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COMMISSION CLERK

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DATE: August 3, 2005

TO: Division of the Commission Clerk and Administrative Services

FROM: Adrienne E. Vining, Senior Attorney, Office of the General Counsel AEV

RE: Docket No. 000694-WU – Petition by Water Management Services, Inc., for Limited Proceeding to Increase Water Rates in Franklin County.

Please place the attached letter from Stephen C. Reilly, Office of Public Counsel, dated July 29, 2005, in the above-referenced docket file.

Thanks.

AEV/jb

cc: Division of Economic Regulation (Willis, Rendell, Lingo, Kyle, Kummer, Stallcup)

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Harold McLean
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Stephen C. Reilly
Associate Public Counsel

July 29, 2005

Adrienne Vining, Esq
Office of General Counsel
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

In Re: Docket No. 000694-WU, Petition of Water Management Services, Inc. for a Limited Proceeding to Increase Water Rates in Franklin County

Dear Ms. Vining:

On July 8, 2005 Water Management Services, Inc. (WMSI) delivered a letter to the Commission concerning the Staff Recommendation in the above Docket. The purpose of that letter was to address two issues in the Staff's Recommendation, Issues 2 and 6. WMSI claims that the Staff's Recommendation on both issues will exacerbate an already negative cash flow situation for the utility. The purpose of this letter is to respond to WMSI's claims concerning Issue 2 and to address the Staff's Recommendation concerning the treatment of past underearnings.

WMSI's states that "in theory" the revenue recommended by the Staff for the construction of supply mains and additional fire protection should be adequate to allow WMSI to recover its costs. WMSI claims that there is a difference between the amount of annual revenue (for depreciation and interest) allowed by the Staff Recommendation, $391,274 and the amount of cash outlay required by the Utility's debt service requirements --$419,000. The difference, $27,276, is caused by a longer depreciation time period for the plant and equipment (32 years) relative to the life of the loan (20 years). OPC points out that the Utility failed to include the $12,000 in annual amortization of retired property that was included in staff's recommendation. Thus, the $27,276 perceived short fall should only be $15,276.

The Utility also stated that it had direct cash outlays funded by short-term debt that did not show up in the revenue requirement and as such the rate recovery time frame would be greater than the debt service requirements. All but one of the items listed are costs that have been included in the overall project costs and included in the final revenue requirement calculation. OPC believes that if short-term funds were used to fund these additions that the DEP loan could certainly have been used to repay the debt and if not, the interest costs should have been incorporated in the weighted cost of debt. The one item not included as a cost in Staff's revenue requirement recommendation was the $209,875 cash reserve contribution required by the DEP loan covenants.

In order to correct the perceived cash flow deficit, WMSI has requested that Staff change its recommendation on the treatment of the $209,875 cash contribution to fund the loan reserve. This contribution is recorded on WMSI's books as a special deposit, which is an interest bearing account. As such, this deposit should be removed from the rate setting equation. In its recommendation, the Staff correctly removed this $209,875 from the interim rate revenue requirement for true–up purposes. WMSI had treated this $209,875 as both a component of its interim revenue requirement and the amortization of the reserve as a component of interest expense. Staff treated the reserve as only a component of the interest expense to be recovered over the life of the DEP loan.

The Utility claims that because of its cash flow problems, the Staff's treatment of the $209,875 is unacceptable. WMSI requests that the amortization of the loan reserve not be included as a factor in determining the effective interest rate, but be included as a cash outlay to be recovered through revenue generated by interim rates in the true-up. Under WMSI's approach, the effective interest rate would be reduced from 3.48% to 3.37%, but the request includes the recovery of the $209,875 for the cash reserve.

It is important to realize that the cash reserve of $209,875 will be returned to WMSI when the DEP loan is paid off. To include this amount in the revenue requirement is simply wrong. If any part of this reserve is collected from customers, WMSI will be double compensated—once through the collection of rates from customers and again when the funds are returned to WMSI.

In addition, it is not clear that the interest income earned on the loan reserve is not sufficient to offset the impact of any amortization. In its initial calculations the Utility used an interest rate for the loan reserve of 1.5% which was the then current rate on a 12-month CD. The Utility did not provide support for this purported interest rate and it appears too low. It is highly likely that the bank will pay more than the 1.5% currently available on a 12-month CD as these funds will essentially be tied-up for 20 years. If the real interest rate approaches 3.5%, there is little, if any, impact to the Utility of having these funds reserved for potential default. Thus, under a scenario where the interest paid on the reserve is higher than 1.50% and approaches 3.5%, the Utility's alternative proposal really offers nothing compared to its original proposal.

Finally, it should be noted that WMSI does not dispute that the loan reserve is not included in the final revenue requirement calculation. The reserve is only added when determining the interim revenue requirement to be compared to the final revenue requirement. If it is inappropriate to include the reserve in the final calculation, it surely is inappropriate to include it in the interim true-up revenue requirement.

The Commission should reject WMSI's request. It is little different from its initial proposal. It does not reflect good regulatory policy; it does not properly match the revenue requirement of the plant improvements with costs; and it over collects monies from customers over the life of the plant. Furthermore, it would be unjust and unreasonable to allow the Utility to collect from customers funds that will be returned to the Company when the DEP loan is paid.

The Staff's proposed methodology is superior; however, OPC requests that the Staff further evaluate two aspects of the loan reserve and revenue requirement. First, OPC requests that the Staff determine the actual interest rate that will be paid by the bank on the loan reserve. The actual interest rate should be used to offset the loan reserve amount prior to amortization, not the 1.50% used by the Utility and accepted by the Staff. Second, OPC recommends that the Staff also determine the actual interest rate paid on the loan reserve of $177,113 which was not a cash outlay by the Utility, but which was withheld from the loan funds. This cost has been included in the Utility's alternative proposal and is also included in the Staff's Recommendation. If the interest rate is higher than the 1.50% assumed by WMSI, the Staff's recommendation will overcompensate the Utility and harm ratepayers.

OPC also requests that the Commission reconsider the Staff recommendation to offset the amount of the $136,828 of over collection of Phase II rates by an alleged $32,864 of under earnings for the years 2000 through 2003. The Staff's recommendation to offset the over collection by past under earnings boarders on retroactive ratemaking. In addition, it is unfair for the Commission to assume that the achieved rate of return reported in the Utility's Annual Reports reflect the achieved rate of return the Commission would find if regulatory principles were applied to the Utility's revenues, expenses, and rate base. The Staff's recommendation essentially finds that the operations of the Utility for the years 2000, 2001, 2002, and 2003, if subjected to regulatory scrutiny, would produce the reported achieved return. As the Commission is well aware, this would be a rare occurrence, if ever.

The Commission only needs to look to the Staff's Audit of March 23, 2005 to find that there are questionable expenses included in the Utility's reported expenses. For example, Audit Exception 1 finds that for the 12 months ending June 2004, the utility reflected expenses of $5,426 for insurance premiums on non-utility vehicles, boats, and trailers owned by the president and CEO of the Utility or other companies to which the president and CEO are affiliated. Audit Disclosure 2 found that the $32,011 in transportation expenses appeared excessive. There were fuel charges for locations that were clearly outside the 85 mile one-way commute between Tallahassee and St. George Island. While some of these expenses are outside the time period where the utility underearned, some of them were included in the year 2003. Moreover, if the Utility carried excessive expenses on its books in 2003 and 2004 it is more than likely that the same problems existed for the earlier years. If the Utility incurred the non-utility insurance premiums for the years 2000 through 2003 and inappropriately reflected these in utility expenses, this one item alone would reduce the amount of underearnings by $21,704 of the $32,864 the Staff credited to the Company. OPC strongly recommends that the Commission eliminate from the Staff's Recommendation the $32,864 which Staff proposes to offset against the overcollection of Phase II revenues of $136,828.

In conclusion, OPC recommends that the Commission uphold the Staff Recommendation regarding the treatment of the $209,785 loan reserve fund after the questions OPC has raised are answered. Finally, OPC implores the Commission to reject the portion of the Staff's Recommendation that offsets the overcollection of Phase II rates with alleged underearnings by WMSI for the years 2000 through 2003.

Sincerely,

Stephen C. Reilly
Associate Public Counsel

SCR/dsb

cc: Kenneth A. Hoffman, Esquire