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May 28, 1996

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Blanca S. Bayo, Director  
Division of Records & Reporting  
Florida Public Service Commission  
2540 Shumard Oak Boulevard  
Tallahassee, FL 32399-0850

HAND DELIVERY

Re: Docket No. 951056-WS  
Application for rate increase in Flagler County by Palm Coast  
Utility Corporation.

Dear Ms. Bayo:

Enclosed on behalf of Palm Coast Utility Corporation, for  
filing in the above docket, are an original and 15 copies of our  
Response to Audit Report.

Please acknowledge receipt of the foregoing by stamping the  
enclosed extra copy of this letter and returning same to my  
attention. Thank you for your assistance.

Sincerely,

*Wayne L. Schiefelbein*

Wayne L. Schiefelbein

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cc:w/encl.: Scott Edmonds, Esq.  
Stephen C. Reilly, Esq.  
Rick Melson, Esq.

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DIVISION OF RECORDS & REPORTING

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FPSC-RECORDS/REPORTING

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DOCKET NO.951056-WS  
Palm Coast Utility Corporation  
Response to Staff Audit Report  
Audit Control No. 96-037-3-1

May 28, 1996

DOCUMENT NUMBER-DATE

05853 MAY 28 1996

FPSC-RECORDS/REPORTING

259

RESPONSE TO AUDIT EXCEPTION NO. 1

SUBJECT: Noncompliance with NARUC Accounting Instruction #18.  
Utility Plant - To be Recorded at Cost

COMMENTS:

UTILITY'S GENERAL RESPONSE TO EXCEPTION NO.1: In general, the auditor takes exception to the cost of two parcels of land purchased by PCUC in 1991 and 1995 for a wastewater rapid infiltration basin (RIB) site.

The auditor begins his opinion with the claim that all ITT related corporations as a group are the ones that devoted the land in question [the new RIB site] to utility service. This seems to imply that he believes the original cost of the land is the cost paid in 1968 by "Ray-Florida Company" the first ITT related company to purchase it. However, since he does not assign a value to the land based on his opinion of 1968 costs, that claim does not appear to be the basis for his exception.

The auditor rejects the content and conclusions of a 1990 independent appraisal prepared to establish an arms-length purchase price for PCUC, and instead makes his own determination of the value of the land in 1991 and 1995 dollars. His value is based on a cost trend between 1968 and 1995 that he developed using two points - a derived cost of land in 1968 and a derived cost of land in 1995.

We hereinbelow address various elements of this Exception No. 1, with which we disagree.

1. PSC Auditor Opinion: The ITT Group of Corporations is the "Person" who first devoted the land to Utility Service.

Utility Response: PCUC disagrees with the opinion of the auditor for the following reasons:

- A. The "ITT Group of Corporations" is a non-entity, is unknown to PCUC and could not have devoted any land to utility service or to any other purpose.
- B. The plant in question is two parcels of land identified by the auditor as 81.576 acres of RIB Site Land and 4.601 acres of buffer. The auditor correctly states as a "fact" that the parcels were purchased by Palm Coast Utility Corporation on July 12, 1991 and January 24, 1995, respectively. [The buffer parcel was purchased at a later date because at the time the RIB site was purchased it was not known by the company that regulatory bodies would require an additional buffer zone to be established.] At all times prior to their purchase by PCUC, these were idle parcels, and were not in use for any purpose, let alone

utility purposes. It is PCUC that first devoted these parcels to utility service.

C. If the auditor is of the opinion that because PCUC and Ray-Florida Company are members of "the ITT Group of Companies" the date at which devotion of land to utility service should be set is the date on which Ray-Florida Company purchased the land, we disagree. All other factors regarding the law and its interpretation by this Commission aside, to draw such a conclusion would presuppose (1) that in 1968 Ray-Florida Company knew that such land would be required for utility purposes some 23 years later, (2) that in 1968, Ray-Florida Company or other ITT affiliate knew that rapid infiltration technology, not yet developed, would be developed, (3) that Ray-Florida Company or other ITT affiliate also knew in 1968 the state's 1990 hydrological and topographical permitting requirements for rapid infiltration technology and which land had the characteristics to meet them. Without this knowledge, neither PCUC or any other entity could devote the subject property to utility service, and (4) that in 1968 it was known that zoning of land would be approved by Flagler County for utility purposes.

2. PSC Auditor Opinion: The property was valued by the appraisal at \$6,497 per acre.

Utility Response: The appraisal valued the property at \$7,000 per acre for the area unencumbered by the FP&L right-of-way easement, while the area encumbered by the FP&L right-of-way easement was valued at \$1,400 per acre.

3. PSC Auditor Opinion: Sales within the immediate area were very limited during the period prior to the date of the appraisal report.

Utility Response: This was due primarily to the fact that land in the immediate vicinity is mostly under the control of ITT, which was not prone to sell off such parcels to non-ITT entities. An opportunity to purchase a well-located ITT potential development parcel would be extremely attractive to a non-ITT developer who could capitalize on installed infrastructure, marketing, etc. of the ITT/Palm Coast Community. For this reason, the appraiser's search was expanded to include properties outside of the immediate neighborhood.

4. PSC Auditor Opinion: A comparison of proximity to utilities was made.

Utility Response: That the location of the property is adjacent to the existing Palm Coast sewer effluent spray field is irrelevant as to availability of utilities. Any wastewater generated from activities on the subject site would have to be transported to a wastewater treatment facility prior to being disposed of in a spray field facility. That is, raw sewage must first be treated before it can be sprayed upon the ground. There was no such treatment plant located adjacent to the subject property at the time of the appraisal.

5. PSC Auditor Opinion: Review the facts within the appraisal of the RIB Site Land.

Utility Response: PCUC has recorded the cost of the subject purchased land based on an independent market appraisal performed in October, 1990 by a qualified real estate appraiser. The appraisal was made prior to the purchase of the land to determine a fair market price. An independent appraisal by a qualified appraiser was chosen as a means of determining price specifically because it was known that a sale between two related companies would be subject to PSC scrutiny. Such an appraisal includes a certification as to the independence of the appraiser and a statement that the appraisal will be supported in a court or regulatory hearing.

Reliance on the lay judgement of the staff auditor, who, to our knowledge, is neither a qualified real estate appraiser nor an independent party, as to the comparability of the properties considered in the appraisal or any other considerations, would be inappropriate.

6. PSC Auditor Opinion: Determine an Original Cost of the RIB Site land to the ITT Group of Corporations.

Utility Response: As previously stated, the ITT Group of Corporations is a non-entity. It does not exist and does not own land. The original cost of the land to Ray-Florida Company is irrelevant unless such entity is the person who first devoted the land to utility service, which is clearly not the case here.

7. PSC Auditor Opinion: Disclose a current ITT sale at a negotiated price to a third party for land within the RIB Site neighborhood.

Utility Response: The March 7, 1996 sale referenced by the County appraiser Mr. Sapp occurred 5 years and 4 months

after the date of valuation contained within PCUC's appraisal report for the RIB site. Information regarding a land sale in 1996 could not have been known to an appraiser in 1991. The cost of land in 1996 is irrelevant to someone making an appraisal in 1990 and should not be used to discredit that appraisal in hindsight. Economic conditions have changed considerably since the RIB site appraisal was completed, which was prior to the Savings & Loan crisis and resulting economic slowdown, and the current ongoing ITT plans to divest itself of holdings in the area.

8. PSC Auditor Opinion: Establish an index which trends the original cost paid by Ray-Florida Company to the above recent sales price per acre.

Utility Response: The auditor has established an index of the change in the cost of land spanning 26 years based on two inputs - a cost in the first year, 1968 and a cost in the last year, 1996. The first input is a calculated average cost of 12,777.20 acres of land purchased en masse by Ray-Florida Company in 1968. The second input is the cost of a 700 acre site purchased from ITT in 1996. Such an index is faulty because a) the establishment of an index based on the average price of thousands of acres of land purchased en masse - some of which is developable and some of which is not - is irrelevant to the determination of the market value of a single parcel of developable land; b) there is no means of verifying that the index, covering 26 years, reflects the change in the cost of land over that period and, specifically, in 1991 when the land in question was purchased; c) there is no basis to determine whether the change in value of individual land parcels over time has been or can be reflected by this derived index or any index.

9. PSC Auditor Opinion: Revalue the RIB Site land at a trended original cost [paid by Ray-Florida Company in 1968].

Utility Response: The instructions in the NARUC system of accounts regarding the stating of original cost are specific. They are to be stated at the cost incurred by the person who first devoted the property to utility service. According to Webster's dictionary, to devote is to dedicate, and to dedicate is to "set apart to a definite use." In order to set apart a parcel of land for a definite use, one must be able to identify the parcel and know for what purpose it is to be used. Neither Ray-Florida Company or other ITT affiliate could have known in 1968 that the subject parcels would be needed or used for utility purposes, nor could they have known of this anytime thereafter unless they were the party responsible for the

design of the utility system. Certainly it cannot be concluded that all land owned by "the ITT Group of Companies", wherever located, is dedicated to utility service merely because there exists a related company that is a public utility. If Ray-Florida Company or other ITT affiliate is not the party that placed this land in utility service, then the cost to Ray-Florida Company is not a proper basis for the original cost of land devoted to utility service. The only party responsible for the design of the utility system is PCUC and therefore only PCUC can be and is identified as the party devoting this land to utility service. Therefore, the proper cost to be stated, in accordance with the NARUC system of accounts, is the original cost to PCUC.

10. PSC Auditor Opinion: The per acre purchase price of \$340.76 or \$341 was calculated.

Utility Response: The value of a site is influenced by a number of factors including size, location, proximity to development, access, and economic and political conditions present at the date of valuation. According to the audit report and workpapers, the \$340.76 per acre purchase price in 1968 was for 12,777.20 acres. The size of this parcel would have a substantial impact upon its purchase price and value. Further, the 1968 transaction was completed prior to installation of the Palm Coast infrastructure, which greatly influenced contemporary (1990) land value. It is inappropriate to attempt to compare a bulk land sale occurring 22 years earlier with a potential development site in 1990. Therefore, the discussion in the audit relating to "indexing of the original cost" is totally inappropriate, and the mathematical calculations therein are grossly misleading. Pure mathematical manipulations of statistical data without the application of common sense, reasoning, judgment and actual market experience is not an acceptable appraisal practice.

11. PSC Auditor Opinion: Relies on statements of the Flagler County Property Appraiser as to validity of appraisal.

Utility Response: Mr. Sapps' statement that the comparable sales are not comparable is without merit. The "DQ" designation by the Flagler County Appraisers Office was made under state guidelines for ad valorem tax assessment purposes only. The two sales referred to as "DQ" by the Flagler County Property Appraisers Office were evidently done so in the absence of independent confirmation by that office. State guidelines for ad valorem tax assessment purposes specify that sales to a governmental authority may

be utilized as comparable properties under certain instances. First, a Sales Ratio Study is performed to determine if the sale is out of line with other sales in the area. Secondly, the sale must be confirmed with both parties to determine if the transaction was under threat of condemnation or other undue influence. If it is determined that the sale is an arms-length transaction, then the sale may be used as a qualified sale for ad valorem tax calculation purposes. If the sale does not pass the tests outlined above, then the sale is labeled "DQ" (Disqualified Sale) and is not utilized for calculation of ad valorem tax purposes for other properties. The simple fact that the two sales referenced in the original appraisal report were sales to governmental authorities does not automatically disqualify them as comparable sales. It may well be that the Flagler County Property Appraisers' office does not have the manpower nor the resources to investigate these sales, however, they may still be valid comparable sales and should be investigated further, as PCUC's independent appraisers have done.

PCUC's independent appraisers have intimate knowledge of one of the sales (Sale 0391-0488) utilized in the appraisal report that Mr. Sapp labeled "DQ", having performed an appraisal of this property for the grantee prior to the sale. The grantee of this sale, Flagler County, is required to pay no more than fair market value for a parcel purchased with public funds and in fact routinely obtains multiple independent appraisals prior to purchase to ensure this fact. It is our understanding that Hamilton and Associates of Daytona Beach was the other independent appraiser retained by Flagler County to appraise this parcel. The Grantor in this case was under no duress to sell the property and the property had in fact been for sale for some time prior to this transaction. In addition, this was one of several competing sites that Flagler County considered purchasing. This transfer was not under the threat of condemnation and represented a negotiated arms-length sale. Therefore, this sale should not be labeled "DQ" and in fact represents a valid qualified sale.

Although PCUC's independent appraisers did not appraise the School Board site (Sale 0406-0071) prior to the transaction, this same discussion holds true for this sale as well since school board purchases are similarly regulated. PCUC's independent appraisers have had the opportunity to appraise several vacant tracts purchased by the school boards of both Flagler and Volusia Counties. In each instance, the appraisers' specific instructions were to estimate fair market value according to the commonly accepted definition of market value. This sale was in fact independently confirmed by PCUC's independent appraisers. This sale



should not be labeled "DQ" and in fact represents a valid qualified sale.

General Utility Conclusion: The cost of the land in question was determined by an independent appraisal by a qualified appraiser. There is no substantive qualified information in the auditor's exception that supports discrediting the appraisal and substituting another value. There should be no adjustments to the cost of land.

RESPONSE TO AUDIT EXCEPTION NO. 2

SUBJECT: Misclassifications of RIB Site Improvements

COMMENTS:

1. PSC Auditor Opinion: "The above soft capital costs of consulting fees, materials, engineering and AFUDC total \$246,287.83."

Utility Response: This is a fact not an opinion. It is supported by documentation [Auditor workpaper 16-6].

2. PSC Auditor Opinion: The addition and improvements should be classified as Structures and Improvements, and the utility charge to Equipment should be reversed.

Utility Response: PCUC disagrees with the auditor's opinion.

The rapid infiltration basins (RIB) were designed and are being used for further treatment and reuse/disposal of reclaimed water. The reclaimed water is applied to the bottom of the RIBs to allow for percolating through the soil for further treatment prior to discharging to the ground water. The RIB is properly considered as treatment and reuse/disposal equipment similar to oxidation ponds, lagoons, filtering equipment, etc. which have a normal useful life of approximately 18 years, as recognized by PSC service life guidelines.

The use of rapid infiltration technology is relatively new and was not specifically envisioned in the NARUC Uniform System of Accounts. PCUC has consistently classified RIBs as treatment and disposal facilities as generally described in Account 380. We do not agree that this RIB should be treated differently and reclassified to Account 354 - Structures and Improvements. The descriptions of grading and clearing in that account, upon which the auditor relies in his workpapers, is grading and clearing "when directly occasioned by the building of a structure." There are no structures at the RIB site. Similarly, the drainage systems and landscaping relate to structure improvements. The RIB site, including any landscaping required as a buffer, is in total a functioning wastewater disposal facility, not a structure with improvements. It should remain in Account 380 and no adjustments are necessary.

RESPONSE TO AUDIT EXCEPTION NO. 3

SUBJECT: Misclassifications of Major Rehabilitations to UPIS

COMMENTS:

1. PSC Auditor Opinion: Certain identified major rehabilitation costs in the amounts of \$1,103,995 should be removed from Plant in Service. The auditor does not clearly indicate how these costs should be treated.

Utility Response: PCUC disagrees with the opinion of the auditor. These costs should remain in plant in service.

The auditor opines that nine sewer line replacement projects totaling \$599,457.47 over a seven year period constitute "recurring periodic expenses which should never be charged to plant."

First, each of the specified rehabilitations and replacements was a unique circumstance which was not considered by the auditor. These projects are not routine and on-going, but rather an immediate response to a failure necessitating rehabilitation to continue service.

Second, these rehabilitation resulted in replacement and retirement of line segments. The costs incurred, as well as the costs of the retired property, were properly accounted for as a retirement in accordance with the 1984 Uniform System of Accounts for Class A Utilities; Accounting Instruction No. 27.

Third, the books and records of PCUC are annually audited by Arthur Andersen LLP, and do not reflect any overstatement of plant costs.

Fourth, while PCUC's books and records have been audited by the PSC in each of PCUC's five prior rate proceedings, there have been no disallowances of "improperly" capitalized repair costs, and PCUC's accounting practices have remained unchanged.

In PCUC's last rate case, based on all of these considerations, the PSC recognized the same type of rehabilitations and replacements as capital improvements. Order No. 22843, pp. 15 - 16.

Similarly for water, structural interior and exterior elevated tank and water plant softening basins rehabilitations are major undertakings and can not conceivably be considered recurring periodic expenses.

PCUC also disagrees with the auditor's analysis of \$215,797.57 of well program costs. This amount is for 3 separate items. First, is \$49,038.13 related to activation of a new well, LW-32. Second, is \$51,040.93 for four new diesel engines to supply back-up power to wellsites SW-5, SW-28, SW-36 and SW-62 in case of thunderstorm power failures. Lastly, is \$115,743.47 associated with redrilling two wells on existing sites, which in no way could be considered a recurring maintenance cost. None of these capital projects are included in the test year well rehabilitation expense referenced by the auditor, nor do they represent the same type of work. The expense included in the test year for well rehabilitation are incurred to increase the productivity of existing wells and primarily include the cost of pulling pump, inspecting, acidizing to clean it, and redeveloping the well area to increase porosity and disinfection. No capital expenditures are anticipated under this rehabilitation program.

Finally, if the auditor's opinion prevails, that the items discussed should be expensed rather than capitalized, then, in determining revenue requirements, the test year expenses need to be increased by amounts equivalent to the amount identified by the auditor as "recurring." We estimate this to be approximately \$100,000 for sewer line rehabilitation and \$54,000 for well projects (in addition to the requested \$100,000 for the well maintenance program).

RESPONSE TO AUDIT EXCEPTION NO. 4

SUBJECT: Operation and Maintenance Expenses

COMMENTS:

1. PSC Auditor Opinion: Auditor recommended four adjustments to operating and maintenance expense.

Utility Response: PCUC accepts the auditor's recommendation.

RESPONSE TO AUDIT EXCEPTION NO. 5

SUBJECT: Water Sold for Resale

COMMENTS:

1. PSC Auditor Opinion: Auditor recommends that water sales to Hammock Dunes for resale be reclassified from Account 461.2 to Account 466.

Utility Response:

PCUC accepts the auditor's recommendation.

RESPONSE TO AUDIT DISCLOSURE NO. 1

SUBJECT: Sprayfield Land Cost

COMMENTS:

1. PSC Auditor Opinion: Auditor recommends substantial disallowance of cost of sprayfield placed in service on 1/15/86, basing his valuation on the indexed cost of land purchased by Ray-Florida Company in 1968.

Utility Response: PCUC disagrees with the auditor's opinion. See Response to Audit Exception No. 1.

Further, the auditor ignores the fact that the independently appraised value of the sprayfield (\$364,500) has been included by the PSC in rate base in PCUC's last two rate cases.

See Order No. 22843 (4/23/90), p. 75, which reflects \$588,895 in approved wastewater rate base for land and land rights. This ties to Schedule A-9 of the MFRs filed in that case, which shows Account 353.3 System Pumping Plant Land and Land Rights of \$282,543, and Account 353.4 Treatment and Disposal Plant Land and Land Rights of \$386,352, for a total of \$588,895. As reflected on PCUC's books, the \$386,352 for Treatment and Disposal Plant Land and Land Rights consists of five entries:

1.	Land Transferred from ITT	12/15/72	\$ 14,505.09
2.	LS Land Purchase - WWTP	1/15/84	4,212.80
3.	LS Rec Fee 83 Land	1/15/85	7.80
4.	LS Land Appraisal	4/15/85	1,500.00
5.	83.305 Acres WWDISP	1/15/86	<u>366,126.00</u> *
			\$386,351.69

[\*Sum of \$364,500 appraised value plus appraiser's fee]

See also Order No. 18625 (1/4/88), at p. 27, which reflects the same \$588,895 in wastewater rate base for land and land rights, prior to used and useful adjustments.

The auditor's justification for reversing these PSC findings appears to rest solely on his concocted 1968 cost to the ITT Group of Companies and Audit Staff's discussions with the Flagler County Appraiser regarding a March, 1996 sale of land (all discussed at length in response to Exception No. 1). The attenuated "logic" of this analysis is not a reasonable basis for reversing a transaction based on an independent appraisal which has been accepted by the PSC in the Utility's last two rate cases.

RESPONSE TO AUDIT DISCLOSURE NO. 2

SUBJECT: Effluent to Dunes Community Development District (DCDD)

COMMENTS:

1. PSC Auditor Opinion: It is the Auditor's opinion that PCUC be allowed to sell reclaimed water to recover some of its costs in treatment and disposal.

Utility Response:

PCUC agrees with the auditor's opinion.



RESPONSE TO AUDIT DISCLOSURE NO. 3

SUBJECT: Operating Revenues

COMMENTS:

1. PSC Auditor Opinion: The utility did not apply the indexed rates per its tariff to November, 1995 customer billings and has understated its 1995 revenue.

Utility Response:

PCUC does not agree that it failed to apply the indexed rates to November, 1995 billing. The indexed rate tariff became effective October 24, 1995. The indexed rates were applied to service rendered after that date. Because of the difference between billing cycles and the accounting closing dates, billings for November at the indexed rate did not appear on the books until December. The 1995 revenues are correctly stated.

However, whether PCUC applied the price index rates in November is of no consequence to this proceeding. The starting point for determining revenue requirements in this proceeding is the adjusted revenue shown in column (5), line 1 of MFR Schedules B-1 and B-2. This adjusted revenue for 1995 assumes the price index rate was in effect for all 12 months of 1995 and was applicable to year end 1995 customers.

RESPONSE TO AUDIT DISCLOSURE NO. 4

SUBJECT: Over-recovery of Rate Case Expense

COMMENTS:

1. PSC Auditor Opinion: PCUC over recovered rate case expense because it did not reduce its rates at the end of the three year amortization period used in Order No. 22843. The auditor references 367.0816, F.S. and Rule 25-30.470, F.A.C.

Utility Response: PCUC disagrees with the auditor.

In approving water and wastewater rate increases in PCUC's most recent general rate case, the PSC, by Order No. 22843 (4/23/90), approved a three-year amortization period for rate case expense. The rate case expense recovery period concluded on or about April, 1993.

The 1989 Legislature mandated a four-year amortization period for water and wastewater utility rate case expense, with an "automatic" rate reduction at the conclusion of the recovery period. Sec. 367.0816, Fla. Stat. However, since PCUC filed its rate application prior to the effective date of the 1989 legislative amendment, the PSC in its rate case order (at p. 62) properly deemed the four-year period to be inapplicable. Further, the PSC did not order PCUC to reduce rates at the end of the amortization period. While the Order did not expressly address the applicability of the "automatic" rate reduction, such rate reduction would not apply in this case, using the same legal reasoning as employed by the PSC in finding the statute's four-year recovery period to be inapplicable.

Thus, while PCUC had fully recovered its rate case expense, it had no legal obligation to reduce its rates.

With regard to the staff auditor's reference to Rule 25-30.470, Florida Administrative Code, this rule did not become effective until November 30, 1993, three and one half years after the rate order was issued.

PCUC was not overcollecting revenues. There was no basis for PCUC to reduce its rates at the end of the amortization period. There is no basis to modify future rates in order to retroactively recognize the auditor's conclusions.

RESPONSE TO AUDIT DISCLOSURE NO. 5

SUBJECT: Reuse Plant

COMMENTS:

1. PSC Auditor Opinion: The auditor states, "If Palm Coast believes that \$2,935,977 of its Sewer Utility Plant in Service can be directly or partially dedicated to Effluent Reuse purposes, then such plant costs should not be imposed on the Sewer ratepayer."

Utility Response: PCUC disagrees with the auditor's opinion. The auditor is incorrect when he characterizes the cost allocation study with respect to the development of an effluent reuse rate as a "dedication" of \$2,935,977 of sewer utility plant to effluent reuse (for sale to a customer). All plant and facilities used to dispose of effluent are essential in order to treat wastewater and provide sewerage disposal service to its customers in compliance with DEP regulatory requirements. Since Palm Coast has an opportunity to sell some of its effluent, it has developed a rate for effluent based on a cost allocation of certain of its sewer utility plant and facilities. The revenues which are estimated to be generated by the sale of effluent have been deducted from the overall sewer system revenue requirement and, therefore, the sewer customers receive the full benefit of the cost allocation to effluent reuse sales. Accordingly, the auditor's recommendation to reduce the sewer utility plant accounts by \$2,935,977 would not only constitute, in part, a double deduction but also deny PCUC the ability to recover the cost of effluent disposal which it must incur in order to serve its regular sewer customers.

RESPONSE TO AUDIT DISCLOSURE NO. 6

SUBJECT: Capital Structure Presentation (Company)

COMMENTS:

1. PSC Auditor Opinion: With reference to loans made to PCUC by Southtrust Bank of Alabama, the auditor states, "The interest rates associated with this outstanding debt may be impaired because of the parents [sic] unconditional guarantees as referenced above."

Utility Response: PCUC does not understand the auditor's opinion. It is a fact that the interest rate is enhanced, not impaired by the guarantee. The purpose of any guarantee is to reduce the risk of non-payment and provide a basis for a lower, or enhanced, interest rate. For stand alone water and sewer utilities, the bank almost always require the unconditional guarantee of the individual stockholders. For affiliated companies, such as PCUC, the unconditional guarantee of the parent provides the same benefit.

The auditor correctly points out that the cost rate for PCUC's debt does not include a component for "credit risk" because there is no risk of non payment. To us that means, the interest rate is enhanced, not impaired. If, however, by impaired the auditor believes that the interest rate made available to PCUC is too low because of the guarantee, PCUC will attempt to obtain financing without a guarantee at the more costly prevailing rates. This will in turn increase customer rates due to the significance of the marginal increase in the cost of capital.

2. PSC Auditor Opinion: The auditor suggests that the Commission determine whether PCUC's outstanding debt is in essence outstanding debt of the parent. If so he recommends that the Commission require PCUC to use the parent's capital structure for this rate proceeding.

Utility Response: The debt obtained by PCUC is clearly PCUC debt. The requirement for a guarantor does not change that. If it did, in every case in which debt was required to be guaranteed by stockholders [which would include most small companies operating Florida], the Commission would look to the capital structure of the stockholder; i.e., recognize 100% equity financing. PCUC has been treated as a stand alone utility by this Commission in all of its rate proceedings. There is no basis for substituting the capital structure of the parent in this case. There is no indication that either the capital structure of the utility is unreasonable or that the cost of debt is unreasonable.

RESPONSE TO AUDIT DISCLOSURE NO. 7

SUBJECT: Capital Structure Presentation (Parent)  
COMMENTS:

1. PSC Auditor Opinion: The parent's capital structure as filed is not comparable to that of the utility because the parent structure was presented using a simple beginning and ending year average and the utility's using a thirteen month average.

Utility Response: PCUC does not disagree with the auditor's observation regarding the differences in presentation. However, PCUC believes that since there has been relatively little variation in structure for the parent, the effect is minimal for the purpose parent capital structure was used in this case. The only use of the parent capital structure in this case was to adjust the taxes allowed for ratemaking. Parent capital structure information is not available on a monthly basis.

2. PSC Auditor Opinion: The parent capital structure information is obsolete because ITT Corporation reorganized effective November 30, 1995.

Utility Response: The auditor's observation is correct. However, since the reorganization is less than a year old, there is not enough information to provide even a simple beginning and ending year end average. It is recommended that for the purposes of this proceeding, the historical structure for ITT Corporation continue to be used.