

State of Florida



Public Service Commission

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

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

DATE: OCTOBER 22, 1998

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

FROM: DIVISION OF WATER AND WASTEWATER (QUIJANO, MERCHANT) *BER*
DIVISION OF LEGAL SERVICES (REYES) *HTS*

RE: DOCKET NO. 981258-WS - LAKE WALES UTILITY CO., LTD. -
INVESTIGATION OF WATER AND WASTEWATER RATES FOR POSSIBLE
OVEREARNINGS
COUNTY: POLK

AGENDA: 11/03/98 - REGULAR AGENDA - DECISION ON SETTING REVENUES
SUBJECT TO REFUND - ON ISSUE 1 INTERESTED PARTIES MAY
PARTICIPATE - ON ISSUES 2 AND 3 PARTICIPATION IS LIMITED
TO COMMISSIONERS AND STAFF

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\WAW\WP\981258WS.RCM

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REC'D-RECORDS/REPORTING

CASE BACKGROUND

Lake Wales Utility Co., Ltd. (Lake Wales or Utility) is a Class B utility providing water and wastewater service for approximately 84 residential and 15 general service water and wastewater customers in Polk County since 1962. The utility's systems are located in Fedhaven. For the twelve months ended December 31, 1997, the utility reported water operating revenues of \$140,740 and a net operating income of \$33,120. Wastewater operating revenues were \$214,793, with a net operating income of \$76,907.

Lake Wales became subject to the jurisdiction of the Public Service Commission on May 14, 1996. In Order No. PSC-97-0567-FOF-WS, the utility was granted grandfather certificates to provide water and wastewater service. Rate Base was last set by Polk County in a 1991 Rate Increase Resolution dated February 2, 1992. A pass-through for regulatory assessment fees was granted by this Commission on February 20, 1997.

Based on a staff's desk audit for the 1997 annual report, Lake Wales appeared to be earning an overall rate of return of 81.56% for water and 28.30% for wastewater. Therefore, we recommend that this docket be opened for an investigation of potential overearnings. Furthermore, staff believes that water and wastewater rate base should be established since both were last set by Polk County as of December 31, 1991.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission initiate an earnings investigation of Lake Wales?

RECOMMENDATION: Yes. The Commission should initiate an investigation of the composition and level of water and wastewater rates to determine potential overearnings. Water and wastewater rate base should also be established since both were last set by Polk County as of December 31, 1991. (QUIJANO)

STAFF ANALYSIS: Based on a staff desk audit of the 1997 Annual Report for Lake Wales, the utility appears to be earning an overall rate of return of 81.56% in water and 28.30% in wastewater. The last rate of return of the utility set by Polk County in a 1991 Rate Increase Resolution, dated February 2, 1992, was 10.7%. Even though the Commission has never established a rate of return, these returns are obviously excessive. Therefore, staff recommends 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 Polk County as of December 31, 1991.

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

RECOMMENDATION: Yes, Lake Wales should hold the following amounts subject to refund. (QUIJANO)

	Revenue <u>Requirements</u>	Amount Subject <u>To Refund</u>	% Subject <u>To Refund</u>
Water	\$112,947	\$28,719	20.27%
Wastewater	\$166,339	\$49,867	23.06%

STAFF ANALYSIS: Based on Lake Wales' 1997 Annual Report, the utility achieved an overall rate of return for water and wastewater systems of 81.56% and 28.30%, respectively. The water operating revenue is \$140,740 while the wastewater operating revenue is \$214,793. The gross annual revenue requirement calculated by staff, based on the staff's adjusted rate base and net operating income totaled \$112,947 for water and \$166,339 for wastewater. The difference of \$28,719 for water and \$49,867 for wastewater should be held subject to refund per Section 367.082, Florida Statutes.

Staff has attached accounting schedules to illustrate the recommended water and wastewater rate base, capital structure, and test year operating income amounts. The rate base schedules are numbered 1-A, 1-B and the adjustments to rate base are on schedule 1-C. The capital structure is schedule number 2 and schedules 3-A, 3-B, and 3-C are the schedules and adjustments for the operating statements. Below, staff will discuss our recommended adjustments for the test year ending December 31, 1997 balances for interim purposes.

RATE BASE

Our calculation of Lake Wales' water and wastewater rate base is based upon information shown in its 1997 Annual Report. Rule 25-30.433(2), Florida Administrative Code, requires the Commission to calculate working capital for Class B utilities using the formula method (one-eighth of operation and maintenance expenses). Since the utility used the formula method in its annual report, no adjustment is necessary. Also, Rule 25-30.433(4), Florida Administrative Code, requires the simple beginning and end-of-year average methodology be used in rate case proceedings. Staff has accordingly adjusted rate base to average amounts. Based on this methodology, we recommend that the interim rate base amounts for

the Lake Wales water and wastewater systems are \$46,325 and \$278,350, respectively.

COST OF CAPITAL

The recommended capital structure for interim refund purposes reflects the utility's outstanding capital balances shown in Lake Wales' 1997 Annual Report. Again, simple averages were computed using the beginning and ending balances for each component of the capital structure. In accordance with Section 367.082(2)(b), Florida Statutes, an interim decrease shall be calculated using the maximum of the range of the last authorized rate of return on equity investment. This Commission has not previously established a rate of return on equity for Lake Wales. Further, Section 367.082(6), Florida Statutes, states that the Commission is allowed to establish interim rates for a utility which does not have an authorized rate of return previously established by the Commission. Accordingly, staff believes it is appropriate to use the Commission's current leverage formula contained in Order No. PSC-98-0903-FOF-WS, issued on July 6, 1998, (Docket No. 980006-WS). Thus, staff recommends that the utility's required rate of return on equity is 9.85% with a range of 8.57% to 9.85%. Using the high-end of the range to calculate any potential overearnings, staff has established an overall rate of return of 9.80% for interim purposes.

NET OPERATING INCOME

On February 20, 1997, the utility implemented a pass-through for regulatory assessment fees (RAFs) that increased revenues by 4.71%. In accordance with the interim statute, the revenue impact of that adjustment is annualized and is, therefore, reflected as an increase of \$926 for water and \$1,413 for wastewater to test year 1997 revenues. Also, the utility did not reflect the correct amount of regulatory assessment fees on the revenues reported in its 1997 annual report. As such, RAFs should be increased by \$2,038 for water and \$3,356 for wastewater, respectively.

Staff has made no other adjustments in operating expenses. As a result, Lake Wales' test year net operating income for water and wastewater are \$31,966 and \$74,901, respectively. This reflects a 52.58% and 23.92% achieved rate of return for water and wastewater, respectively. The revenue requirements using the interim rate of return of 9.80% are \$112,947 for water and \$166,339 for wastewater. As such, staff recommends that \$28,719 in water and \$49,867 in wastewater revenues be held subject to refund pending the final determination by the Commission in the instant case.

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

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 total amount of \$50,884 for water and wastewater. 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 should be required to provide a report by the 20th day of each month indicating the monthly and total revenue collected subject to refund. (QUIJANO)

STAFF ANALYSIS: Pursuant to Section 367.082, Florida Statutes, when the Commission authorizes an interim decrease, the utility is authorized to continue collecting its previously authorized rates. However, revenues collected under those rates shall be placed under bond, escrow, letter of credit, or corporate undertaking subject to refund with interest at a rate ordered by the Commission. As recommended in Issue 2, the amount of potential overearnings is a total of \$78,586, or \$28,719 for the water system and \$49,867 for wastewater system on an annual basis. On February 20, 1997, the utility implemented a pass-through of \$5,678 for water and \$7,689 for wastewater. According to Section 367.081 (4)(d), Florida Statutes, if, within 15 months after the filing of a utility's annual report, the Commission finds that the utility exceeded the range of its last authorized rate of return on equity after an adjustment in rates, the Commission may order the utility to refund, with interest, the difference to the ratepayers and adjust rates accordingly. The utility's 1997 Annual Report was filed on February 27, 1998, consequently, fifteen (15) months from that date is May 27, 1999. Therefore, only \$23,041 for water and \$42,178 for wastewater, or a total of \$65,219 in additional revenues should be held subject to refund for interim purposes.

Assuming a 9-month time frame, the total potential refund amount is \$50,884. Accordingly, \$50,884 in incremental 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 \$50,884. 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 of 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 \$5,654 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 \$50,884. 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 days of each month indicating the monthly and total revenue collected subject to refund. Should a refund be required, the refund should be with

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interest and undertaken in accordance with Rule 25-30.360, Florida Administrative Code.

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

LAKE WALES UTILITY CO., LTD.
 SCHEDULE OF WATER RATE BASE - SIMPLE AVERAGE
 TEST YEAR ENDED 12/31/97

SCHEDULE NO. 1-A
 DOCKET 981258-WS

DESCRIPTION	TEST YEAR PER UTILITY	UTILITY ADJUSTMENTS	ADJUSTED TEST YEAR PER UTILITY	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR
1 UTILITY PLANT IN SERVICE	\$429,973	\$0	\$429,973	(\$359)	\$429,615
2 LAND & LAND RIGHTS	\$14,473	\$0	\$14,473	\$0	\$14,473
3 NON-USED & USEFUL COMPONENTS	\$0	\$0	\$0	\$0	\$0
4 ACCUMULATED DEPRECIATION	(\$352,483)	\$0	(\$352,483)	\$9,281	(\$343,203)
5 CIAC	(\$218,000)	\$0	(\$218,000)	\$0	(\$218,000)
6 AMORTIZATION OF CIAC	\$155,740	\$0	\$155,740	(\$3,205)	\$152,536
7 CWIP	\$0	\$0	\$0	\$0	\$0
8 ADVANCES FOR CONSTRUCTION	\$0	\$0	\$0	\$0	\$0
9 UNFUNDED POST-RETIRE. BENEFITS	\$0	\$0	\$0	\$0	\$0
10 DEFERRED INCOME TAXES	\$0	\$0	\$0	\$0	\$0
11 WORKING CAPITAL ALLOWANCE	\$10,905	\$0	\$10,905	\$0	\$10,905
12 OTHER	\$0	\$0	\$0	\$0	\$0
RATE BASE	\$40,608	\$0	\$40,608	\$5,718	\$46,325

LAKE WALES UTILITY CO., LTD.
 SCHEDULE OF WASTEWATER RATE BASE - SIMPLE AVERAGE
 TEST YEAR ENDED 12/31/97

SCHEDULE NO. 1-B
 DOCKET 981258-WS

DESCRIPTION	TEST YEAR PER UTILITY	UTILITY ADJUSTMENTS	ADJUSTED TEST YEAR PER UTILITY	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR
1 UTILITY PLANT IN SERVICE	\$654,841	\$0	\$654,841	(\$611)	\$654,230
2 LAND	\$34,247	\$0	\$34,247	\$0	\$34,247
3 NON-USED & USEFUL COMPONENTS	\$0	\$0	\$0	\$0	\$0
4 ACCUMULATED DEPRECIATION	(\$412,985)	\$0	(\$412,985)	\$10,218	(\$402,768)
5 CIAC	(\$157,439)	\$0	(\$157,439)	\$0	(\$157,439)
6 AMORTIZATION OF CIAC	\$139,316	\$0	\$139,316	(\$3,055)	\$136,262
7 ACQUISITION ADJUSTMENTS - NET	\$0	\$0	\$0	\$0	\$0
8 ADVANCES FOR CONSTRUCTION	\$0	\$0	\$0	\$0	\$0
9 UNFUNDED POST-RETIRE. BENEFITS	\$0	\$0	\$0	\$0	\$0
10 DEFERRED INCOME TAXES	\$0	\$0	\$0	\$0	\$0
11 WORKING CAPITAL ALLOWANCE	\$13,818	\$0	\$13,818	\$0	\$13,818
12 OTHER	\$0	\$0	\$0	\$0	\$0
RATE BASE	\$271,798	\$0	\$271,798	\$6,552	\$278,350

LAKE WALES UTILITY CO., LTD.
ADJUSTMENTS TO RATE BASE
TEST YEAR ENDED 12/31/97

SCHED. NO. 1-C
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EXPLANATION	WATER	WASTEWATER
<u>PLANT IN SERVICE</u>		
1 Using 1996 and 1997 amounts to compute for simple average	(359)	(611)
Total	<u>(359)</u>	<u>(611)</u>
<u>ACCUMULATED DEPRECIATION</u>		
1 Using 1996 and 1997 amounts to compute for simple average	9,281	10,218
Total	<u>9,281</u>	<u>10,218</u>
<u>ACCUM. AMORT. OF CIAC</u>		
1 Using 1996 and 1997 amounts to compute for simple average	(3,205)	(3,055)
Total	<u>(3,205)</u>	<u>(3,055)</u>

LAKE WALES UTILITY CO., LTD.
 CAPITAL STRUCTURE - SIMPLE AVERAGE
 TEST YEAR ENDED 12/31/97

SCHEDULE NO. 2
 DOCKET 981258-WS

DESCRIPTION	TOTAL CAPITAL	SPECIFIC ADJUSTMENT (EXPLAIN)	PRO RATA ADJUSTMENTS	CAPITAL RECONCILED TO RATE BASE	RATIO	COST RATE	WEIGHTED COST
PER STAFF 1997 - SIMPLE AVERAGE							
1 LONG TERM DEBT	\$110,643	\$0	(\$3,378)	\$107,265	33.04%	9.32%	3.08%
2 SHORT-TERM DEBT	\$16,583	\$0	(\$506)	\$16,077	4.95%	9.32%	0.46%
3 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
4 COMMON EQUITY	\$207,674	\$0	(\$6,340)	\$201,334	62.01%	10.09%	6.26%
5 CUSTOMER DEPOSITS	\$0	\$0	\$0	\$0	0.00%	6.00%	0.00%
6 DEFERRED INCOME TAXES	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
7 DEFERRED ITC'S-ZERO COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
8 DEFERRED ITC'S-WTD. COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
9 OTHER	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
10 TOTAL CAPITAL	<u>\$334,900</u>	<u>\$0</u>	<u>(\$10,225)</u>	<u>\$324,675</u>	<u>100.00%</u>		<u>9.80%</u>
					<u>LOW</u>	<u>HIGH</u>	
						<u>8.09%</u>	<u>10.09%</u>
						<u>8.56%</u>	<u>9.80%</u>

LAKE WALES UTILITY CO., LTD.
 STATEMENT OF WATER OPERATIONS
 TEST YEAR ENDED 12/31/97

SCHEDULE NO. 3-A
 DOCKET 981258-WS

DESCRIPTION	TEST YEAR PER UTILITY	UTILITY ADJUSTMENTS	ADJUSTED TEST YEAR PER UTILITY	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR	REVENUE INCREASE	REVENUE REQUIREMENT
1 OPERATING REVENUES	\$140,740	\$0	\$140,740	\$926	\$141,666	(\$28,719) -20.27%	\$112,947
OPERATING EXPENSES:							
2 OPERATION AND MAINTENANCE	\$87,236	\$0	\$87,236	\$0	\$87,236	\$0	\$87,236
3 DEPRECIATION	\$12,152	\$0	\$12,152	\$0	\$12,152	\$0	\$12,152
4 AMORTIZATION	\$0	\$0	\$0	\$0	\$0	\$0	\$0
5 TAXES OTHER THAN INCOME	\$8,232	\$0	\$8,232	\$2,080	\$10,312	(\$1,292)	\$9,020
6 INCOME TAXES	\$0	\$0	\$0	\$0	\$0	\$0	\$0
7 TOTAL OPERATING EXPENSES	\$107,620	\$0	\$107,620	\$2,080	\$109,700	(\$1,292)	\$108,408
8 OPERATING INCOME	\$33,120	\$0	\$33,120	(\$1,154)	\$31,966	(\$27,426)	\$4,540
9 RATE BASE	\$40,608		\$40,608		\$46,325		\$46,325
10 RATE OF RETURN	81.56%		81.56%		69.00%		9.80%

LAKE WALES UTILITY CO., LTD.
 STATEMENT OF WASTEWATER OPERATIONS
 TEST YEAR ENDED 12/31/97

SCHEDULE NO. 3-B
 DOCKET 981258-WS

DESCRIPTION	TEST YEAR PER UTILITY	UTILITY ADJUSTMENTS	ADJUSTED TEST YEAR PER UTILITY	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR	REVENUE INCREASE	REVENUE REQUIREMENT
1 OPERATING REVENUES	\$214,793	0	\$214,793	\$1,413	\$216,206	(\$49,867) -23.06%	\$166,339
OPERATING EXPENSES							
2 OPERATION AND MAINTENANCE	110,546	0	\$110,546	\$0	\$110,546	\$0	\$110,546
3 DEPRECIATION	14,326	0	\$14,326	\$0	\$14,326	\$0	\$14,326
4 AMORTIZATION	0	0	\$0	\$0	\$0	\$0	\$0
5 TAXES OTHER THAN INCOME	\$13,014	\$0	\$13,014	\$3,419	\$16,433	(\$2,244)	\$14,189
6 INCOME TAXES	\$0	\$0	\$0	\$0	\$0	\$0	\$0
7 TOTAL OPERATING EXPENSES	\$137,886	\$0	\$137,886	\$3,419	\$141,305	(\$2,244)	\$139,061
8 OPERATING INCOME	\$76,907	\$0	\$76,907	(\$2,006)	\$74,901	(\$47,623)	\$27,278
9 RATE BASE	\$271,798		\$271,798		\$278,350		\$278,350
10 RATE OF RETURN	28.30%		28.30%		26.91%		9.80%

LAKE WALES UTILITY CO., LTD.
ADJUSTMENTS TO OPERATING INCOME
TEST YEAR ENDED 12/31/97

SCHED. NO. 3-C
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EXPLANATION	WATER	WASTEWATER
OPERATING REVENUES		
1 Pass-Through Adjustment for Jan-Feb 20, 1997	926	1,413
Total	<u>926</u>	<u>1,413</u>
TAXES OTHER THAN INCOME		
1 RAFs on revenue adjustments above	42	64
2 Correct understated test RAFs.	2,038	3,356
Total	<u>2,080</u>	<u>3,419</u>