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COMMISSION
CLERK

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

DATE: July 6, 2006

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

FROM: Division of Economic Regulation (Joyce, Rendell, Rieger) *SOP*
Office of the General Counsel (Fleming) *VF* *WJ* *TH* *1908*

RE: Docket No. 060260-WS – Application for increase in water and wastewater rates in Highlands County by Lake Placid Utilities, Inc.

AGENDA: 07/18/06 – Regular Agenda – Decision on Suspension of Rates and on Interim Rates – Participation is at the Discretion of the Commission.

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Arriaga

CRITICAL DATES: 07/18/06 (60-Day Suspension Date)

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\060260.RCM.DOC

Case Background

Lake Placid Utilities, Inc. (Lake Placid or utility) is a Class C utility providing water and wastewater service to approximately 125 water and 194 wastewater customers in Highlands County. Water and wastewater rates were last established for this utility in its 1995 rate proceeding, referred to herein as The 1995 Rate Proceeding.¹

On May 11, 2006, the utility filed its application for approval of final and interim rate increase in this docket and requested that the Commission process the case under the Proposed

¹ See Order No. PSC-96-0910-FOF-WS, issued July 15, 1996, in Docket No. 951027-WS, In re: Application for rate increase in Highlands County by Utilities, Inc.

DOCUMENT NUMBER-DATE

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FPSC-COMMISSION CLERK

Agency Action procedure. After review of the Minimum Filing Requirements (MFRs), staff determined that the MFRs contained a number of deficiencies that will require revisions by the utility. These revisions will not be received until after the statutory 60-day limit to suspend the requested interim rate increase; therefore, the official filing date has not been established.

The test year for interim and final purposes is the historical test year ended December 31, 2005. Lake Placid has requested an annual interim revenue increase of \$49,376 or 70.12% for wastewater only. The utility has requested final revenue increases of \$30,017 or 66.12% for water and \$41,902 or 102.12% for wastewater.

The sixty-day statutory deadline for the Commission to suspend the utility's requested final rates was July 16, 2006. However, by letter dated June 5, 2006, the utility agreed to extend the statutory time frame by which the Commission is required to address Lake Placid's interim rate request. By letter dated May 24, 2006, the utility confirmed that it was not requesting interim water rates. This recommendation addresses the suspension of Lake Placid's final rates and staff's recommended interim wastewater rate increase. The Commission has jurisdiction pursuant to Sections 367.081, and 367.082, Florida Statutes .

Discussion of Issues

Issue 1: Should the utility's proposed water and wastewater rates be suspended?

Recommendation: Yes. Lake Placid's proposed water and wastewater rates should be suspended. The docket should remain open pending the Commission's final action on the utility's requested rate increase. (Joyce)

Staff Analysis: Section 367.081(6), Florida Statutes, provides that the rates proposed by the utility shall become effective within sixty days after filing unless the Commission votes to withhold consent of implementation of the requested rates. Further, Section 367.081(8), Florida Statutes, permits the proposed rates to go into effect (secured and subject to refund) at the expiration of five months if: (1) the Commission has not acted upon the requested rate increase; or (2) if the Commission's PAA action is protested by a party other than the utility.

Staff has reviewed the filing and has considered the proposed rates, the revenues thereby generated, and the information filed in support of the rate application. Staff recommends that it is reasonable and necessary to require further amplification and explanation regarding this data, and to require production of additional and/or corroborative data. This further examination will include on-site investigations by staff accountants and engineers. Based on the foregoing, staff recommends that it is appropriate to suspend the utility's proposed rate increase.

Issue 2: Should an interim revenue increase be approved?

Recommendation: No. The utility should not be authorized to collect an interim wastewater revenue increase. (Joyce, Rieger)

Staff Analysis: Lake Placid requested wastewater interim rates designed to generate annual revenues of \$119,788. This represents an increase of \$49,376, or 70.12%. The utility filed rate base, cost of capital, and operating statements to support its requested interim water and wastewater increase for the test year ended December 31, 2005.

Pursuant to Section 367.082(5)(b)1, Florida Statutes, the achieved rate of return for interim purposes must be calculated by applying appropriate adjustments consistent with those made in the utility's most recent rate proceeding. Staff has reviewed the utility's interim request, as well as prior orders concerning the utility's rate base. Staff's recommended adjustments are discussed below. Staff has attached accounting schedules to illustrate staff's recommended rate base, capital structure, and test year operating income amounts. The rate base schedule is labeled as No. 1, with adjustments shown on Schedule No. 1-A; the capital structure schedule is No. 2, and the operating income schedule is No. 3, with the adjustments shown on Schedule No. 3-A.

Rate Base

In its application, Lake Placid used a simple average to calculate its requested rate base and cost of capital. Lake Placid is a Class C utility and filed its interim request consistent with the averaging requirement of Rule 25-30.433(4), Florida Administrative Code.

Used And Useful

In MFR Schedule F-4, the utility requested that the wastewater treatment plant be considered 86% used and useful. This determination is based on a four month seasonal flow average which occurred during the test year from January through April of 2005. The treatment plant is permitted by the Department of Environmental Protection (DEP) on an annual average daily flow (AADF). Rule 25-30.432, Florida Administrative Code, indicates that used and useful percentages shall be based on the stated DEP permitted capacity. For comparison purposes, the utility provided used and useful analysis for both the AADF and seasonal flows. The AADF calculation showed a 43% used and useful determination.

The utility has indicated that Rule 25-30.432, F.A.C., permits the Commission to consider other factors. Lake Placid believes that circumstances in this case should allow for flows reflecting the seasonality of customer occupancy. The utility states that the use of AADF cannot properly reflect these flows in a used and useful determination. Rule 25-30.432, F.A.C., does allow for other flow considerations such as infiltration and inflow, permitted capacity differing from design capacity, plant component differences, and decreases due to conservation or a reduction in the number of customers. Staff believes that using seasonal flows, when the treatment plant is permitted for AADF, is inappropriate and not allowed per rule for used and useful considerations. Historically, when it comes to permitted capacity, the Commission has adhered to this rule. However, staff will consider the utility's request during the analysis of the final used and useful determination.

For interim purposes, staff believes that the AADF permitted capacity should be used for consideration in the used and useful calculation for the wastewater treatment plant. Therefore, staff recommends that the wastewater treatment plant be considered 43% used and useful.

Staff has recalculated the utility's used and useful amount based on the above. As such, staff recommends that net used and useful plant be reduced by \$40,508. Corresponding adjustments should be made to reduce depreciation expense by \$2,344, and property tax expense by \$293. Staff also believes that in error the utility reduced plant in service by \$17,900. As such, staff has increased plant in service by this amount.

Based on the above adjustments, staff recommends that Lake Placid's interim rate base should be \$181,471.

Cost of Capital

Rule 25-30.433(3), Florida Administrative Code, states:

Used and useful debit deferred taxes shall be offset against used and useful credit deferred taxes in capital structure. Any resulting net debit deferred taxes shall be included as a separate line item in the rate base calculation. Any resulting net credit deferred taxes shall be included in the capital structure calculation. No other deferred debits shall be considered in rate base when the formula method of working capital is used.

On MFR Schedule D-2, Lake Placid reflected a simple average balance of \$1,191 for accumulated deferred income taxes (ADITs). This amount was derived by a positive 2004 year-end balance of \$2,511 and a negative 2005 year-end balance of \$130. However, according to MFR Schedule A-19, the utility reflected a simple average ADITs credit balance of \$24,582 and on schedule A-18 a year-end simple average ADITs debit balance of \$4,927. This results in a \$19,655 net credit balance of which \$15,884 is the used and useful portion. Thus, Lake Placid understated its ADITs in the capital structure because it did not offset the used and useful debit taxes against the used and useful credit deferred taxes in the capital structure. Therefore, staff recommends that the utility's simple average ADITs balance should be increased by \$14,693 (\$15,884 less 1,191).

The utility's capital structure is based on that of its parent company, Utilities, Inc., which includes long-term debt, short-term debt, and common equity. Deferred income taxes and customer deposits are specifically identified to Lake Placid. Staff has reviewed the utility's requested capital structure and finds that the utility erred in using the leverage formula in calculating its cost rate for common equity. Section 367.082(5)(b)3, Florida Statutes, states that in calculating an interim increase, the minimum of the range of the last authorized ROE shall be used. In Lake Placid's last rate case, the midpoint of the authorized ROE was established as 11.56%, with a range of 10.56%-12.56%. See The 1995 Rate Proceeding. Accordingly, for interim purposes, staff recommends a cost of equity of 10.56%. Based on the above, staff's recommended cost of capital for interim purposes is 7.20%. Schedule No. 2 details staff's recommended capital structure.

The authorized range of reasonableness for the return on equity provides Lake Placid with an authorized overall rate of return from 7.37% to 8.10%. Upon review, staff believes that the utility earned an overall rate of return in the interim test year of 8.37%, which is greater than the 8.10% maximum overall rate of return allowed by this Commission. Therefore, for interim purposes, the utility earned above the range of reasonableness established by this Commission.

Net Operating Income

Operating Revenues

Upon staff's review of the utility's operating revenues, we believe that one adjustment is appropriate. Section 367.085(5)(b)(1), Florida Statutes, states that revenues should be annualized to reflect any rate changes that occurred during the interim test year. Staff has annualized the utility's revenues from rates that became effective July 1, 2005, and recommends an increase of \$20,353 for wastewater.

Taxes other than Income

Staff has reviewed Lake Placid's operating income and believes one adjustment is appropriate. The utility reflected test year regulatory assessment fees (RAFs) of \$1,715 for wastewater. Based on staff review, that amount does not reflect 4.5% of test year revenues. To correct this, staff believes that RAFs should be increased by \$1,451 for wastewater.

Based on these adjustments, staff recommends that the appropriate test year operating income is \$15,182 for wastewater. Schedule 3 details staff's recommended net operating income, with adjustments reflected on Schedule No. 3-A

REVENUE REQUIREMENT

The revenue requirement derived from using the minimum of the range of the authorized return on equity is \$87,722, which is less than the utility's test year revenues of \$90,765. The utility's authorized range for overall rate of return is from 7.37% to 8.10%. The utility earned an overall rate of return in the interim test year of 8.37%, which is greater than the 8.10% maximum overall rate of return allowed by this Commission. Based on staff's recommendation regarding the utility's operating expenses and the appropriate cost of capital on an average rate base, staff believes that it is not appropriate to allow an interim revenue increase.

Pursuant to Section 367.082(2)(b) & (5)(b), Florida Statutes, where there is an interim decrease in rates, the maximum of the range of the last authorized rate of return on equity shall be placed subject to refund.

As the utility appears to be overearning, when using the maximum of the range of the authorized return on equity of 12.56%, the revenue requirement is \$89,954 resulting in a potential overearnings of approximately \$811, which is less than 1% of operating revenues. Staff believes this amount is immaterial. Therefore, staff is not recommending that this amount be held subject to refund. Accordingly, staff recommends that Lake Placid's rates remain unchanged for interim purposes.

Docket No. 060260-WS

Date: July 6, 2006

Issue 3: Should this docket be closed?

Recommendation: No. The docket should remain open pending the Commission's final action on the utility's requested rate increase. (Joyce, K. Fleming)

Staff Analysis: The docket should remain open pending the Commission's final action on the utility's requested rate increase.

Lake Placid Utilities, Inc. Schedule of Wastewater Rate Base Test Year Ended 12/31/05			Schedule No. 1 Docket No. 060260-WS		
Description	Test Year Per Utility	Utility Adjust- ments	Adjusted Test Year Per Utility	Staff Adjust- ments	Staff Adjusted Test Year
1 Plant in Service	\$560,019	(\$16,835)	\$543,184	\$17,900	\$561,084
2 Land and Land Rights	\$21,665	\$0	21,665	0	21,665
3 Non-used and Useful Components	0	(13,188)	(\$13,188)	(40,508)	(53,696)
4 CWIP	0	0	0	0	0
5 Accumulated Depreciation	(302,910)	0	(302,910)	0	(302,910)
6 CIAC	(154,466)	0	(154,466)	0	(154,466)
7 Amortization of CIAC	\$103,172	\$0	103,172	0	103,172
8 Working Capital Allowance	<u>\$0</u>	<u>\$6,622</u>	<u>6,622</u>	<u>0</u>	<u>6,622</u>
9 Total Rate base	<u>\$227,480</u>	<u>(\$23,401)</u>	<u>\$204,079</u>	<u>(\$22,608)</u>	<u>\$181,471</u>

Lake Placid Utilities, Inc.
Adjustments to Rate Base
Test Year Ended 12/31/05

Schedule No. 1-A
Docket No. 060260-WS

Explanation	Wastewater
<u>Plant In Service</u>	
To reflect the appropriate amount of historical plant	\$17,900
Total	<u>\$17,900</u>
<u>Non-used and Useful</u>	
To reflect net non-used and useful adjustment	<u>(\$40,508)</u>

Lake Placid Utilities, Inc.
Capital Structure-Simple Average
Test Year Ended 12/31/05

Schedule No. 2
Docket No. 060260-WS

Description	Total Capital	Specific Adjustments	Subtotal Adjusted Capital	Prorata Adjustments	Capital Reconciled to Rate Base	Ratio	Cost Rate	Weighted Cost		
Per Utility										
1 Long-term Debt	\$124,044,203	\$0	\$124,044,203	\$0	\$124,044,203	54.84%	6.81%	3.73%		
2 Short-term Debt	11,347,000	0	\$11,347,000	0	\$11,347,000	5.02%	2.00%	0.10%		
3 Preferred Stock	0	0	\$0	0	\$0	0.00%	0.00%	0.00%		
4 Common Equity	90,787,422	0	\$90,787,422	0	\$90,787,422	40.14%	11.77%	4.72%		
5 Customer Deposits	0	0	\$0	0	\$0	0.00%	6.00%	0.00%		
6 Deferred Income Taxes	<u>1,191</u>	<u>0</u>	<u>\$1,191</u>	<u>0</u>	<u>\$1,191</u>	<u>0.00%</u>	<u>0.00%</u>	<u>0.00%</u>		
7 Total Capital	<u>\$226,179,816</u>	<u>\$0</u>	<u>\$226,179,816</u>	<u>\$0</u>	<u>\$226,179,816</u>	<u>100.00%</u>		<u>8.56%</u>		
Per Staff										
8 Long-term Debt	\$124,044,203	\$0	\$124,044,203	(\$123,953,388)	\$90,815	50.04%	6.81%	3.41%		
9 Short-term Debt	11,347,000	0	\$11,347,000	(\$11,338,693)	8,307	4.58%	2.00%	0.09%		
10 Preferred Stock	0	0	\$0	\$0	0	0.00%	0.00%	0.00%		
11 Common Equity	90,787,422	0	\$90,787,422	(\$90,720,955)	66,467	36.63%	10.56%	3.87%		
12 Customer Deposits	0	0	\$0	\$0	0	0.00%	6.00%	0.00%		
13 Deferred Income Taxes	<u>1,191</u>	<u>14,693</u>	<u>\$15,884</u>	<u>\$0</u>	<u>15,884</u>	<u>8.75%</u>	<u>0.00%</u>	<u>0.00%</u>		
14 Total Capital	<u>\$226,179,816</u>	<u>\$14,693</u>	<u>\$226,194,509</u>	<u>(\$226,013,036)</u>	<u>\$181,472</u>	<u>100.00%</u>		<u>7.37%</u>		
						LOW	HIGH			
						RETURN ON EQUITY	<u>10.56%</u>	<u>12.56%</u>		
						OVERALL RATE OF RETURN	<u>7.37%</u>	<u>8.10%</u>		

**Lake Placid Utilities, Inc.
Statement of Wastewater Operations
Test Year Ended 12/31/05**

**Schedule No. 3
Docket No. 060260-WS**

Description	Test Year Per Utility	Utility Adjust- ments	Adjusted Test Year Per Utility	Staff Adjust- ments	Staff Adjusted Test Year	Revenue Increase	Revenue Requirement
1 Operating Revenues:	<u>70,362</u>	<u>49,426</u>	<u>119,788</u>	<u>(29,023)</u>	<u>90,765</u>	<u>(\$3,042)</u> -3.35%	<u>87,722</u>
Operating Expenses							
2 Operation & Maintenance	52,976	0	52,976	0	52,976	0	52,976
3 Depreciation	13,194	0	13,194	(2,344)	10,850	0	10,850
4 Amortization	529	(529)	0	0	0	0	0
5 Taxes Other Than Income	5,271	3,348	8,619	(2,190)	6,429	(137)	6,292
6 Income Taxes	<u>13,559</u>	<u>13,971</u>	<u>27,530</u>	<u>(22,202)</u>	<u>5,328</u>	<u>(1,093)</u>	<u>4,235</u>
7 Total Operating Expense	<u>85,529</u>	<u>16,790</u>	<u>102,319</u>	<u>(26,736)</u>	<u>75,583</u>	<u>(1,230)</u>	<u>74,353</u>
8 Operating Income	<u>(15,167)</u>	<u>32,636</u>	<u>17,469</u>	<u>(2,287)</u>	<u>15,182</u>	<u>(1,812)</u>	<u>13,369</u>
9 Rate Base	<u>227,480</u>		<u>204,079</u>		<u>181,471</u>		<u>181,471</u>
10 Rate of Return	<u>-6.67%</u>		<u>8.56%</u>		<u>8.37%</u>		<u>7.37%</u>

Lake Placid Utilities, Inc.
Adjustment to Operating Income
Test Year Ended 12/31/05

Schedule 3-A
Docket No. 060260-WS

Explanation	Wastewater
<u>Operating Revenues</u>	
1 Remove requested final revenue increase.	(49,376)
2 To reflect the appropriate amount of TY Revenues	20,353
Total	<u>(29,023)</u>
<u>Depreciation Expense - Net</u>	
To remove net depreciation of non-U&U plant.	(\$2,344)
<u>Taxes Other Than Income</u>	
1 RAFs on revenue adjustments above	(3,348)
2 To reflect the appropriate historical TY RAFs	1,451
3 To reflect reduced property taxes on NU & U Property.	(293)
4 Total	<u>(2,190)</u>