

State of Florida



Public Service Commission

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TALLAHASSEE, FLORIDA 32399-0850

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DATE: AUGUST 7, 2003
TO: DIRECTOR, DIVISION OF THE COMMISSION ADMINISTRATIVE SERVICES (BAYÓ)
FROM: DIVISION OF ECONOMIC REGULATION (IWENJIORA) OFFICE OF THE GENERAL COUNSEL (K.FLEMING)
RE: DOCKET NO. 030601-SU - INVESTIGATION INTO 2002 EARNINGS OF NORTH PENINSULA UTILITIES CORPORATION IN VOLUSIA COUNTY.
AGENDA: 08/19/03 - REGULAR AGENDA - DECISION ON SETTING REVENUES SUBJECT TO REFUND - INTERESTED PERSONS MAY PARTICIPATE
CRITICAL DATES: NONE
SPECIAL INSTRUCTIONS: NONE
FILE NAME AND LOCATION: S:\PSC\ECR\WP\030601.RCM

CASE BACKGROUND

North Peninsula Utilities Corporation (North Peninsula or utility) is a Class C wastewater utility serving approximately 548 customers in Volusia County. According to its 2002 annual report, the utility reported operating revenues of \$187,899 and operating expenses of \$161,307. This resulted in a net operating income of \$26,592.

By Order No. 16184, issued June 4, 1986, in Docket No. 850121-SU, the Commission processed a staff assisted rate case for this utility when the utility was known as Shore Utility Corporation. A transfer docket was opened in 1989 to transfer Shore Utility Corporation to North Peninsula. By Order No. 22345, issued December 27, 1989, in Docket No. 891016-SU, the Commission approved the transfer. Rate base was established during this transfer proceeding for book value of the property being transferred and did not include the normal ratemaking adjustments of working capital calculations and used and useful adjustments.

DOCUMENT NUMBER-DATE

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FPSC-COMMISSION CLERK

DOCKET NO. 030601-SU

DATE: August 7, 2003

In addition to the mentioned docketed activities, the utility has taken advantage of price indexing and pass-through opportunities. North Peninsula received price index rate increases in 1991, 1992, 1993, 1994, 1995, 1996, 1998, 2000, 2001, and 2002. The utility also received pass-through rate increases in 1993, 1994, 1995, 1996, 1998, and 2000.

By Order No. PSC-97-0263-FOF-SU, issued March 11, 1997, in Docket No. 960984-SU, the Commission found the utility to be overearning and ordered a refund (with interest) of index and pass-through increases which contributed to the utility overearning in 1995 and 1996, and also ordered a refund of interim revenues which were held subject to refund. Also, by Order No. PSC-00-1676-PAA-SU, issued September 19, 2000, in Docket No. 000715-SU, the Commission found the utility to be overearning and ordered a refund, with interest, of the 1998 price index and pass-through rate increase.

A review of North Peninsula's 2002 annual report indicated that the utility may have exceeded its authorized rate of return. Based on results of its analysis, staff believes it is necessary and appropriate to initiate an audit of the utility's books and records and an investigation into the potential overearning of this utility. The Commission has jurisdiction pursuant to Sections 367.081 and 367.082, Florida Statutes.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission initiate an earnings investigation of North Peninsula Utilities Corporation?

RECOMMENDATION: Yes, the Commission should initiate an investigation of North Peninsula Utilities Corporation to determine potential overearning. (IWENJIORA)

STAFF ANALYSIS: Section 367.082, Florida Statutes, authorizes the Commission to initiate an investigation of a utility's earnings upon a preliminary demonstration that the utility is earning a rate of return which is outside the range of reasonableness. To the extent that the achieved rate of return exceeds the authorized rate of return applied to rate base, the Commission may require revenues to be collected subject to refund pending the result of the investigation. See, Section 367.082(1) and (5), Florida Statutes.

Staff's preliminary analysis indicates that during 2002, the utility's water system earned a 15.49% return. Using the utility's 2002 capital structure, the maximum of the range of reasonableness for the rate of return is 7.00%. Therefore, based on the results of staff's preliminary analysis, a full investigation of this utility's earnings is appropriate.

DOCKET NO. 030601-SU

DATE: August 7, 2003

ISSUE 2: Should any amount of annual wastewater revenues be held subject to refund, and, if so, what is the appropriate amount?

RECOMMENDATION: Yes, North Peninsula should hold annual wastewater revenues of \$10,073 subject to refund. (IWENJIORA)

STAFF ANALYSIS: As stated in Issue No. 1, staff believes that North Peninsula may be overearning. Pursuant to Section 367.082(5)(b)1., Florida Statutes, the achieved rate of return for setting revenues subject to refund shall be calculated by applying appropriate adjustments consistent with those used in the utility's most recent rate proceeding. The attached schedules illustrate staff's recommended rate base, capital structure, and operating income amounts, which are discussed below.

RATE BASE

Pursuant to Rule 25-30.433(4), Florida Administrative Code, the averaging method used by the Commission to calculate rate base and the cost of capital for a Class C utility is the simple beginning and end-of-year average. The utility's 2002 Annual Report reflects North Peninsula's year-end financial data. Therefore, staff has used the simple average of 2001 and 2002 to analyze the utility's wastewater system.

Accumulated Depreciation: The utility recorded an end-of-year accumulated depreciation balances of \$598,231 for 2002 and \$560,530 for 2001. Pursuant to Rule 25-30.433(4), staff made an averaging adjustment to decrease accumulated depreciation by \$18,850. As a result, staff's recommended accumulated depreciation balance is \$579,381.

Accumulated Amortization: The utility recorded a Contribution in Aid of Construction Accumulated Amortization end-of-year balances of \$492,182 for 2002 and \$463,007 for 2001. Pursuant to Rule 25-30.433(4), staff made an averaging adjustment to decrease accumulated amortization by \$14,588. As a result, staff's recommended accumulated amortization balance is \$477,594.

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 \$16,320. This represents one-eighth of the average of 2001 and 2002 O&M expenses of \$127,978 and \$133,143, respectively.

Rate Base Summary:

Based on the foregoing, staff recommends that the appropriate test year rate base is \$143,978. Rate base is shown on Schedule No. 1-A.

COST OF CAPITAL

Consistent with Section 367.082(5)(b), Florida Statutes, the required rate of return shall be calculated using the last authorized rate of return on equity, the current embedded cost of fixed-rate capital and the actual cost of other sources of capital. This section also requires that the return on equity for an interim decrease shall be calculated using the maximum of the range of the utility's last authorized return on equity. In Order No. PSC-00-1676-PAA-SU, issued September 19, 2000, in Docket No. 000715-SU, the Commission authorized a 9.94% return on equity; however, North Peninsula's current capital structure is 100% debt. Therefore, the overall rate of return is based on the weighted cost of debt.

The utility's capital structure has been reconciled with staff's recommended rate base. Staff's recommended overall rate of return is 7.00%

The overall rate of return is shown on Schedule No. 2.

OPERATING INCOME

Operating Revenue:

Section 367.082(5)(b)1., Florida Statutes, states that any rate changes which occurred during the test year must be annualized in order to calculate the achieved rate of return. On August 1, 2002, the utility implemented a price index rate adjustment. Therefore, staff has annualized revenues using the year-end number of customers and the rates in effect at year end. Based on this calculation, staff has decreased revenues by \$4,494.

Taxes Other Than Income:

Taxes Other Than Income were decreased by \$202 to reflect Regulatory Assessment Fees (RAFs) on staff's annualized revenue discussed above. In addition, staff's adjustments caused a revenue decrease of \$12,797. The revenue decrease generates a reduction in RAFs of \$576.

REVENUE REQUIREMENT

Based on staff's recommended adjustments, the revenue requirement should be \$170,608, which represents a decrease of \$12,797 or 6.98%. However, pursuant to Section 367.081(4)(d), Florida Statutes, the revenue associated with the price index rate adjustment remains subject to refund 15 months after the filing of the utility's annual report for the year the increase was implemented. As stated above, North Peninsula implemented its price index increase, an annual increase of \$2,724, on August 1, 2002. The utility filed its 2002 Annual Report on May 3, 2003. Therefore, the revenues generated by the price index are subject to refund through August 3, 2004. Based on the above, staff recommends that \$10,073 (\$12,797 - \$2,724) in revenues be held subject to refund pending the final determination by the Commission.

The staff adjusted revenue, operating expenses, and revenue requirement are shown on Schedule No. 3-A.

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 amount of \$6,768. In lieu of a letter of credit or bond, the utility should obtain an escrow agreement which requires the utility to deposit an amount monthly, as discussed below, until completion of the overearning investigation. Pursuant to Rule 25-30.360(6), Florida Administrative Code, the utility should be required to provide a report by the 20th of each month indicating the monthly and total revenue collected subject to refund. The utility should be put on notice that failure to comply with these requirements will result in the initiation of a show cause proceeding. (IWENJIORA)

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 overearning on an annual basis is \$12,797. However, \$2,724 of the potential overearning is the result of a 2002 price index. Pursuant to Section 367.081(4)(d), Florida Statutes, the revenues associated with the price index and pass-through rate adjustments are already subject to refund, and are not required to be protected by a bond or corporate undertaking. Therefore, only \$10,073 in annual wastewater revenues, should be collected under guarantee, subject to refund with interest. Assuming an 8-month time frame, the potential refund amount is \$6,768.

Based on the above, staff has reviewed the financial data of the utility in order to determine whether North Peninsula can support a corporate undertaking of \$6,768. The criteria for a corporate undertaking includes sufficient liquidity, ownership equity, profitability, and interest coverage to guarantee any potential refund. Staff has reviewed the 2000, 2001, and 2002 annual reports of the North Peninsula to determine the financial condition of the utility. Staff's analysis shows that the utility has minimal liquidity and interest coverage. While the utility has shown improvement by posting net income of nearly \$7,000 in 2002, this follows net losses of \$19,000 in 2001 and \$27,000 in 2000. In addition, North Peninsula has a negative equity balance of over \$300,000. Based upon this analysis, staff recommends that the utility cannot support a corporate undertaking in the amount of

\$6,768. 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, the 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:

1. The account is established at the direction of this Commission for the purpose set forth above;
2. No withdrawals of funds shall occur without the prior approval of the Commission through the Director of the Commission Clerk and Administrative Services;
3. The account shall be interest bearing;
4. Information concerning that escrow account shall be available from the institution to the Commission or its representative at all times;
5. The amount of revenue subject to refund shall be deposited in the escrow account within seven days of receipt; and
6. Pursuant to Cosentino v. Elson, 263 So. 2d 253 (Fla 3d DCA 1972), escrow accounts are not subject to garnishments.

The utility should deposit 3.69% of wastewater revenues collected into the escrow account each month to secure for a possible refund. The escrow agreement should also state the following:

1. If a refund to the customers is required, all interest earned on the escrow account shall be distributed to the customers; and
2. 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 \$6,768. 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 overearning 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 overearning 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 should 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. These costs are the responsibility of, and should be borne by, the utility. Finally, the utility should be put on notice that if it does not comply with the requirements stated in this recommendation, show cause proceedings will be initiated.

DOCKET NO. 030601-SU

DATE: August 7, 2003

ISSUE 4: Should this docket be closed?

RECOMMENDATION: No, this docket should remain open pending staff's investigation of the utility's earnings for 2002. (IWENJIORA, K.FLEMING)

STAFF ANALYSIS: Based on staff's preliminary analysis, staff believes that the utility is overearning by \$12,797. Therefore, this docket should remain open pending an audit of the utility's books and records and staff's investigation of earnings for 2002.

DOCKET NO. 030601-SU

DATE: August 7, 2003

NORTH PENINSULA UTILITIES CORP.		SCHEDULE NO. 1-A	
TEST YEAR ENDING 12/31/02 SCHEDULE OF WASTEWATER RATE BASE		DOCKET NO. 030601-SU	
DESCRIPTION	BALANCE PER UTILITY	STAFF ADJUST. TO UTIL. BAL.	BALANCE PER STAFF
1. UTILITY PLANT IN SERVICE	\$806,039	\$0	\$806,039
2. LAND & LAND RIGHTS	46,800	\$0	\$46,800
3. NON-USED AND USEFUL COMPONENTS	0	\$0	\$0
4. CIAC	(623,394)	\$0	(\$623,394)
5. ACCUMULATED DEPRECIATION	(598,231)	\$18,850	(\$579,381)
6. AMORTIZATION OF CIAC	492,182	(14,588)	\$477,594
7. WORKING CAPITAL ALLOWANCE	0	\$16,320	\$16,320
8. WASTEWATER RATE BASE	<u>\$123,396</u>	<u>\$20,582</u>	<u>\$143,978</u>

DOCKET NO. 030601-SU
 DATE: August 7, 2003

NORTH PENINSULA UTILITIES CORP. TEST YEAR ENDING 12/31/02 SCHEDULE OF CAPITAL STRUCTURE				SCHEDULE NO. 2 DOCKET NO. 030601-SU				
CAPITAL COMPONENT	PER UTILITY	SPECIFIC ADJUSTMENTS	BALANCE BEFORE PRO RATA ADJUSTMENTS	PRO RATA ADJUSTMENTS	BALANCE PER STAFF	PERCENT OF TOTAL	COST	WEIGHTED COST
1. COMMON STOCK	\$100	\$0	\$100					
2. RETAINED EARNINGS	(301,852)	219,941	(\$81,911)					
3. PAID IN CAPITAL	400	0	\$400					
4. OTHER COMMON EQUITY	<u>81,411</u>	<u>0</u>	<u>\$81,411</u>					
5. TOTAL COMMON EQUITY	(\$219,941)	\$219,941	0	0	0	0.00%	9.94%	0.00%
6. LONG TERM DEBT								
S. Comm. Bank	356,334	0	356,334	(212,356)	143,978	100.00%	7.00%	7.00%
	0	0	0	0	0	0.00%	0.00%	0.00%
	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>
TOTAL LONG TERM DEBT	356,334	0	356,334	(212,356)	143,978	100.00%		
7. CUSTOMER DEPOSITS	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0.00%</u>	6.00%	<u>0.00%</u>
8. TOTAL	<u>\$136,393</u>	<u>\$0</u>	<u>\$356,334</u>	<u>(\$212,356)</u>	<u>\$143,978</u>	<u>100.00%</u>		<u>7.00%</u>
RANGE OF REASONABLENESS						<u>LOW</u>	<u>HIGH</u>	
RETURN ON EQUITY						<u>8.94%</u>	<u>10.94%</u>	
OVERALL RATE OF RETURN						<u>7.00%</u>	<u>7.00%</u>	

DOCKET NO. 030601-SU

DATE: August 7, 2003

NORTH PENINSULA UTILITIES CORP. TEST YEAR ENDING 12/31/02 SCHEDULE OF WASTEWATER OPERATING INCOME			SCHEDULE NO. 3-A DOCKET NO. 030601-SU		
	TEST YEAR PER UTILITY	STAFF ADJ. PER UTILITY	STAFF ADJUSTED TEST YEAR	ADJUST. FOR DECREASE	REVENUE REQUIREMENT
1. OPERATING REVENUES	<u>\$187,899</u>	<u>(\$4,494)</u>	<u>\$183,405</u>	<u>(\$12,797)</u> -6.98%	<u>\$170,608</u>
OPERATING EXPENSES:					
2. OPERATION & MAINTENANCE	133,143	0	133,143	0	133,143
3. DEPRECIATION (NET)	8,526	0	8,526	0	8,526
4. AMORTIZATION	0	0	0	0	0
5. TAXES OTHER THAN INCOME	19,638	(202)	19,436	(576)	18,860
6. INCOME TAXES	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
7. TOTAL OPERATING EXPENSES	<u>\$161,307</u>	<u>(\$4,696)</u>	<u>\$161,105</u>	<u>(576)</u>	<u>\$160,529</u>
8. OPERATING INCOME/(LOSS)	<u>\$26,592</u>		<u>\$22,300</u>		<u>\$10,079</u>
9. WASTEWATER RATE BASE	<u>\$123,396</u>		<u>\$143,978</u>		<u>\$143,978</u>
10. RATE OF RETURN	<u>21.55%</u>		<u>15.49%</u>		<u>7.00%</u>