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M E M O R A N D U M

DECEMBER 4, 1997

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

FROM: DIVISION OF WATER & WASTEWATER (EDWARDS, KAPROTH)
DIVISION OF LEGAL SERVICES (VACCARO)

RE: DOCKET NO. 971504-WU - A.P. UTILITIES, INC. - INVESTIGATION OF WATER RATES FOR POSSIBLE OVEREARNINGS
COUNTY: MARION

AGENDA: 12/16/97 - REGULAR AGENDA - DECISION ON INITIATING AN INVESTIGATION AND SETTING REVENUES SUBJECT TO REFUND - ON ISSUES 1 and 4 PARTIES MAY PARTICIPATE - ON ISSUES 2 AND 3 PARTICIPATION IS LIMITED TO COMMISSIONERS AND STAFF

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: I:\PSC\WAW\WP\971504.RCM

DOCUMENT NUMBER-DATE
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FPSC-RECORDS/REPORTING

CASE BACKGROUND

A.P. Utilities, Inc. (APU or utility) is a Class B utility providing water service to 1,090 water customers in Marion County. For the test year ended December 31, 1996, the utility reported water operating revenues of $244,277 and operating expenses of $176,413, which resulted in a net operating income of $67,874.

North Central Florida Utilities, Inc. was transferred to APU in Order No. 21762, issued on August 21, 1989, in Docket No. 881063-WU. Mr. Phillip Woods purchased APU and the Commission approved the transfer of majority organizational control by Order No. 24977, issued August 26, 1991, in Docket No. 910117-WU. This purchase also included the Aqua Pure Water Company (Aqua Pure) and Marico Properties, Inc. (Marico). Aqua Pure Water Company was transferred to APU by Order No. 25075, issued on September 17, 1991, in Docket No. 910118-WU. Marico was transferred to APU by Order 25063, issued on September 13, 1991, in Docket No. 910119-WU.

In Docket No. 961141-WU, the utility was ordered to show cause as to why it should not be fined for failure to pay its 1991-1995 regulatory assessment fees (RAFs) and failure to file several years of annual reports in Order No. PSC-97-0286-FOF-WU, issued on March 13, 1997. In Docket No. 971076-WS, a show cause proceeding was initiated against A.P. Utilities, Inc., for failure to pay its 1996 RAFs and not filing timely its 1996 annual report. At the November 18, 1997 Agenda, the Commission voted to order the utility to show cause why it should not be fined for not paying its 1996 RAFs and for untimely filing of its 1996 annual report.

Based on a desk audit of the 1996 annual report for APU, staff began an informal investigation into potential overearnings. The 1996 annual report indicated that APU was earning an overall rate of return of 25.35%. Staff requested an audit of the utility's books. Based on the auditor's suggested adjustments, it appears that the utility is earning an overall rate of return of 23.32%. As a result of the audit findings, we are recommending that this docket be opened for an investigation of potential overearnings of APU and to hold revenues subject to refund. Further, since APU has not demonstrated that it is timely filing its RAFs, we are recommending that all collections for RAFs be held subject to refund.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission initiate an overearnings investigation of APU?

RECOMMENDATION: Yes. The Commission should initiate an investigation of the composition and level of water rates to determine potential overearnings. Rate base should be set because rate base has not been established since the transfer of majority organizational control to the present owner. (KAPROTH)

STAFF ANALYSIS: Based on a desk audit of the 1996 annual report for APU, staff began an informal investigation into potential overearnings. The 1996 annual report indicated that APU was earning an overall rate of return of 25.35%. Staff requested an audit of the utility's books after the test year ended December 31, 1996. Staff's audit indicated that the acheived overall rate of return of 23.32%. Based on this, staff believes that this docket should be opened to investigate the potential overearnings of the utility. Furthermore, staff believes that rate base should be set because rate base has not been established since the transfer of majority organizational control to the present owner.

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

RECOMMENDATION: Yes, APU should hold annual water revenues of $31,037 subject to refund for possible overearnings. The following amount is recommended: (KAPROTH)

	Total	Amount Subject To Refund	% Subject To Refund
Water	$222,370	$31,037	13.96%

STAFF ANALYSIS: Test year water operating revenues, as adjusted by the staff auditor, totaled $222,370 for the year ended December 31, 1996. The annual water revenue requirement calculated by staff, based on the auditor's adjusted rate base and net operating income totals $191,333. After staff has completed its investigation, we will be able to determine if the utility is, in fact, overearning.

Staff has attached accounting schedules to illustrate the recommended water rate base, capital structure, and the test year operating income. Rate base is attached as Schedule No. 1. The capital structure is Schedule No. 2. Schedule No. 3 is reserved for the operating statement. Below, staff will discuss the necessary adjustments.

For purposes of this interim recommendation, the schedules reflect year-end test year balances per the auditor, as well as specific audit adjustments. Since there was no filing on the part of the utility, the amounts per audit do not necessarily reflect the utility's position.

RATE BASE

Section 367.082(5)(b)1, Florida Statutes, requires that, in calculating the amount to be held subject to refund, adjustments be made consistent with those made in the utility's last rate proceeding. The staff auditor reviewed the utility's books and determined that the utility did not adjust it books to reflect the Commission ordered adjustments per Orders Nos. 21762, 25063 and 25075, issued August 21, 1989, September 13, 1991 and September 17, 1991, respectively. Consequently, the auditor made adjustments to correct utility plant in service, land, accumulated depreciation and accumulated amortization of CIAC. Further the auditor made an adjustment to correct $9,637 in erroneously expensed capital additions.

Additionally, the auditor used the formula method to calculate working capital, or 1/8 of operation and maintenance expenses, since the utility has not had a prior rate proceeding and is a Class B utility. Rule 25-30.433(2), Florida Administrative Code, states that working capital for Class B utilities shall be calculated using the formula method. Therefore, working capital should be $17,675. Based on the above auditor's adjustments, we recommend that water rate base for interim purposes be established at $289,419.

COST OF CAPITAL

The capital structure is based on the utility's debt and customer deposits. The utility's equity balance is negative. Therefore, this component is not considered in determining the interim cost of capital. Staff included $2,560 in customer deposits that was stated in the utility's 1996 annual report. The cost rate for customer deposits, as provided by Rule 25-30.311(4)(a), Florida Administrative Code, is 6%. The auditor determined the cost rate for the $498,997 of debt to be 9.64%. For the purposes of holding revenues subject to refund, staff recommends an overall rate of return of 9.62%.

NET OPERATING INCOME

Due to numerous problems encountered with the utility's books and records, the staff auditor proposed several adjustments to the utility's operating expenses. These adjustments correct errors, remove undocumented charges, remove non-utility charges, correct out of period charges, reclassify costs and disallow charges. Section 367.082(5)(b)1, Florida Statutes, requires that all adjustments be consistent with those made in the utility's last rate proceeding. Since there has not been a prior rate proceeding that determined net operating income, staff believes that the auditor's adjustments should be deemed corrections of errors and are appropriate until a further investigation can be conducted.

In addition, the auditor did not include an expense for income taxes or RAFs. Staff has not included an allowance for income taxes until a further investigation can be conducted into the appropriateness of an income tax expense. Also, the utility has no equity and, therefore, no income tax expense would be appropriate. Staff did include a $10,007 expense for RAFs. Even though the utility has not paid its 1996 RAFs, this is a yearly expense that is required to be paid and needs to be included in the calculation of revenues subject to refund. Therefore, staff recommends an increase to taxes other than income of $10,007 for RAFs.

Revenue Requirement

Staff's calculation indicates a water revenue requirement of $191,333 for the interim test year, representing a decrease of $31,037 or 13.96%. Accordingly, staff recommends that $31,037 in water revenues be held subject to refund pending the final determination by the Commission.

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

RECOMMENDATION: The utility should be required to file a bond, letter of credit or escrow agreement to guarantee the amount subject to refund. The letter of credit or bond should be in the amount of $24,243. In lieu of a letter of credit or bond, the utility may obtain an escrow agreement which requires the utility to deposit an amount monthly, as discussed below, until completion of the overearnings investigation. Pursuant to Rule 25-30.360(6), Florida Administrative Code, the utility shall provide a report by the 20th day of each month indicating the monthly and total revenue collected subject to refund. (KAPROTH)

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. The amount of potential overearnings for APU is $31,037 on an annual basis. Assuming a 9-month time frame, the potential refund amount is $24,243. Therefore, only $24,243 in annual revenues should be collected under guarantee, subject to refund with interest.

Based on the analysis by the Division of Auditing and Financial Analysis of the utility's financial statements, the utility cannot support a corporate undertaking for $24,243. This is due to the utility's insufficient liquidity, negative owner's equity, inadequate interest coverage, and its highly leveraged capital structure. Therefore, staff recommends that the utility provide a letter of credit, bond or escrow agreement to guarantee the funds collected subject to refund.

If the security provided is an escrow account, said account should be established between the utility and an independent financial institution pursuant to a written escrow agreement. The Commission should be a party to the written escrow agreement and a signatory to the escrow account. The written escrow agreement should state the following: that the account is established at the direction of this Commission for the purpose set forth above; that no withdrawals of funds shall occur without the prior approval of the Commission through the Director of the Division of Records and Reporting; that the account shall be interest bearing; that information concerning that escrow account shall be available from the institution to the Commission or its representative at all times; that the amount of revenue subject to refund shall be deposited in the escrow account within seven days of receipt; and that pursuant to Cosentino v. Elson, 263 So. 2d 253 (Fla 3d. DCA 1972), escrow accounts are not subject to garnishments.

The utility should deposit $2,694 into the escrow account each month for possible overearnings. The escrow agreement should also state the following: that if a refund to the customers is required, all interest earned on the escrow account shall be distributed to the customers; and if a refund to the customers is not required, the interest earned on the escrow account shall revert to the utility.

If the security provided is a bond or a letter of credit, said instrument should be in the amount of $24,243. If the utility chooses a bond as security, the bond should state that it will be released or should terminate only upon subsequent order of the Commission addressing overearnings or requiring a refund. If the utility chooses to provide a letter of credit as security, the letter of credit should state that it is irrevocable for the period it is in effect and that it will be in effect until a final Commission order is rendered addressing overearnings or requiring a refund.

Irrespective of the type of security provided, the utility should keep an accurate and detailed account of all monies it receives. Pursuant to Rule 25-30.360(6), Florida Administrative Code, the utility shall provide a report by the 20th day of each month indicating the monthly and total revenue collected 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.

If the utility does not comply with the requirements stated in this recommendation, it should be put on notice that show cause proceedings will be initiated immediately after any missed actions by APU.

ISSUE 4: Should the utility be required to escrow its regulatory assessment fees on a monthly basis?

RECOMMENDATION: Yes. The utility should be ordered to establish a separate joint, interest-bearing escrow account for all 1998 RAFs within 30 days. The account must comply with the requirements outlined in the staff analysis of this recommendation. In addition, the utility should be ordered to place 4.5% of monthly service revenues billings beginning with January, 1998 billings, including miscellaneous service charges, into the interest-bearing joint escrow account for payment of its RAFs. The utility should also be ordered to maintain a record of the revenues billed for each month and the utility should file a report with the Division of Water and Wastewater no later than 20 days after each monthly billing. These reports shall indicate the amount of revenue billed each month under the categories of monthly service rates and miscellaneous service revenues. (KAPROTH)

STAFF ANALYSIS: In setting rates, the Commission includes revenues sufficient to provide for the utility's obligation to pay RAFs. However, in this case, the utility has historically collected the RAFs but not paid them to the Commission, as it is required to do. RAFs are intended to defray the costs incurred in Public Service Commission regulation of utilities.

The utility has not paid the majority of its RAFs from 1991 through 1996. The utility now owes the Commission $81,454.24, which includes penalties and interest for non-payment of its RAFs. The utility did make a payment of $2,000 in October, 1997 and another payment of $2,000 in November, 1997. Of these payments, $3,260 was applied to the amount owed for RAFs. The remainder was retained by the collection agency for its services. As a result, staff recommends that the Commission order the utility to establish a separate interest-bearing escrow account for the purpose of depositing 4.5% of all monthly service billings (monthly service and miscellaneous service charges) for payment of the RAFs. This is consistent with Order No. PSC-92-0478-FOF-WU, issued June 9, 1992, in Docket No. 920318-WU, titled : In Re: Initiation of Proceeding by Florida Public Service Commission to Require St. George Island Utility Company, Ltd., in Franklin County to Escrow Funds for Payment of Regulatory Assessment Fees. By that order, the Commission required St. George Island Utility Company, Ltd. to escrow its RAFs based on the utility's failure to pay past RAFS.

If the security provided is an escrow account, said account should be established between the utility and an independent financial institution pursuant to a written escrow agreement. The Commission should be a party to the written escrow agreement and a signatory to the escrow account. The written escrow agreement should state the following: that the account is established at the direction of this Commission for the purpose set forth above; that no withdrawals of funds shall occur without the prior approval of the Commission through the Director of the Division of Records and Reporting; that the account shall be interest-bearing; that information concerning that escrow account shall be available from the institution to the Commission or its representative at all times; and that pursuant to Cosentino v. Elson, 263 So. 2d 253 (Fla 3d. DCA 1972), escrow accounts are not subject to garnishments.

The following additional conditions should be required to be part of the escrow agreement: the interest earned by the escrow account shall be maintained in the account and used to pay any penalties and interest associated with delinquent payment; the 4.5% of all service revenues and miscellaneous service charge billings for each month beginning in January, 1998, shall be deposited into the account within seven days of receipt. Further, a draft of the agreement should be required to be submitted to the Commission for its approval.

The utility should also be required to maintain record of the revenues billed for each month and the utility should be required to file a report with the Division of Water and Wastewater no later than 20 days after each monthly billing. These reports should indicate the amount of revenue billed for the month under the categories of monthly service rates and miscellaneous service charges.

This method of forced savings does not address the past delinquent amounts. As noted in the case background, these past due RAFs are being addressed in other dockets.

A.P. UTILITIES, INC.
SCHEDULE OF WATER RATE BASE
TEST YEAR ENDED 12/31/96

SCHEDULE NO. 1
DOCKET 971504-WU

DESCRIPTION	AUDITED ADJUSTED TEST YEAR	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR
1 UTILITY PLANT IN SERVICE	$733,846	$0	$733,846
2 LAND & LAND RIGHTS	$42,222	$0	$42,222
3 NON-USED & USEFUL COMPONENT	$0	$0	$0
4 ACCUMULATED DEPRECIATION	($254,550)	$0	($254,550)
5 CIAC	($378,935)	$0	($378,935)
6 AMORTIZATION OF CIAC	$129,160	$0	$129,160
7 CWIP	$0	$0	$0
8 ADVANCES FOR CONSTRUCTION	$0	$0	$0
9 UNFUNDED POST-RETIRE. BENEFIT	$0	$0	$0
10 DEFERRED INCOME TAXES	$0	$0	$0
11 WORKING CAPITAL ALLOWANCE	$17,675	$0	$17,675
12 OTHER	$0	$0	$0
RATE BASE	$289,418	$0	$289,418

A.P. UTILITIES, INC.
CAPITAL STRUCTURE
TEST YEAR ENDED 12/31/96

SCHEDULE NO. 2
DOCKET 971504-WU

DESCRIPTION	TOTAL CAPITAL	SPECIFIC ADJUSTMENTS (NOTE A)	PRO RATA ADJUSTMENTS	CAPITAL RECONCILED TO RATE BASE	RATIO	COST RATE	WEIGHTED COST
PER STAFF - 1996 YEAR-END							
11 LONG TERM DEBT	$498,997	$0	($211,056)	$287,941	99.49%	9.64%	9.59%
12 SHORT-TERM DEBT	$0	$0	$0	$0	0.00%	0.00%	0.00%
13 PREFERRED STOCK	$0	$0	$0	$0	0.00%	0.00%	0.00%
14 COMMON EQUITY	$0	$0	$0	$0	0.00%	0.00%	0.00%
15 CUSTOMER DEPOSITS (A)	$0	$2,560	($1,083)	$1,477	0.51%	6.00%	0.03%
16 DEFERRED INCOME TAXES	$0	$0	$0	$0	0.00%	0.00%	0.00%
17 DEFERRED ITC'S-ZERO COST	$0	$0	$0	$0	0.00%	0.00%	0.00%
18 DEFERRED ITC'S-WTD. COST	$0	$0	$0	$0	0.00%	0.00%	0.00%
19 OTHER	$0	$0	$0	$0	0.00%	0.00%	0.00%
17 TOTAL CAPITAL	$498,997	$2,560	($212,139)	$289,418	100.00%		9.62%

	LOW	HIGH
RETURN ON EQUITY	0.00%	0.00%
OVERALL RATE OF RETURN	9.62%	9.62%

NOTES:
(A) Customer deposits from the 1996 annual report

A.P. UTILITIES, INC.
STATEMENT OF WATER OPERATIONS
TEST YEAR ENDED 12/31/96

SCHEDULE NO. 3
DOCKET 971504-WU

	DESCRIPTION	AUDITED ADJUSTED TEST YEAR	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR	REVENUE DECREASE	REVENUE REQUIREMENT
1	OPERATING REVENUES	$222,370	$0	$222,370	($31,037) -13.96%	$191,333
	OPERATING EXPENSES:					
2	OPERATION AND MAINTENANCE	$141,401	0	141,401		141,401
3	DEPRECIATION	$8,632	0	8,632		8,632
4	AMORTIZATION	$0	0	0		0
5	TAXES OTHER THAN INCOME	$4,844	10,007	14,851	(1,397)	13,454
6	INCOME TAXES	$0	$0	$0	$0	$0
7	TOTAL OPERATING EXPENSES	$154,877	$10,007	$164,884	($1,397)	$163,487
8	OPERATING INCOME	$67,493	($10,007)	$57,487	($29,641)	$27,846
9	RATE BASE	$289,418		$289,418		$289,418
10	RATE OF RETURN	23.32%		19.86%		9.62%