

FLORIDA PUBLIC SERVICE COMMISSION  
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M E M O R A N D U M

AUGUST 28, 1997

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TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYO)

FROM: DIVISION OF WATER & WASTEWATER (WEBB) <sup>KW</sup> PWTM m H  
DIVISION OF LEGAL SERVICES (JAEGER) JH

RE: DOCKET NO. 970991-SU - INVESTIGATION INTO RATES AND  
CHARGES OF FLORIDA CITIES WATER COMPANY - LEE COUNTY -  
SOUTH FT. MYERS WASTEWATER SYSTEM - FOR POTENTIAL  
OVEREARNINGS  
COUNTY: LEE

AGENDA: 09/09/97 - REGULAR AGENDA - DECISION ON HOLDING REVENUES  
SUBJECT TO REFUND - INTERESTED PERSONS MAY PARTICIPATE  
ON ISSUE 1 - PARTICIPATION LIMITED TO COMMISSION AND  
STAFF ON ISSUES 2 & 3

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: S:\PSC\WAW\WP\970991SU.RCM

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FPSC-RECORDS/REPORTING

## CASE BACKGROUND

Florida Cities Water Company (FCWC or utility) is a Class A utility that provides wastewater service for two communities in Ft. Myers, Florida: a northern sector and a southern sector. The South Ft. Myers wastewater system was serving approximately 8,966 equivalent residential connections (ERCs) at December 31, 1996. The utility serves an area that has been designated by the South Florida Water Management District as a critical use area. For the twelve months ended December 31, 1996, the South Ft. Myers wastewater system reported operating income of \$805,958, inclusive of revenues for the treatment of Lee County wastewater under an amended Agreement dated August 28, 1996. This Agreement is the subject of a prior FCWC Docket No. 961231-WS, Order No. PSC-97-0019-FOF-WS, issued on January 6, 1997.

By this order, FCWC was approved for a new class of service to treat and dispose of reclaimed water from Lee County. Lee County had approached FCWC regarding treatment and disposal of reclaimed water from its Ft. Myers Beach wastewater treatment plant as a short-term response to an emergency situation which had developed at the plant. Due to inadequate disposal capacity through the reuse of reclaimed water, Lee County's storage ponds overflowed. Lee County then entered into a consent order with the Florida Department of Environmental Protection (DEP) to address the overflow. While Lee County plans to construct a deep well injection system as a permanent solution, FCWC agreed to receive and dispose of the reclaimed water from Lee County as a temporary measure, which should not extend beyond July, 1998.

FCWC's filing in Docket No. 961231-WS requested that the revenues received by FCWC pursuant to the Agreement with Lee County be treated as non-recurring so that they will not be considered in determining the level of regulated earnings for FCWC. The utility requested that if the revenue from this Agreement results in overearning, the Commission should defer those overearnings to subsequent years.

By Order No. PSC-97-0019-FOF-WS, the Commission found it appropriate to treat the estimated annual revenues of \$122,912 associated with the Agreement as non-recurring. However, FCWC is required to file semi-annual earnings reports with the Commission to allow our staff to monitor the utility's earnings. Additionally, if the revenues associated with this Agreement place FCWC outside its approved rate of return, the matter was to be addressed in a subsequent docket.

A review of FCWC's 1996 Annual Report indicates that the utility's wastewater system in South Ft. Myers may be exceeding its

last authorized return on equity investment. The increase in revenues due to FCWC's Agreement with Lee County has almost certainly caused the overearnings posture of the South Ft. Myers wastewater system. Therefore, in accordance with the Commission's decision in Docket No. 961231-WS, we recommend that the Commission initiate an overearnings investigation.

## DISCUSSION OF ISSUES

ISSUE 1: Should the Commission initiate an earnings investigation of FCWC's South Ft. Myers wastewater system?

RECOMMENDATION: Yes, the Commission should initiate an investigation of the level of wastewater rates to determine potential overearnings. (WEBB)

STAFF ANALYSIS: Staff's review of FCWC's 1996 Annual Report indicates that FCWC's South Ft. Myers wastewater system was earning a 10.06% overall return on rate base at year-end 1996. Our review also indicates an achieved rate of return on equity of approximately 18.08% for this period. The last authorized return on equity was set at 12.44%, with a range of 11.44% to 13.44%, by Order No. PSC-93-1288-SU, issued on September 7, 1993. Based on this analysis, we recommend that the Commission should investigate overearnings in FCWC's South Ft. Myers wastewater system.

ISSUE 2: Should any amount of annual wastewater revenues be held subject to refund?

RECOMMENDATION: Yes, FCWC should hold annual revenues of \$399,046 subject to refund. As such, the following amounts are recommended: (WEBB)

	<u>Total</u> <u>Revenues</u>	<u>Addl. Amt.</u> <u>Subject to</u> <u>Refund</u>	<u>% Subject</u> <u>to Refund</u>
Wastewater	\$3,946,388	\$399,046	10.11%

STAFF ANALYSIS: According to FCWC's 1996 Annual Report, the utility achieved a 10.06% overall rate of return for wastewater service in South Ft. Myers. In the utility's last rate proceeding for the South Ft. Myers wastewater system (Docket No. 920808-SU, Order No. PSC-93-1288-FOF-SU, issued on September 7, 1993), the Commission approved a range of reasonableness for total capital investment of 8.60% to 9.18%. The corresponding range for equity investment was 11.44% to 13.44%.

Using the upper boundary of 13.44% for equity earnings, and appropriate interest rates for other components in the capital structure, a 9.56% overall cost of capital is indicated. Additionally, our preliminary review suggests that the utility achieved a 18.08% return on equity investment in 1996 with respect to wastewater service in South Ft. Myers.

Chapter 367.082 (5)(b), Florida Statutes, requires that adjustments consistent with those made in the last individual rate proceeding shall be made in arriving at the achieved rate of return of the utility. Additionally, the statute requires the annualization of any rate changes that occurred during the test period. Our recommendation reflects the appropriate adjustments, and the nature of such adjustments is outlined in the respective sections below.

We have attached accounting schedules to illustrate our recommendations regarding rate base (Schedules 1-A and 1-B), capital structure (Schedule 2), and test year operating income (Schedules 3-A and 3-B).

#### RATE BASE

Our calculation of the South Ft. Myers wastewater rate base balance is based upon information shown in the utility's 1996 Annual Report. Rule 25-30.433 (4), Florida Administrative Code, requires Class A utilities to calculate rate base and cost of

capital using a 13-month average. Since month by month balances are not contained in the annual report, simple averages were computed using the beginning and ending balances for all rate base components. For interim purposes, working capital was calculated using the formula method (one-eighth of O&M), which is consistent with the method used in FCWC's last wastewater rate proceeding. Based on this methodology, working capital reflects a downward adjustment. Our recommended rate base amount also reflects an allocation of FCWC's total unfunded SFAS 106 Obligation (Post-Retirement Benefits). Accordingly, the recommended rate base amount for the South Ft. Myers wastewater system is \$7,883,672.

#### COST OF CAPITAL

The recommended capital structure for interim refund purposes reflects the utility's outstanding capital balances shown in FCWC's 1996 Annual Report. Again, simple averages were computed using the beginning and ending balances for each component of the capital structure. In accordance with Section 367.082(2)(b), Florida Statutes, the amount held subject to refund should be calculated using the top of the range of the last authorized return on equity investment. The last authorized range of return on equity investment was set at 11.44% to 13.44% in Docket No. 920808-SU, Order No. PSC-93-1288-FOF-SU, issued on September 7, 1993. Applying the 13.44%, and applicable interest rates for other components of the capital structure, the weighted cost of capital for purposes of holding revenues subject to refund is 9.56%.

#### NET OPERATING INCOME

On or about June 14, 1996, the utility implemented an index adjustment that increased revenues by \$35,096 on an annual basis. In accordance with the interim statute, the full revenue impact of that adjustment has been annualized and is reflected as an increase of \$17,548 to test year revenues. Also, in accordance with the interim statute, test year revenues have been increased for the revenues received by FCWC for the treatment of Lee County wastewater, as the charges for this new class of service went into effect July 10, 1996. The basis for staff's recommended adjustment is contained in the most recent semi-annual earnings report for the South Ft. Myers wastewater system of FCWC. As mentioned in the case background, this report is required to be filed in accordance with Commission Order No. PSC-97-0019-FOF-WS, issued on January 6, 1997. For the year ended June 30, 1997, revenues of \$221,330, net of tax, were reported from the treatment of Lee County wastewater. Staff grossed-up these revenues for the utility's 34% federal tax bracket, 5.5% state tax rate, and 4.5% for regulatory assessment fees, which resulted in a revenue increase of \$371,587. Additionally, staff has recommended a decrease to operation and maintenance expenses of \$27,230, which represents an adjustment

downward to the Commission approved rate case expense in the utility's last wastewater rate proceeding. All other components in the statement of wastewater operations were taken from FCWC's 1996 Annual Report.

Staff's recommended adjustments result in a revenue requirement of \$3,512,246 for the interim test period. This represents a decrease of \$434,142 or 11% from the adjusted test year balance. As the utility implemented a \$35,096 index adjustment in 1996, the revenues associated with this increase are already subject to refund, according to Section 367.081(4)(d), Florida Statutes. Therefore, staff recommends that \$399,046 (\$434,142 less \$35,096) in wastewater revenues be held subject to refund pending the final determination by the Commission in the instant case.

**ISSUE 3:** What is the appropriate security to guarantee the amount subject to refund?

**RECOMMENDATION:** A corporate undertaking in the amount of \$421,181, guaranteed by FCWC, should be accepted as security. (WEBB)

**STAFF ANALYSIS:** Pursuant to Section 367.082, Florida Statutes, the utility is authorized to continue collecting the previously authorized rates. As recommended in Issue 2, the amount of potential overearnings for the wastewater system is \$434,142 on an annual basis. The utility filed for an index in 1996, which was effective for service rendered after June 14, 1996. According to Section 367.081(4)(d), Florida Statutes, an index is subject to refund for up to fifteen months after the date of filing of the annual report for the year the index was implemented. The utility's 1996 Annual Report was filed on March 31, 1997, consequently, fifteen months from that date is June 30, 1998. Since that index is already subject to refund, only \$399,046 in annual revenues should be collected under guarantee, subject to refund with interest. Assuming a 12-month time frame, the potential refund is \$421,181 including interest.

The Division of Auditing and Financial Analysis has advised that a corporate undertaking signed by Florida Cities Water Company would be sufficient to protect the potential refund. Therefore, staff recommends that the utility be allowed to provide a corporate undertaking in the amount of \$421,181 as guarantee of any potential refund of wastewater revenues collected under the interim conditions.

Further, an accurate and detailed account of all monies received should be kept by the utility. By no later than the twentieth (20th) day of each month, the utility should file a report showing the amount of revenues collected each month subject to refund. Should a refund be required, the refund should be with interest and undertaken in accordance with Rule 25-30.360, Florida Administrative Code.

In no instance should maintenance and administrative costs associated with any refund be borne by the customers. These costs are the responsibility of, and should be borne by the utility.



FCWC -- SOUTH FT. MYERS WASTEWATER  
 SCHEDULE OF WASTEWATER RATE BASE  
 TEST YEAR ENDED 12/31/96

SCHEDULE NO. 1-A  
 DOCKET NO. 970991-SU

COMPONENT	AVG. BAL. PER UTILITY ANNUAL RPT.	UTILITY ADJUSTMENTS	UTILITY ADJUSTED TEST YEAR 12/31/96	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR 12/31/96
1 UTILITY PLANT IN SERVICE	\$ 27,135,082	0 \$	27,135,082		27,135,082
2 LAND	0	0	0	0	0
3 NON-USED & USEFUL COMPONENTS	(1,843,500)	0	(1,843,500)	0	(1,843,500)
4 CONSTRUCTION WORK IN PROGRESS	0	0	0	0	0
5 ACCUMULATED DEPRECIATION	(8,961,153)	0	(8,961,153)	0	(8,961,153)
6 CIAC	(13,329,612)	0	(13,329,612)	0	(13,329,612)
7 AMORTIZATION OF CIAC	4,734,950	0	4,734,950	0	4,734,950
8 ADVANCES FOR CONSTRUCTION	0	0	0	0	0
9 WORKING CAPITAL ALLOWANCE	202,503	0	202,503	(3,756)	198,747
10 OTHER: ALLOC. OF GENERAL OFFICE	0	0	0	0	0
11 UNFUNDED SFAS 106 OBLIGATION	0	0	0	(50,841)	(50,841)
<b>RATE BASE</b>	<b>\$ 7,938,270</b>	<b>0 \$</b>	<b>7,938,270</b>	<b>(54,597)</b>	<b>7,883,672</b>

FCWC -- SOUTH FT. MYERS WASTEWATER  
ADJUSTMENTS TO RATE BASE  
TEST YEAR ENDED 12/31/96

SCHEDULE NO. 1-B  
DOCKET NO. 970991-SU  
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EXPLANATION	WASTEWATER
1 <u>UNFUNDED SFAS 106 OBLIGATION</u> Adjustment to allocate a portion of the average bal. to South Ft. Myers system	(50,841)
2 <u>WORKING CAPITAL</u> Adjustment to reflect one-eighth of O&M	(3,756)

FCWC -- SOUTH FT. MYERS WASTEWATER  
 CAPITAL STRUCTURE - WASTEWATER  
 TEST YEAR ENDED 12/31/96

SCHEDULE NO. 2  
 DOCKET NO. 970991-SU

DESCRIPTION	TOTAL CAPITAL	SPECIFIC ADJUSTMENTS (EXPLAIN)	PRO RATA ADJUSTMENTS	CAPITAL RECONCILED TO RATE BASE	RATIO	COST RATE	WEIGHTED COST
<b>PER UTILITY</b>							
1 LONG TERM DEBT	34,214,167	0	(30,224,337) \$	3,989,830	46.03%	7.81%	3.59%
2 SHORT-TERM DEBT	0	0	0	0	0.00%	9.00%	0.00%
3 PREFERRED STOCK	9,000,000	0	(8,019,341)	980,659	11.31%	9.00%	1.02%
4 COMMON EQUITY	23,405,734	0	(20,751,317)	2,654,417	30.62%	12.44%	3.81%
5 CUSTOMER DEPOSITS	831,713	0	(748,961)	82,752	0.95%	6.00%	0.06%
6 DEFERRED ITC'S-ZERO COST	0	0	0	0	0.00%	0.00%	0.00%
7 DEFERRED ITC'S-WTD COST	1,638,381	0	(1,459,958)	178,423	2.06%	9.61%	0.20%
8 DEFERRED INCOME TAXES	<u>2,495,891</u>	0	<u>(1,713,608)</u>	<u>782,283</u>	<u>9.02%</u>	0.00%	<u>0.00%</u>
9 TOTAL CAPITAL	<u>71,585,885</u>	0	<u>(62,917,521) \$</u>	<u>8,668,364</u>	<u>100.00%</u>		<u>8.68%</u>
<b>PER STAFF</b>							
10 LONG TERM DEBT	34,214,167	0	(30,405,969) \$	3,808,197	47.79%	7.81%	3.73%
11 SHORT-TERM DEBT	0	0	0	0	0.00%	0.00%	0.00%
12 PREFERRED STOCK	9,000,000	0	(7,998,258)	1,001,742	12.57%	9.00%	1.13%
13 COMMON EQUITY	23,405,734	0	(20,800,566)	2,605,168	32.70%	13.44%	4.39%
14 CUSTOMER DEPOSITS	831,713	0	(739,139)	92,574	1.16%	6.00%	0.07%
15 DEFERRED ITC'S-ZERO COST	0	0	0	0	0.00%	0.00%	0.00%
15 DEFERRED ITC'S-WTD COST	1,638,381	0	(1,456,022)	182,359	2.29%	9.95%	0.23%
16 DEFERRED INCOME TAXES	<u>2,495,891</u>	0	<u>(2,218,087)</u>	<u>277,804</u>	<u>3.49%</u>	0.00%	<u>0.00%</u>
17 TOTAL CAPITAL	<u>71,585,885</u>	0	<u>(63,618,040) \$</u>	<u>7,967,845</u>	<u>100.00%</u>		<u>9.56%</u>
<b>RANGE OF REASONABLENESS</b>					<b>LOW</b>	<b>HIGH</b>	
AUTHORIZED RETURN ON EQUITY					<u>11.44%</u>	<u>13.44%</u>	
OVERALL RATE OF RETURN					<u>8.90%</u>	<u>9.56%</u>	

FCWC -- SOUTH FT. MYERS WASTEWATER  
 STATEMENT OF WASTEWATER OPERATIONS  
 TEST YEAR ENDED 12/31/96

SCHEDULE NO. 3-A  
 DOCKET NO. 970991-SU

DESCRIPTION	TEST YEAR PER UTILITY	UTILITY ADJUSTMENTS	UTILITY ADJUSTED TEST YEAR 12/31/96	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR 12/31/96	REVENUE INCREASE	REVENUE REQUIREMENT
1 OPERATING REVENUES	3,557,253	0	3,557,253	389,135	3,946,388	(434,142)	3,512,246
OPERATING EXPENSES						-11.00%	
2 OPERATION AND MAINTENANCE	1,617,210	0	1,617,210	(27,230)	1,589,980 \$		1,589,980
3 DEPRECIATION	613,938	0	613,939	0	613,939		613,939
4 AMORTIZATION	0	0	0	0	0		0
5 TAXES OTHER THAN INCOME	319,164	0	319,165	17,511	336,676	(19,536)	317,140
6 INCOME TAXES	226,501	0	226,502	167,336	393,838	(156,016)	237,822
7 TOTAL OPERATING EXPENSES	2,776,814	0	2,776,815	157,617	2,934,433	(175,553)	2,758,881
8 OPERATING INCOME	780,439	0	780,438	231,518	1,011,955	(258,590)	753,365
9 RATE BASE	7,938,270		7,938,270		7,883,672		7,883,672
RATE OF RETURN	9.83%		9.83%		12.84%		9.56%

FCWC -- SOUTH FT. MYERS WASTEWATER  
 ADJUSTMENTS TO OPERATING STATEMENT  
 TEST YEAR ENDED 12/31/96

SCHEDULE NO. 3-B  
 DOCKET NO. 970991-SU  
 PAGE 1 OF 1

EXPLANATION	WASTEWATER
<b>1 OPERATING REVENUES</b>	
To adjust for revenues on treatment of Lee County WW	371,587
To adjust for annualized 6/14/96 index	\$ 17,548
Estimate of potential overearnings in 1996	(434,142)
<b>2 OPERATION &amp; MAINTENANCE EXPENSES</b>	
To adjust for Commission approved rate case exp. in Docket No. 920808-SU	\$ (27,230)
<b>3 TAXES OTHER THAN INCOME</b>	
Regulatory assessment fees on revenue adjustment	\$ 17,511
Regulatory assessment fees associated with overearnings	(19,536)
<b>4 INCOME TAXES</b>	
Income taxes related to recommended revenue decrease	\$ (156,016)
Income taxes associated with adjusted test year income	167,336