00%	0.00%
TOTAL CAPITAL	\$11,652,823	\$ 0	\$ (6,621,326)	\$ 5,021,507	100.00%		9.82%
				RANGE OF REASONABLENESS		LOW	HIGH
				RETURN ON EQUITY		12.11%	14.11%
				OVERALL RATE OF RETURN		9.75%	9.89%

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GULF UTILITY COMPANY
STATEMENT OF WATER OPERATIONS
TEST YEAR ENDED 6/30/85

SCHEDULE NO. 3-A
DOCKET NO. 960234-WS

DESCRIPTION	TEST YEAR PER AUDIT	AUDIT ADJUSTMENTS	BALANCE PER AUDIT	STAFF ADJUSTMENTS	STAFF ADJ. AVERAGE BALANCE	REVENUE INCREASE	REVENUE REQUIREMENT
1 OPERATING REVENUES	\$ 2,089,347	\$ 0	\$ 2,089,347	\$ 0	\$ 2,089,347	\$ (353,482)	\$ 1,735,855
OPERATING EXPENSES:						-18.82%	
2 OPERATION AND MAINTENANCE	\$ 1,180,884	\$ (4,363)	\$ 1,176,521	\$ 0	\$ 1,176,521	\$	\$ 1,176,521
3 DEPRECIATION	511,856	(1,726)	510,130	0	510,130		510,130
4 AMORTIZATION	(348,307)	0	(348,307)	0	(348,307)		(348,307)
5 TAXES OTHER THAN INCOME	187,100	0	187,100	0	187,100	(15,007)	171,183
6 INCOME TAXES	0	143,839	143,839	0	143,839	(130,223)	13,416
7 TOTAL OPERATING EXPENSES	\$ 1,531,533	\$ 137,550	\$ 1,669,083	\$ 0	\$ 1,669,083	\$ (146,130)	\$ 1,522,953
8 OPERATING INCOME	\$ 557,814	\$ (137,550)	\$ 420,264	\$ 0	\$ 420,264	\$ (297,361)	\$ 212,902
9 RATE BASE	\$ 2,318,646		\$ 2,152,968		\$ 2,152,968		\$ 2,152,968
10 RATE OF RETURN	24.02%		19.52%		19.52%		9.89%
11 RETURN ON EQUITY					150.82%		14.11%

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GULF UTILITY COMPANY
STATEMENT OF WASTEWATER OPERATIONS
TEST YEAR ENDED 6/30/95

SCHEDULE NO. 3-B
DOCKET NO. 960234-WS

	TEST YEAR PER AUDIT	AUDIT ADJUSTMENTS	BALANCE PER AUDIT	STAFF ADJUSTMENTS	STAFF ADJ. AVERAGE BALANCE	REVENUE INCREASE	REVENUE REQUIREMENT
1 OPERATING REVENUES	\$ 1,042,151	\$ 0	\$ 1,042,151	\$ 0	\$ 1,042,151	\$ 0	\$ 1,042,151
OPERATING EXPENSES						0.00%	
2 OPERATION AND MAINTENANCE	\$ 662,450	\$ (1,020)	\$ 660,521	\$ 0	\$ 660,521	\$	\$ 660,521
3 DEPRECIATION	397,291	(1,726)	395,475	0	395,475		395,475
4 AMORTIZATION	(270,472)	0	(270,482)	0	(270,482)		(270,482)
5 TAXES OTHER THAN INCOME	119,846	0	119,846	0	119,846	0	119,846
6 INCOME TAXES	0	(45,804)	(45,804)	0	(45,804)	0	(45,804)
7 TOTAL OPERATING EXPENSES	<u>\$ 909,105</u>	<u>\$ (49,450)</u>	<u>\$ 859,646</u>	<u>\$ 0</u>	<u>\$ 859,646</u>	<u>\$ 0</u>	<u>\$ 859,646</u>
8 OPERATING INCOME	<u>\$ 133,046</u>	<u>\$ 49,450</u>	<u>\$ 182,505</u>	<u>\$ 0</u>	<u>\$ 182,505</u>	<u>\$ 0</u>	<u>\$ 182,505</u>
9 RATE BASE	<u>\$ 2,833,582</u>		<u>\$ 2,868,619</u>		<u>\$ 2,868,619</u>		<u>\$ 2,868,619</u>
10 RATE OF RETURN	<u>4.54%</u>		<u>6.36%</u>		<u>6.36%</u>		<u>6.36%</u>
11 RETURN ON EQUITY					<u>-36.38%</u>		<u>-36.38%</u>