

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Investigation of possible
overearnings by Lake Groves
Utilities, Inc. in Lake County.

DOCKET NO. 020567-WS
ORDER NO. PSC-02-1011-PCO-WS
ISSUED: July 26, 2002

The following Commissioners participated in the disposition of
this matter:

LILA A. JABER, Chairman
J. TERRY DEASON
BRAULIO L. BAEZ
MICHAEL A. PALECKI
RUDOLPH "RUDY" BRADLEY

ORDER INITIATING INVESTIGATION INTO RATES AND CHARGES
AND MAKING REVENUES SUBJECT TO REFUND

BY THE COMMISSION:

BACKGROUND

Lakes Groves Utilities, Inc. (Lake Groves or utility) is a Class B utility providing water and wastewater service to approximately 2,248 water and 2,088 wastewater customers in Lake County. According to its 2001 annual report, the utility's operating revenue was \$750,622 for water and \$520,309 for wastewater, and the net operating income was \$324,624 for water and \$265,888 for wastewater.

By Order No. 24283, issued March 25, 1991, in Docket No. 900957-WS, this Commission granted Lake Groves an original certificate. That Order set the initial rates and charges using a return on common equity (ROE) of 13.51%, and this rate was to be used by Lake Groves in future proceedings involving such matters as calculation of allowance for funds used during construction (AFUDC) and interim rates. The utility has never filed for a rate case, and rate base has never been established for this utility.

Pursuant to Order No. PSC-99-0164-FOF-WS (the transfer order), issued January 26, 1999, in Docket No. 980958-WS, this Commission approved the transfer of majority organizational control of Lake

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FPSC-COMMISSION CLERK

Groves to Utilities, Inc. In the transfer order, we ordered Utilities, Inc. to adopt and use the rates, classification, and regulations of Lake Groves. Accordingly, we find that 13.51% as the mid-point and 14.51% as the upper limit of the range of approved returns of equity for interim purposes for this utility is appropriate.

Based on review of the utility's 2001 Annual Report, Lake Groves achieved a 35.19% overall rate of return on its water rate base, and this equates to a 76.26% ROE, which is greater than is authorized. The utility achieved an 8.37% overall rate of return on its wastewater rate base, which equates to an 11.54% ROE. Therefore, we find it necessary and appropriate to initiate an investigation into the potential water overearnings of this utility.

We have jurisdiction pursuant to Sections 367.081, 367.082 and 367.121, Florida Statutes.

INITIATION OF OVEREARNINGS INVESTIGATION

Section 367.082, Florida Statutes, authorizes us 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 required rate of return applied to rate base, we may require revenues to be collected subject to refund pending the result of the investigation.

Our preliminary analysis, based on the review of the utility's 2001 Annual Report, indicates that during 2001 the utility's water system earned a 35.19% overall rate of return, while the wastewater system earned an 8.37% overall rate of return. Using the utility's capital structure from the annual report and the maximum of the range of the utility's last authorized return on equity (14.51%), we have calculated a maximum appropriate overall rate of return of 9.60%. The utility achieved a 35.19% overall rate of return on its water rate base, which equates to a 76.26% ROE, which exceeds the ROE authorized for Lake Groves by Order No. 24283. The utility's achieved overall rate of return of 8.37% on its wastewater rate base equates to an 11.54% ROE. The combined overall rate of return

for both water and wastewater was 14.42%, which equates to a combined 26.12% ROE.

Based on the above, a full investigation of this utility's earnings for water service is appropriate. The test year for the investigation shall be the year ended December 31, 2001. This docket shall remain open pending the completion of our investigation of the utility's earnings.

ANNUAL WATER REVENUES TO BE HELD SUBJECT TO REFUND

Pursuant to Section 367.082, Florida Statutes, in determining whether an interim decrease is appropriate, we must, on a prima facie basis, determine if the utility's achieved rate of return exceeds its required rate of return. The achieved rate of return for interim purposes shall be calculated by applying appropriate adjustments consistent with those used in the utility's most recent rate proceeding, and annualizing any rate changes that occurred during the interim test year. The required rate of return is calculated by taking the test-year cost of capital and using the maximum of the range of the last authorized ROE. We have reviewed the utility's annual report to determine if the utility's reported rate base, cost of capital, and net operating income amounts are consistent with the interim statute.

Rate Base

Lake Groves is a Class B utility. Chapter 25-30.433(2), Florida Administrative Code, specifies that working capital for Class B and C utilities shall be calculated using the formula method (one-eighth of operation and maintenance expenses). The utility has presented working capital using the formula method in the annual report and no adjustment is necessary.

Based on our review, no further adjustments to rate base are necessary. Our adjusted water rate base and wastewater rate base are attached as Schedule 1.

Cost of Capital

Lake Groves has not had a rate proceeding since the transfer of majority organizational control to Utilities, Inc. In its 2001

Annual Report, the utility reflected a last authorized ROE of 13.51%. This was the ROE established for Lake Groves by Order No. 24283 in Docket No. 900957-WS. This ROE was based upon the leverage formula which was in effect at the time, and was intended to allow the utility to earn a fair rate of return when the utility reached 80% of its projected capacity. The Order also stated that the approved ROE was to be used in future proceedings involving such things as calculation of AFUDC and interim rates.

Based on the above, and in accordance with Section 367.082(5)(b), Florida Statutes, we find that the appropriate ROE for this utility is 13.51%, with a range of 12.51% to 14.51%. Using the maximum of the range and the reported cost rates for other components in the utility's capital structure yields a 9.60% overall cost of capital for interim purposes. Schedule 2 reflects our adjusted cost of capital.

Net Operating Income

Pursuant to Section 367.082(5)(b)1., Florida Statutes, any rate changes implemented during the interim test year shall be annualized. There were no rate changes during the test year, and no annualizing adjustments are necessary.

We have recalculated income tax expense based on the adjusted rate base, cost of capital and operating income amounts. After making the above adjustments, the test year net operating income is calculated to be \$325,655 for water and \$266,424 for wastewater. This reflects an achieved overall rate of return of 35.19% for water and 8.37% for wastewater. Our calculations of water and wastewater net operating income are attached as Schedules 3-A and 3-B, respectively.

Revenue Requirement

Using the required rate of return for interim decrease purposes of 9.60%, the water revenue requirement is \$353,074. This reflects a decrease of \$397,548 (or 52.96%) from the adjusted test year operating revenues of \$750,622. Accordingly, annual water revenues in the amount of \$397,548 shall be held subject to refund pending our final determination of Lake Groves' level of earnings in this docket.

The adjusted wastewater net operating income of \$266,424 generates an achieved rate of return of 8.37%, which is less than the minimum of the range of the required overall rate of return of 8.77%. Thus, no wastewater revenues shall be held subject to refund.

APPROPRIATE SECURITY TO GUARANTEE THE AMOUNT SUBJECT TO REFUND

Pursuant to Section 367.082(2)(b), Florida Statutes, when revenues are held subject to refund and secured in a proceeding for an interim decrease, the utility is authorized to continue collecting the previously authorized rates. The amount of potential overearnings on an annual basis is \$397,548 for the water system. Assuming a 10-month time frame, the potential refund amount is approximately \$334,000.

We have analyzed whether Lake Groves can support a corporate undertaking in the amount of \$334,000. The criteria for a corporate undertaking include sufficient liquidity, ownership equity, profitability, and interest coverage to guarantee any potential refund. The 2000 and 2001 Annual Reports of Lake Groves' affiliated company, Utilities, Inc. of Florida (UIF), were used to determine the financial condition of the utility. Our analysis shows that UIF has had minimal liquidity and negative working capital for the two-year period. In addition, UIF reports insufficient interest coverage and negative income for 2001. However, for the same two-year period UIF's common equity ratio has increased and it has net positive income for the period. Based upon UIF's current level of equity relative to the amount of the corporate undertaking, and contingent upon the written guarantee of the parent, Utilities, Inc., we find that the utility can support a corporate undertaking in the amount of \$334,000.

This brief financial analysis is only appropriate for deciding if the utility can support a corporate undertaking in the amount proposed and should not be considered a finding regarding other issues in this investigation.

The utility shall 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 day of each month indicating the monthly and total revenue

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collected subject to refund. Should a refund be required, the refund shall be with interest and undertaken in accordance with Rule 25-30.360, Florida Administrative Code.

In no instance shall maintenance and administrative costs associated with any refund be borne by the customers. The costs are the responsibility of, and should be borne by, the utility. Finally, the utility shall be on notice that failure to comply on a timely basis with the requirements of this Order will result in the initiation of a show cause proceeding.

Based on the foregoing, it is

ORDERED by the Florida Public Service Commission that an investigation of the water rates and charges of Lake Grove Utilities, Inc., shall be initiated. It is further

ORDERED that all matters contained in the schedules attached hereto are by reference incorporated herein. It is further

ORDERED that Lake Grove Utilities, Inc., shall hold annual water revenues of \$397,548, or 52.96% subject to refund. It is further

ORDERED that Lake Grove Utilities, Inc., shall provide a corporate undertaking in the amount of \$334,000, guaranteed in writing by Utilities, Inc., to guarantee the amount subject to refund within ten days of the effective date of this Order opening this investigation. It is further

ORDERED that no later than the 20th of each month, Lake Grove Utilities, Inc., shall file monthly reports consistent with the requirements set forth in the body of this Order. Should a refund be required, the refund shall be with interest and undertaken in accordance with Rule 25-30.360, Florida Administrative Code. It is further

ORDERED that Lake Grove Utilities, Inc., shall be on notice that failure to comply on a timely basis with the requirements of this Order will result in the initiation of a show cause proceeding. It is further

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ORDERED that Lake Grove Utilities, Inc., shall keep an accurate and detailed account of all monies it receives. It is further

ORDERED that this docket shall remain open pending the Commission's completion of the earnings investigation.

By ORDER of the Florida Public Service Commission this 26th day of July, 2002.

BLANCA S. BAYÓ, Director
Division of the Commission Clerk
and Administrative Services

By: Kay Flynn
Kay Flynn, Chief
Bureau of Records and Hearing
Services

(S E A L)

RRJ

NOTICE OF FURTHER PROCEEDINGS OR JUDICIAL REVIEW

The Florida Public Service Commission is required by Section 120.569(1), Florida Statutes, to notify parties of any administrative hearing or judicial review of Commission orders that is available under Sections 120.57 or 120.68, Florida Statutes, as well as the procedures and time limits that apply. This notice should not be construed to mean all requests for an administrative hearing or judicial review will be granted or result in the relief sought.

Any party adversely affected by this order, which is non-final in nature, may request (1) reconsideration within 15 days pursuant to Rule 25-22.060, Florida Administrative Code, or (2) judicial review by the Florida Supreme Court, in the case of an electric, gas or telephone utility, or the First District Court of Appeal, in the case of a water or wastewater utility. A motion for reconsideration shall be filed with the Director, Division of the Commission Clerk and Administrative Services, in the form prescribed by Rule 25-22.060, Florida Administrative Code. Citizens of the State of Florida v. Mayo, 316 So.2d 262 (Fla. 1975), states that an order on interim rates is not final or reviewable until a final order is issued. Such review may be requested from the appropriate court, as described above, pursuant to Rule 9.100, Florida Rules of Appellate Procedure.

LAKE GROVES UTILITIES, INC. SCHEDULE OF RATE BASE TEST YEAR ENDED 12/31/2001		SCHEDULE NO. 1 DOCKET NO. 020567-WS	
DESCRIPTION	TEST YEAR PER UTILITY	COMM ADJUST- MENTS	COMM ADJUSTED TEST YEAR
WATER			
1 UTILITY PLANT IN SERVICE	\$4,095,976	\$0	\$4,095,976
2 LAND & LAND RIGHTS	\$0	\$0	\$0
3 NON-USED & USEFUL COMPONENTS	\$0	\$0	\$0
4 ACCUMULATED DEPRECIATION	(\$445,502)	\$0	(\$445,502)
5 CIAC	(\$3,018,671)	\$0	(\$3,018,671)
6 AMORTIZATION OF CIAC	\$274,620	\$0	\$274,620
7 WORKING CAPITAL ALLOWANCE	<u>\$18,867</u>	<u>\$0</u>	<u>\$18,867</u>
8 RATE BASE	<u>\$925,290</u>	<u>\$0</u>	<u>\$925,290</u>
WASTEWATER			
9 UTILITY PLANT IN SERVICE	\$6,025,272	\$0	\$6,025,272
10 LAND	\$0	\$0	\$0
11 NON-USED & USEFUL COMPONENTS	\$0	\$0	\$0
12 ACCUMULATED DEPRECIATION	(\$496,141)	\$0	(\$496,141)
13 CIAC	(\$2,627,434)	\$0	(\$2,627,434)
14 AMORTIZATION OF CIAC	\$258,809	\$0	\$258,809
15 WORKING CAPITAL ALLOWANCE	\$15,067	\$0	\$15,067
16 OTHER	<u>\$6,173</u>	<u>\$0</u>	<u>\$6,173</u>
17 RATE BASE	<u>\$3,181,746</u>	<u>\$0</u>	<u>\$3,181,746</u>

LAKE GROVES UTILITIES, INC. CAPITAL STRUCTURE TEST YEAR ENDED 12/31/2001					SCHEDULE NO. 2 DOCKET NO. 020567-WS		
DESCRIPTION	TOTAL CAPITAL	SPECIFIC ADJUST- MENTS (EXPLAIN)	PRO RATA ADJUST- MENTS	CAPITAL RECONCILED TO RATE BASE	RATIO	COST RATE	WEIGHTED COST
PER UTILITY 2001 - YEAR-END							
1 LONG-TERM DEBT	\$1,550,741	\$0	\$0	\$1,550,741	37.76%	8.52%	3.22%
2 SHORT-TERM DEBT	\$529,521	\$0	\$0	\$529,521	12.89%	1.92%	0.25%
3 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
4 COMMON EQUITY	\$1,702,033	\$0	\$0	\$1,702,033	41.44%	13.51%	5.60%
5 CUSTOMER DEPOSITS	\$86,191	\$0	\$0	\$86,191	2.10%	6.00%	0.13%
6 DEFERRED INCOME TAXES	\$238,550	\$0	\$0	\$238,550	5.81%	0.00%	0.00%
7 DEFERRED ITC'S	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
10 TOTAL CAPITAL	<u>\$4,107,036</u>	<u>\$0</u>	<u>\$0</u>	<u>\$4,107,036</u>	<u>100.00%</u>		<u>9.19%</u>
PER COMMN 2001 - YEAR END							
11 LONG TERM DEBT	\$1,550,741	\$0	\$0	\$1,550,741	37.76%	8.52%	3.22%
12 SHORT-TERM DEBT	\$529,521	\$0	\$0	\$529,521	12.89%	1.92%	0.25%
13 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
14 COMMON EQUITY	\$1,702,033	\$0	\$0	\$1,702,033	41.44%	13.51%	5.60%
15 CUSTOMER DEPOSITS	\$86,191	\$0	\$0	\$86,191	2.10%	6.00%	0.13%
16 DEFERRED INCOME TAXES	\$238,550	\$0	\$0	\$238,550	5.81%	0.00%	0.00%
17 DEFERRED ITC'S	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
18 TOTAL CAPITAL	<u>\$4,107,036</u>	<u>\$0</u>	<u>\$0</u>	<u>\$4,107,036</u>	<u>100.00%</u>		<u>9.19%</u>
					LOW	HIGH	
RETURN ON EQUITY					<u>12.51%</u>	<u>14.51%</u>	
OVERALL RATE OF RETURN					<u>8.77%</u>	<u>9.60%</u>	

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LAKE GROVES UTILITIES, INC. STATEMENT OF WATER OPERATIONS TEST YEAR ENDED 12/31/2001				SCHEDULE NO. 3-A DOCKET NO. 020567-WS	
DESCRIPTION	TEST YEAR PER UTILITY	COMMN ADJUST- MENTS	COMMN ADJUSTED TEST YEAR	REVENUE INCREASE	REVENUE REQUIREMENT
1 OPERATING REVENUES	<u>\$750,622</u>	<u>\$0</u>	<u>\$750,622</u>	<u>(\$397,548)</u> -52.96%	<u>\$353,074</u>
OPERATING EXPENSES:					
2 OPERATION & MAINTENANCE	\$150,937	0	150,937		150,937
3 DEPRECIATION	\$84,671	0	84,671		84,671
4 AMORTIZATION	(\$78,355)	0	(78,355)		(78,355)
5 TAXES OTHER THAN INCOME	\$91,279	0	91,279	(17,890)	73,389
6 INCOME TAXES	<u>\$177,466</u>	<u>(\$1,031)</u>	<u>\$176,435</u>	<u>(\$142,866)</u>	<u>\$33,569</u>
7 TOTAL OPERATING EXPENSES	<u>\$425,998</u>	<u>(\$1,031)</u>	<u>\$424,967</u>	<u>(\$160,755)</u>	<u>\$264,212</u>
8 OPERATING INCOME	<u>\$324,624</u>	<u>\$1,031</u>	<u>\$325,655</u>	<u>(\$236,793)</u>	<u>\$88,862</u>
9 RATE BASE	<u>\$925,290</u>		<u>\$925,290</u>		<u>\$925,290</u>
10 RATE OF RETURN	<u>35.08%</u>		<u>35.19%</u>		<u>9.60%</u>

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LAKE GROVES UTILITIES, INC. STATEMENT OF WASTEWATER OPERATIONS TEST YEAR ENDED 12/31/2001				SCHEDULE NO. 3-B DOCKET NO. 020567-WS	
DESCRIPTION	TEST YEAR PER UTILITY	COMMN ADJUST- MENTS	COMMN ADJUSTED TEST YEAR	REVENUE INCREASE	REVENUE REQUIREMENT
1 OPERATING REVENUES	<u>\$520,309</u>	<u>\$0</u>	<u>\$520,309</u>	<u>\$0</u>	<u>\$520,309</u>
				0.00%	
OPERATING EXPENSES					
2 OPERATION & MAINTENANCE	\$120,535	\$0	\$120,535		\$120,535
3 DEPRECIATION	\$89,376	\$0	\$89,376		\$89,376
4 AMORTIZATION	(\$74,598)	\$0	(\$74,598)		(\$74,598)
5 TAXES OTHER THAN INCOME	\$26,753	\$0	\$26,753	\$0	\$26,753
6 INCOME TAXES	<u>\$92,355</u>	<u>(\$536)</u>	<u>\$91,819</u>	<u>\$0</u>	<u>\$91,819</u>
7 TOTAL OPERATING EXPENSES	<u>\$254,421</u>	<u>(\$536)</u>	<u>\$253,885</u>	<u>\$0</u>	<u>\$253,885</u>
8 OPERATING INCOME	<u>\$265,888</u>	<u>\$536</u>	<u>\$266,424</u>	<u>\$0</u>	<u>\$266,424</u>
9 RATE BASE	<u>\$3,181,746</u>		<u>\$3,181,746</u>		<u>\$3,181,746</u>
10 RATE OF RETURN	<u>8.36%</u>		<u>8.37%</u>		<u>8.37%</u>