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Public Service Commission
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TALLAHASSEE, FLORIDA 32399-0850

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

DATE: February 5, 2004

TO: Director, Division of the Commission Clerk & Administrative Services (Bayó)

FROM: Division of Economic Regulation (Joyce, Kyle, Merchant)
Office of the General Counsel (Jaeger)

JOK *AM*
AK *MS*

RE: Docket No. 031006-WS – Petition by Utilities, Inc. for approval of allowance for funds used during construction (AFUDC) rate for its Florida subsidiaries including Water Service Corp.

AGENDA: 02/17/04 – Regular Agenda – Proposed Agency Action – Interested Persons May Participate

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\031006.RCM.DOC

Case Background

Utilities, Inc. (UI) is the parent corporation of the following 16 utilities that provide water and wastewater services in the state of Florida: Alafaya Utilities, Inc., Bayside Utility Services, Inc., Cypress Lakes Utilities, Inc., Labrador Utilities, Inc., Lake Utility Services, Inc., Mid-County Services, Inc., Miles Grant Water and Sewer Company, Sandy Creek Utility Services, Inc., Sanlando Utilities Corporation, Tierra Verde Utilities, Inc., Utilities, Inc. of Eagle Ridge, Utilities, Inc. of Florida, Utilities, Inc. of Longwood, Utilities, Inc. of Pennbrooke, Utilities, Inc. of Sandalhaven, and Wedgefield Utilities, Inc. Water Service Corp. (WSC) is also a wholly-owned subsidiary of UI. WSC provides necessary administrative and financial services to all of UI's subsidiaries.

On October 27, 2003, UI filed a petition for the establishment of an allowance for funds used during construction (AFUDC) rate for all of its Florida subsidiaries and WSC. According

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to its petition, UI requests establishment of AFUDC rates in order to accurately accrue and recover their costs of providing service. AFUDC is an accounting entry designed to permit a utility to recover the cost associated with financing eligible construction activities. AFUDC is not a tariffed rate or charge.

In accordance with Rule 25-30.116(4), Florida Administrative Code, UI has filed Schedules: A, a schedule showing the capital structure, cost rates and weighted average cost of capital that are the basis for the AFUDC rate requested; B, a schedule showing capital structure; and C, a schedule showing the calculation of the monthly AFUDC rate using the methodology set out in Rule 25-30.116(4). In Schedule A of its petition, UI states that the common equity and long-term debt amounts are derived from the capital structure of UI, and that the customer deposits and deferred income taxes reflect the total of those of the Florida subsidiaries.

This recommendation addresses the establishment of an AFUDC rate for the Florida subsidiaries and WSC. The Commission has jurisdiction pursuant to Section 367.121, Florida Statutes.

Discussion of Issues

Issue 1: What is the appropriate AFUDC rate for UI's Florida subsidiaries and WSC?

Recommendation: An annual AFUDC rate of 9.03% should be approved for UI's Commission-regulated Florida subsidiaries. **The discounted monthly rate should be 0.751966%.** The approved rate should be applicable for eligible construction projects beginning January 1, 2003. No AFUDC rate should be established for WSC, because it is not a regulated utility subject to the Commission's jurisdiction. (JOYCE, KYLE, JAEGER)

Staff Analysis: Rule 25-30.116(2)(a), Florida Administrative Code, provides that an AFUDC rate shall be determined using the utility's most recent 12-month average embedded cost of capital. UI calculated the average cost of capital using the 12-month period ended December 31, 2002. In its calculation, UI used a capital structure comprised of the total common equity and long-term debt of UI, along with the combined balances of the specific customer deposits and deferred income taxes for all the Commission-regulated Florida subsidiaries. According to its petition, UI has requested an annual AFUDC rate of 9.40%.

Rationale for Approving One AFUDC Rate

The Florida subsidiaries included in UI's request include systems which have never had an AFUDC rate approved, and systems which have had rates approved at various times, and whose currently approved rates range from 5.72% to 13.16%. As noted in Schedule A of this recommendation, the equity and long-term debt of UI is by far the largest portion of the overall capital structure of the subsidiaries; as a result, staff believes that it is equitable to approve a uniform AFUDC rate for all of UI's Commission-regulated subsidiaries. Further, staff believes that it is prudent and cost-effective to approve a uniform rate in one proceeding, rather than considering multiple requests from the individual subsidiaries.

Calculation of the AFUDC Rate

Staff has reviewed the calculations submitted by UI. UI calculated the cost of equity capital to be 11.32%, stating that this was derived from the current leverage formula as found in Order No. PSC-03-0707-PAA-WS, issued June 13, 2003, in Docket No. 030006-WS, In Re: Water and wastewater industry annual reestablishment of authorized range of return on common equity for water and wastewater utilities pursuant to Section 367.081(4)(f), F.S., which was consummated by Order No. PSC-03-0799-CO-WS issued July 8, 2003. The utility used all sources of capital to determine the equity ratio used in the formula. Pursuant to Order No. PSC-03-0707-PAA-WS, the equity ratio to be used in the formula should be calculated as follows: "Equity Ratio = Common Equity/(Common Equity + Preferred Equity + Long Term Debt + Short Term Debt)." Using only those components as defined in the Order, staff calculates the cost of equity to be 11.27%.

Further, staff believes that combining UI's total equity and long-term debt with the Florida subsidiaries' customer deposits and deferred income taxes results in a distorted weighted cost, which overstates the required rate of return. Staff believes that it is more appropriate to

reconcile UI's capital to the combined rate base of the Florida subsidiaries, which is consistent with the methodology employed for UI's Florida subsidiaries in calculating the cost of capital for rate setting purposes. For this purpose, staff used the rate bases provided in the 2002 Annual Reports of the Florida subsidiaries (with the exception of Utilities, Inc. of Pennbrooke).

The Commission approved the transfer of Pennbrooke Utilities, Inc.'s certificates to UI in Order No. PSC-03-1000-PAA-WS (Transfer Order), issued September 5, 2003, in Docket No. 030236-WS, In Re: Application for transfer of facilities and Certificate Nos. 466-W and 400-S from Pennbrooke Utilities, Inc. to Utilities, Inc. of Pennbrooke, in Lake County (Consummating Order PSC-03-1104-CO-WS, issued October 6, 2003). In the Transfer Order, the water and wastewater rate bases of Utilities, Inc. of Pennbrooke were established as of April 30, 2003, and staff has used those rate bases for its calculation of the appropriate cost of capital and resulting AFUDC rate. As shown on Schedule A, staff calculates the weighted cost of capital for all of UI's Florida systems to be 9.03%. Staff recommends that a rate of 9.03% be approved and a discounted monthly rate of 0.751966% be applied to the qualified construction projects of UI's Florida subsidiaries.

Establishment of AFUDC rate for WSC

Rule 25-30.011, Florida Administrative Code, sets forth the application and scope of rules, including Rule 25-30.116, Florida Administrative Code, which regulate Florida water and wastewater utilities. Rule 25-30.011(1), Florida Administrative Code, states, in relevant part:

These rules and regulations shall, as appropriate, apply to all water systems and/or wastewater systems which are now, or may hereafter be, subject to the jurisdiction of the Florida Public Service Commission.

Chapter 367.021(11), Florida Statutes, defines a "system" as: "... facilities and land used or useful in providing service and, upon a finding by the commission, may include a combination of functionally related facilities and land." Further, Chapter 367.021(12), Florida Statutes, defines a "utility" as:

... a water or wastewater utility and, except as provided in s. 367.022, includes every person, lessee, trustee, or receiver owning, operating, managing, or controlling a system, or proposing construction of a system, who is providing, or proposes to provide, water or wastewater service to the public for compensation.

WSC provides administrative support to UI's operating subsidiaries, but does not itself provide utility services to customers. Staff does not believe that WSC meets the above definitions of a "utility" or "system" subject to the Commission's regulation and jurisdiction. As such, staff does not believe that the Commission has jurisdiction to establish an AFUDC rate for WSC. Therefore, staff is recommending an AFUDC rate for the 16 regulated utilities, but not for WSC, which is not regulated.

Effective Date

In its petition, UI requests that the approved rate be effective January 1, 2002. Rule 25-30.116(5), Florida Administrative Code, states that “(t)he new AFUDC rate shall be effective the month following the end of the 12-month period used to establish that rate and may not be retroactively applied to a previous fiscal year unless authorized by the Commission.” UI used the 12-month period ended December 31, 2002, to establish its requested rate, and provided no explanation as to why it believes that the Commission should authorize an effective date earlier than the date specified by Rule 25-30.116(5), Florida Administrative Code. Accordingly, staff recommends that the new AFUDC rate should be effective for qualified construction projects beginning January 1, 2003.

Staff notes that the Commission recently approved individual AFUDC rates for five systems operated by Utilities, Inc. of Florida (UIF). Order No. PSC-03-1440-FOF-WS, issued December 22, 2003, in Docket No. 020071-WS, In Re: Application for rate increase in Marion, Orange, Pasco, Pinellas, and Seminole Counties by Utilities, Inc. of Florida. By stipulation, the effective date of the approved rates was set as the effective date of the final order. The capital structure used in the above case was a thirteen-month average for the year ended December 31, 2001. UI’s petition in the instant case was filed approximately two months after the hearing at which the stipulation in Docket No. 020071-WS was entered. Because the instant petition is based upon the most current available capital structure (2002), staff believes that it is appropriate to include UIF’s systems in the calculation of a uniform AFUDC rate, and to set a uniform effective date of January 1, 2003, for all of UI’s Commission-regulated subsidiaries.

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Date: February 5, 2004

Issue 2: Should this docket be closed?

Recommendation: Yes. If no timely protest from a substantially affected person on the Commission approved AFUDC rate is received upon the expiration of the protest period, the PAA Order on the AFUDC rate will become final upon the issuance of a Consummating Order, and the docket should be closed. (JAEGER)

Staff Analysis: If no timely protest from a substantially affected person on the Commission approved AFUDC rate is received upon the expiration of the protest period, the PAA Order on the AFUDC rate will become final upon the issuance of a Consummating Order, and the docket should be closed.

Docket No. 031006-WS
 Date: February 5, 2004

UTILITIES, INC.
 STAFF RECOMMENDED AFUDC RATE
 TEST YEAR ENDED 12/31/02

SCHEDULE A
 DOCKET 031006-WS

DESCRIPTION	TOTAL CAPITAL	SPECIFIC ADJUSTMENTS (EXPLAIN)	SUBTOTAL ADJUSTED CAPITAL	PRO RATA ADJUSTMENTS	CAPITAL RECONCILED TO RATE BASE	RATIO	COST RATE	WEIGHTED COST
PER UTILITY 2002 - 12-MONTH AVERAGE								
1 LONG TERM DEBT	\$90,172,122	\$0	\$90,172,122	\$0	\$90,172,122	50.42%	7.82%	3.95%
2 SHORT-TERM DEBT	0	0	\$0	0	\$0	0.00%	0.00%	0.00%
3 PREFERRED STOCK	0	0	\$0	0	\$0	0.00%	0.00%	0.00%
4 COMMON EQUITY	85,857,906	0	\$85,857,906	0	\$85,857,906	48.01%	11.32%	5.44%
5 CUSTOMER DEPOSITS	685,641	0	\$685,641	0	\$685,641	0.38%	6.00%	0.02%
6 DEFERRED INCOME TAXES	2,109,551	0	\$2,109,551	0	\$2,109,551	1.18%	0.00%	0.00%
7 DEFERRED ITC'S-ZERO COST	0	0	\$0	0	\$0	0.00%	0.00%	0.00%
8 DEFERRED ITC'S-WTD. COST	0	0	\$0	0	\$0	0.00%	0.00%	0.00%
9 OTHER	0	0	\$0	0	\$0	0.00%	0.00%	0.00%
10 TOTAL CAPITAL	<u>\$178,825,220</u>	<u>\$0</u>	<u>\$178,825,220</u>	<u>\$0</u>	<u>\$178,825,220</u>	<u>100.00%</u>		<u>9.40%</u>

PER STAFF 2002 - 12-MONTH AVERAGE

11 LONG TERM DEBT	\$90,172,122	\$0	\$90,172,122	(\$67,565,982)	\$22,606,140	48.17%	7.82%	3.77%
12 SHORT-TERM DEBT	0	0	\$0	\$-0	0	0.00%	0.00%	0.00%
13 PREFERRED STOCK	0	0	\$0	\$-0	0	0.00%	0.00%	0.00%
14 COMMON EQUITY	85,857,906	0	\$85,857,906	(\$64,333,340)	21,524,566	45.87%	11.27%	5.17%
15 CUSTOMER DEPOSITS	685,641	0	\$685,641	\$0	685,641	1.46%	6.00%	0.09%
16 DEFERRED INCOME TAXES	2,109,551	0	\$2,109,551	\$0	2,109,551	4.50%	0.00%	0.00%
17 DEFERRED ITC'S-ZERO COST	0	0	\$0	\$-0	0	0.00%	0.00%	0.00%
18 DEFERRED ITC'S-WTD. COST	0	0	\$0	\$-0	0	0.00%	0.00%	0.00%
19 OTHER	0	0	\$0	\$-0	0	0.00%	0.00%	0.00%
20 TOTAL CAPITAL	<u>\$178,825,220</u>	<u>\$0</u>	<u>\$178,825,220</u>	<u>(\$131,899,322)</u>	<u>\$46,925,898</u>	<u>100.00%</u>		<u>9.03%</u>

DISCOUNTED MONTHLY AFUDC RATE

0.751966%