JACK SHREVE
PUBLIC COUNSEL

STATE OF FLORIDA
OFFICE OF THE PUBLIC COUNSEL

c/o The Florida Legislature
111 West Madison St.
Room 812
Tallahassee, Florida 32399-1400
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July 15, 1999

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

Re: Case No. 971220-WS

Dear Ms. Bayo:

Enclosed for filing in the above-referenced docket are original and 15 copies of the Direct Testimony of Hugh Larkin, Jr. , witness for the Citizens of the State of Florida.

Please indicate the time and date of receipt on the enclosed duplicate of this letter and return it to our office.

Sincerely,

Harold McLean
Associate Public Counsel

HM:bsr

Enclosures

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Application for Transfer of Certificates Nos. 592-W and 509-S from Cypress Lakes Associates, Ltd. To Cypress Lakes Utilities, Inc., in Polk County	)	Docket No. 971220-WS

DIRECT TESTIMONY OF
HUGH LARKIN, JR.
Witness for the Citizens of the State of Florida

Jack Shreve
Public Counsel
Office of Public Counsel
c/o the Florida Legislature
111 West Madison Street
Room 801
Tallahassee, FL 32399-1400
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DIRECT TESTIMONY OF HUGH LARKIN, JR.

ON BEHALF OF THE CITIZENS OF FLORIDA

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 971220-WS

I. INTRODUCTION

Q. WHAT IS YOUR NAME, OCCUPATION AND BUSINESS ADDRESS?

A. My name is Hugh Larkin, Jr. I am a Certified Public Accountant licensed in the States of Michigan and Florida and the senior partner in the firm of Larkin & Associates, Certified Public Accountants, with offices at 15728 Farmington Road, Livonia, Michigan 48154.

Q. PLEASE DESCRIBE THE FIRM LARKIN & ASSOCIATES.

A. Larkin & Associates is a Certified Public Accounting and Regulatory Consulting firm. The firm performs independent regulatory consulting primarily for public service/utility commission staffs and consumer interest groups (public counsel, public advocates, consumer counsels, attorneys general, etc.). Larkin & Associates has extensive experience in the utility regulatory field as expert witnesses in over 400 regulatory proceedings including numerous water and sewer, gas, electric and telephone utilities.

Q. HAVE YOU PREVIOUSLY TESTIFIED BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION?

A. Yes, I have on numerous occasions. I have been accepted as an expert witness on utility regulation.

Q. BY WHOM WERE YOU RETAINED AND WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The firm of Larkin & Associates was retained by the Office of Public Counsel ("OPC") to address the issue of the appropriateness of a negative acquisition adjustment in conjunction with the purchase of the assets of Cypress Lakes Associates, Ltd. by Cypress Lakes Utilities, Inc. at a price below the net book value of the acquired assets.

Q. IN YOUR OPINION, IS IT ALWAYS APPROPRIATE TO RECORD A NEGATIVE ACQUISITION ADJUSTMENT?

A. Yes, it is. An acquisition adjustment is essentially the difference between the purchase price paid to acquire a utility's assets and the depreciated original cost of those assets at the date of acquisition. In simple terms, an acquisition adjustment represents the difference between the purchase price paid and the rate base determined as of the date of the transfer.

Q. PLEASE DISCUSS THE SPECIFICS OF THIS CASE.

A. In the instant case, Cypress Lakes Associates, Ltd. sold to Cypress Lakes Utilities, Inc. ("Utilities, Inc.") the water and waste water facilities which service Cypress Lakes Mobile Home Community. Cypress Lakes Associates, Ltd. did not maintain books and records that showed the actual investment in the water and wastewater facilities. The Staff's Certificate of Transfer Audit determined that the net book value of the water and wastewater facilities were $582,805 and $891,277, respectively. Utilities, Inc. purchased the property for $820,000. This is $654,082 below the net book value.

B. The price is also approximately 43% below the cost which will be used to determine rates in future cases if an acquisition adjustment is not recorded.

Q. WHY IS IT NOT REASONABLE TO REQUIRE RATEPAYERS TO PAY A RATE OF RETURN AND DEPRECIATION ON THE AMOUNTS DETERMINED BY THE STAFF?

A. There are several reasons. First, the Cypress Lakes community was developed by Cypress Lakes Ventures, Ltd., who developed the property in order to operate it as the developer and manager of a mobile home community. The investment that Cypress Lakes Ventures, Ltd., and the subsequent owner Cypress Lakes Associates, Ltd., made in the utility facilities were based on the needs of the developer to provide water and wastewater services in order to develop a mobile home community. The investment made by the developer is not necessarily a reflection of what should have been invested based on the size and needs of the community. Thus, when those facilities are exposed to a market valuation, the true market value of the assets are determined. Ratepayers have supported overstated investments in the past. This does not mean they should continue to do so in the future. The fact that the acquisition price for these systems was below the depreciated original cost indicates that the depreciated original cost overstated the value of the acquired assets in terms of providing utility services to customers.

A second reason ratepayers should not pay based on the amounts determined by the Staff is because the assets may have generally deteriorated at a rate greater then the depreciation rate used has reflected. Therefore, the assets, through normal wear and tear, have deteriorated in value at a rate far greater than the books have indicated.

A third reason is that the assets may have not been properly maintained because the motivation of the owner was not to enter into the utility business. These temporary utility owners were motivated generally by the desire to market real estate, not to maintain the facilities in order to provide reasonable and adequate service. These utility facilities, therefore may have deteriorated due to a lack of maintenance or a lack of proper installation in the initial phase. The original owner, in a desire to keep utility rates down, may not have maintained the utility property because higher utility rates may have discouraged sales of the real estate lots that he was motivated to market. These artificially low utility rates allowed the developer to sell his property by maintaining lower than normal utility rates. The property, therefore, deteriorated. When the property was sold, it was sold at the real market value absent normal maintenance. Ratepayers should receive the impact of this negative acquisition adjustment in their rates, since the underlying reason for the lower than book value sale of the assets was a lack of reasonable maintenance. If the Commission were to not reflect a negative acquisition adjustment, these ratepayers would now find themselves in a position where they have to make up the level of maintenance that was neglected by paying a rate of return and depreciation on deteriorated assets.

Q. DO YOU KNOW WHICH OF THESE REASONS MOTIVATED THE SELLER OF THE PROPERTY IN THIS INSTANCE TO TAKE LESS THAN THE NET BOOK VALUE OF THE ASSETS?

A. No, I do not. However, the Commission need not determine why a seller would take less than his investment in an asset in order to determine that a negative acquisition adjustment is appropriate. Clearly, all the Commission need find is that the market value paid for the asset reflects its true economic value, and ratepayers should be charged based on that true economic value and nothing more.

Q. WHAT RETURN WILL THE COMPANY EARN IF THE COMMISSION DOES NOT RECOGNIZE A NEGATIVE ACQUISITION ADJUSTMENT?

A. The Company will earn a rate of return that is not justified by the risk associated with a monopoly enterprise, such as a water and wastewater facility. I have demonstrated these excess earnings on Schedule 1, attached to my testimony. Using a hypothetical capital structure of 40% equity and 60% debt, and the Commission's return on equity from the most recent leverage graph of 10.12%, calculated the pre-tax return which the Company would earn if the Commission fails to require a negative acquisition adjustment. Schedule 1 shows that the Company would earn a pre-tax of 20.48% on its $820,000 investment. This return is almost 80% higher than the return the Commission would authorize on actual investment using the latest approved leverage graph.

Q. WILL THE COMPANY EARN ADDITIONAL RETURN IF A NEGATIVE ACQUISITION ADJUSTMENT IS NOT RECOGNIZED?

A. Yes, since the dollar amount of the plant-in-service, less accumulated depreciation and net of CIAC at the day of acquisition exceeds the cash investment, the Company will be allowed to recover an excess amount of depreciation expense. In other words, the Company will be allowed to depreciate the amount that is recorded on its books as the asset value and not the amount it actually invested. The Company will be allowed to recover return not only on an excess investment, but it will also recover return on hypothetical depreciation. This will result because the actual investment of the Company is $820,000, but for ratemaking purposes it will depreciate $1,474,082. The difference in depreciation using a hypothetical 3.5% depreciation rate is an additional $22,892, which ratepayers would be required to pay each and every year. This recovery would be in addition to the excess rate of return which the Company will earn of $74,500 (See Schedule 1. $167,898 - $93,398 = $74,500). This additional return on the Company's investment will raise the 20.48% return shown on Schedule 1 to 29.56%.

Clearly, there is no justification for allowing the Company to earn an excess return of 29.56% based on a flawed theory that somehow not recording a negative acquisition adjustment benefits ratepayers. In fact, acquisition of this facility by Utilities, Inc. may actually result in even higher rates then those currently in effect for Cypress Lakes customers.

Q. WOULD YOU PLEASE EXPLAIN?

A. In a recent case involving Mid-County Services, Inc., Utilities, Inc. requested a substantial increase in rates. Utilities, Inc. is the parent company to Mid-County Services, Inc. The driving factor underlying the increase in rates was the allocation by Utilities, Inc. to Mid-County Services, Inc. of overhead costs. The overhead allocation which Utilities, Inc. wanted to impose on Mid-County Services, Inc. counted each customer location as a basis for allocating overhead costs. Thus, the more densely populated an area was with apartments, or in this case, mobile homes, the more expense that would be allocated, regardless of the water consumption. Clearly, if that allocation methodology were imposed on Cypress Lakes, expenses would not go down as theorized by Company Witness Wentz, rather they would, in fact, go up. Cypress Lakes customers would be asked to pay overhead costs, which they are probably not now paying, without any concrete improvement in service.

In summary, utilities should not be rewarded with unreasonably high rates of return based on investments which do not exist. There has not been a showing, and cannot be a showing, that ratepayers will benefit from unreasonably high rates of return that clearly outstrip the Commission's approved leverage formula.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

CERTIFICATE OF SERVICE
DOCKET NO. 971220-WS

I HEREBY CERTIFY that a true and correct copy of the foregoing Direct Testimony of Hugh Larkin, Jr. has been furnished by U.S. Mail or *hand delivery to the following parties, this 15th day of July, 1999.

Harold McLean

Jennifer Brubaker, Esquire
Division of Legal Services
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

Cypress Lakes Utilities, Inc.
200 Weathersfield Avenue
Altamonte Springs, Florida 32714

Michael L. Resnick, Esquire
1342 E. Vine Street, Suite 236
Kissimmee, Florida 34744

Ben Girtman, Esquire
1020 East Layfayette Street
Suite 207
Tallahassee, Florida 32301-4552

971220.tst

Cypress Lakes Utilities, Inc.
Hypothetical Example of Windfall
to Company caused by Excessive Rates
if a Negative Acquisition Adjustment is
Not Adopted

Docket No. 971220-WS
Exhibit ____HL-1
Schedule 1

Calculated Return On and Return Of Investment Using Net Book Value and Cash Purchase Price.

For illustrative purposes, I have used a capital structure as follows:

Description	Percent	Cost	Weighted Cost	Revenue Multiplier	Pre-tax Return
Equity	40.00%	10.12%	4.05%	1.62802	6.59%
Debt	60.00%	8.00%	4.80%	1	4.80%
Total	100.00%		8.85%		11.39%

The revenue multiplier uses the State income tax rate of 5.5% and the Federal tax rate of 35%.

Return Requirement Impact of Failing to Recognize a Negative Acquisition Adjustment:

	NBV at 12/31/97	Cash Purchase Price
Dollar Amount	$1,474,082	$820,000
Return Requirement Using Pre-tax return above @11.39%	$167,898	$93,398
Depreciation at composite rate of 3.5%	$ 51,592	$28,700
Total return requirement	$ 219,490	$122,098

Pre-tax return on investment of $820,000: $67,898 divided by $820,000	20.48%

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