State of Florida

ORIGINAL

Public Service Commission

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

DATE: January 8, 2001

TO: Records and Reporting

FROM: Connie Binford, Bureau of Rate Cases CB

RE: Docket No. 000295-WU, Application for Increase in Water Rates in Highlands County by Placid Lakes Utilities, Inc.

Please place this document in the above docket file. It is the utility's response to the audit.

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FPSC-RECORDS/REPORTING

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October 30, 2000

Trish Merchant
Florida Public Service Commission
Division of Economic Regulation
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

Re: Docket No. 000295-WU

Dear Ms. Merchant:

Enclosed herewith on behalf of Placid Lakes Utilities, Inc. ("Placid Lakes") are an original and five (5) copies of Placid Lakes' responses to audit exceptions 1 and 2 and audit disclosures 1-9 and 11 reflected in the staff's rate case audit in the above-referenced docket.

Sincerely,

Kenneth A. Hoffman

Kenneth A. Hoffman

KAH/pjc

cc: Ms. Pam Brewer (w/enclosure)
Mr. John Guastella (w/enclosure)
Mr. Gary White (w/enclosure)

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Audit Exception No. 1

The automated bookkeeping system ("Quick Books") utilized by the Company was not designed using the NARAC Uniform System of Accounts. To abandon the current accounting program or modify it to conform with NARUC account numbers and descriptions, has not been cost effective to date. However, the Company is currently attempting to modify "Quick Books" to comply with NARUC and also convert from cash to an accrual system of accounting.

All regulatory documents (such as Annual Reports, rate filing MFRs, etc.) are prepared using the NARUC Uniform System of Accounts.

Audit Exception No. 2

Until the preparation of this rate proceeding, the utility was unaware of a requirement for written authorization from the FPSC prior to capitalizing interest during construction. The Company submitted the construction loan and line of credit documents to the FPSC for approval. The FPSC Staff never mentioned the need for prior approval for charging AFUDC.
Since the FPSC approved the loan documents, the Company felt that they were acting properly and entitled to charge interest during construction to the construction projects.

Audit Disclosure No. 1

The CIAC audit difference of $4,022 will not be contested by the Company.

Audit Disclosure No. 2

These audit adjustments are a result of slightly differing composite depreciation rates calculated by the audit staff. The composite rate difference reflects a timing difference between when the Company made effective the adjustments to plant in service and when staff made those adjustments effective.

These minor differences will not be contested by the Company.

Audit Disclosure No. 3

These audit adjustments to depreciation expense and accumulated depreciation reflect the timing difference between when the Company made effective the adjustments to plant in service and when staff made those adjustments effective.

These minor differences will not be contested by the Company.

Audit Disclosure No. 4

The audit adjustment of $2,140 will not be contested by the Company.

Audit Disclosure No. 5

The MFRs adjust the Company's booked RAF to reflect the amount due on adjusted operating revenues (see Schedules B-3, Schedule of Adjustments to Operating Income). It appears that the staff auditors have included RAF on "below the line" AFPI revenue as part of their calculation.

The Company's methodology for the calculation of RAF is correct as reflected in the MFRs.

Audit Disclosure No. 6

The audit staff recommends an $18,228 reduction of O&M expense, which consists of three adjustments.

First, the auditors recommend a reduction of $13,775 for accounting services performed by Dorrell, Hancock & Carter (see the attached "Table"). There are multiple errors in this adjustment. The auditors examined all of the Dorrell, Hancock & Carter invoices and ignored the fact that three of the invoices (in the amount of $1,965) were out-of-period costs which were expensed in 1998, not booked during the 1999 test year. The audit adjustment also ignores the fact that the MFRs adjusted out $8,285 of Dorrell, Hancock & Carter invoices from O&M expense (see Schedule B-5, page 2 of MFRs). The Auditor's adjustments therefore contain duplicative entries (see the attached "Table"). This audit adjustment also recommends a reduction of $5,285 from rate case expense in O&M expenses. This is incorrect for several reasons. The total amount of deferred rate case expense for services provided by Dorrell, Hancock & Carter were projected at $5,000 (see Schedule B-10) and as a deferred expense amortized over a four year period, only $1,250 is recorded as test year O&M expense.

The Company finds exception with the $13,775 adjustment as it is erroneous and duplicative.

The second part of this total adjustment recommends a reduction of $1,521 for wastewater related expenses. The Company agrees, upon further examination that four wastewater testing invoices (total of $1,071) and one wastewater license fee ($450) were inadvertantly included in the test year O & M expenses of these MFRs.

The Company agrees to this portion of the adjustment.

The third part of this adjustment recommends an additional reduction of $2,932 for "non-utility expenses, averaging adjustments, and estimated amounts". These items, though not itemized in staff's disclosure, contain a $50 charitable contribution (characterized by staff as non-utility) and staff's disagreement (in part) with the Company's adjustments to normalize or average management fees, supply costs, transportation expenses, and miscellaneous expenses.

It is the Company's position that its adjustments are appropriate, and disagree with staff's $2,932 reduction.

Dorrell, Hancock & Carter, CPA (Accounting Services)

Invoices: Entry	Task Description	Amount	Booked to TY Expense Acct 632	Booked to Deferred Exp	MFR O&M Exp. Adjustmt.	MFR Rate Case Exp. Adj.	Acct'g Exp. Remaining In MFRs	Acct'g Exp. Rate Case In MFRs	Auditor's Adjustmt.	Acct'g Exp. Remaining (Auditor's)	Acct'g Exp. Rate Case (Auditor's)
10/98 *	Regulatory Compliance Project	$875	$0	$0	$0	$0	$0	$0	($875)	($875)	
11/98 *	Regulatory Compliance Project	660	0	0	0	0	0	0	(660)	(660)	
12/98 *	Regulatory Compliance Project	430	0	0	0	0	0	0	(430)	(430)	
01/99	Regulatory Compliance Project	420	420	0	(420)	0	0	0	(420)	(420)	
02/99	Regulatory Compliance Project	1,225	1,225	0	(1,225)	0	0	0	(1,225)	(1,225)	
03/99	Regulatory Compliance Project	850	850	0	(850)	0	0	0	(850)	(850)	
04/99	Regulatory Compliance Project	285	285	0	(285)	0	0	0	(285)	(285)	
05/99	Regulatory Compliance Project	1,700	1,700	0	(1,700)	0	0	0	(1,700)	(1,700)	
06/99	Annual Report Preparation	5,760	5,760	0	(1,760)	0	4,000	0	0	4,000	
07/99	Regulatory Compliance Project	2,045	2,045	0	(2,045)	0	0	0	(2,045)	(2,045)	
08/99	Assist with Rate Case	4,750	0	4,750	0	1,250	0	1,250	(4,750)	0	(3,500)
09/99	Assist with Rate Case	535	0	535	0	0	0	0	(535)	0	(535)
		$19,535	$12,285	$5,285	($8,285)	$1,250	$4,000	$1,250	($13,775)	($4,490)	($4,035)

Note (*): These invoices represent out-of-period expenses as they were booked and accounted for in 1998 O&M expenses.

Audit Disclosure No. 7

The Company has no comment.

Audit Disclosure No. 8

As detailed in the Company's comments to Audit Disclosure No. 6, the MFRs do not reflect $13,775 of Dorrell, Hancock & Carter charges for rate case expense. The total rate case expense attributed to the accounting firm is $5,000 (see Schedule B-10). In order to avoid duplicate effort and cost, the firm was asked to provide the schedules, support, and findings resulting from their extensive audit work relative to the regulatory compliance project and preparation of the 1998 FPSC Annual Report. The actual cost of fulfilling this request, along with, but not limited to, reviewing the preliminary income tax schedules and calculations was $5,285.

The Company disagrees with Disclosure No. 8, related to the cost of accounting services included in rate case expense. The amount of $13,775 as it based on erroneous assumptions and calculations (as detailed in the Company's response to Disclosure No. 6). The Company does agree that the rate case expense projections should be updated for the actual cost incurred during the proceedings.

Audit Disclosure No. 9

The Company disagrees with Staff's calculations of taxes, other than income tax. The regulatory assessment fee (RAF) is calculated correctly in the MFRs (see Disclosure No. 5 response). Property tax on non-used and useful plant should be adjusted out of revenue requirement for rate setting purposes. It is also appropriate to adjust property taxes for test year changes to plant in service as reflected in the MFRs.

Rate Base Exhibit

Placid Lakes Utilities, Inc.
Schedule of Water Rate Base
Historical Test Year Ended December 31, 1999

Rate Base Exhibit
CORRECTED

Description	Sch A-1,pg.1 Per Book Balance 12/31/99	Utility Adjustments	Sch A-1,pg.1 Adjusted Balance 12/31/99	Audit Adjustments	Audit Balance 12/31/99	Audit Average Balance 1999	Sch A-1,pg.2 As Filed Average Balance 1999
Utility Plant in Service	$1,860,086	$0	$1,860,086	($45,333)	$1,814,753	$1,790,237	$1,835,306
Utility Land & Land Rights	1,000	0	1,000	0	1,000	1,000	1,000
Less: Non-Used & Useful Plant	0	(95,752)	(95,752)	0	(95,752)	(103,265)	(103,265)
Construction Work in Progress	0	0	0	0	0	0	0
Less: Accumulated Depreciation	(583,896)	0	(583,896)	5,571	(578,325)	(553,167)	(557,719)
Less: CIAC	(1,010,604)	(0)	(1,010,604)	4,022	(1,006,582)	(980,624)	(984,646)
Accumulated Amortization of CIAC	405,016	0	405,016	524	405,540	389,948	389,285
Acquisition Adjustments	0	0	0	0	0	0	0
Accum. Amort. of Acq. Adjustments	0	0	0	0	0	0	0
Advances For Construction	0	0	0	0	0	0	0
Working Capital Allowance	0	38,328	38,328	(2,279)	36,049	35,735	38,014
Rate Base	$671,602	($57,424)	$614,178	($37,495)	$576,683	$579,865	$617,975

The Audit Staff's schedule misrepresents the MFRs. Schedule A-1, page 1, reflects year-end balances and therefore a year-end rate base. The year-end rate base includes a working capital allowance based on annualized O&M expenses and a non-used and useful adjustment based on year-end balances. This schedule, reflecting year-end rate base, was used to develop the revenue requirements for the permanent rates. Schedule A-1, page 2, reflects average balances and therefore an average balance rate base. The average balance test period was used only for the purpose of developing the interim rates. Staff's presentation of the MFRs, on their "Rate Base Exhibit", co-mingles balances from Schedule A-1, pages 1 and 2 thereby losing that distinction.

Net Operating Income Exhibit

Staff's schedule reflects the MFRs' Schedule B-1, page 2 amounts which were used to develop the revenue requirement for interim, not permanent rates. The year-end test period approved would require annualization of both revenue and expense amounts as calculated and reflected on Schedule B-1, page 1 of the Company's MFRs. The audit staff's exhibit does not reflect a year-end test period, but rather an average year test period which is incorrect in this filing.

Placid Lakes Utilities
Comments to Related Rate Case Audit

Audit Disclosure No. 11

Staff's analysis of Advances from Associated Companies identifies the various levels of funding provided by the Company's parent, Lake Placid Holding Company (LPH). While the Company does not take issue with the identification of the sources of funds, which are entirely from LPH, Staff's analysis does not fully address its basis for determining the appropriate rate of return to be applied in this case.

As Staff describes, LPH has provided funds over the years to cover both capital additions and operating expenses. This scenario of parent company financing of newly formed and growing utilities is typical for virtually all developer-related utilities. It is the primary way that parent companies (or stockholders) invest in their utilities. Eventually, such Advances from Associated Companies can be converted to debt and equity when the utilities are able to attract outside capital.

Staff uses the parent's capital structure to calculate a rate of return or "Cost of Capital." LPH's capital structure consists of all equity, of which about 21% is preferred stock. Staff uses the 7% preferred stock rate and a 9.14% equity return based on the FPSC's leverage graph for the balance of the equity. The resultant rate of return is 8.69%.

The Company takes exception to the 8.69% rate of return because it does not reflect the Company's cost of capital. The LPH loans to the Company are at a rate of prime plus 1%. Today's prime rate is 9.5%, producing a loan rate of 10.5%. This debt rate is lower than the Company could obtain elsewhere, if it could obtain outside financing on its own. In response to Guastella Associates' effort to obtain financing on behalf of the Company, CoBank advises by letter dated August 18, 2000 that it no longer lends to small utilities in amounts less than $1.0 Million. But if it did, a fixed 15-year term rate would be 11% plus fees. Attached is CoBank's letter. Because equity investments are more risky than debt, an equity rate for the Company would be about 200 to 300 basis points higher, or 13% - 14%. When, as in this case, the FPSC's leverage graph produces an equity rate significantly less than the lower risk debt rate that the Company pays with respect to certain loans from its parent, and less than it could possibly obtain from outside sources, the leverage graph can not be used.

The Company has requested a 12% overall return, to be applied to its total equity capital structure. That rate is slightly higher than the lowest debt rate and less than an equity rate of return using a modest premium above the debt rate. The Company's proposed rate of return, therefore, reflects the lowest possible cost of capital. Staff's 8.69% is significantly below the Company's cost of capital, considering any analysis that would be appropriate for a utility of this size.

COBANK
Rural America's Cooperative Bank

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August 18, 2000

John Guastella, President
Guastella & Associates
50 Beach Road
Tequesta, FL 33469

RE: Placid Lakes Utilities, Inc.

Dear John:

Due to a myriad of different problems with some of our smaller loans along with the costs of making and servicing loans to the smaller utilities such as Placid Lakes, CoBank is currently not making loans of less than $1 million. I see that the adjusted current ratebase is calculated at $614,178 and their net worth is negative. Our normal practice is not to lend in excess of the ratebase amount and our minimum equity/capitalization ratio we look for is generally a minimum of 20%. Year-end financial statements must also be audited.

If Placid Lakes were able to qualify for a $1 million loan, the current upfront fee would be 2% of the loan amount and a fixed rate for a 15-year amortizing loan would be 11%. While the negative equity will take time to rebuild, Placid Lakes will certainly need to demonstrate that it has the rates approved needed to service any lender's debt with some cushion for any unexpected cost. As you know, any bump in costs for a system this size can have a dramatic impact on the actual income statement results achieved. Given the current cost of debt, poor historical performance, lack of meaningful equity and no audits, this appears to be a good case where applying a blended cost of capital is immaterial as adding debt to the equation would add certain requirements and costs. A system of this size may be better suited by the use of 100% equity financing in its cost of capital structure.

If I can provide further information or assistance, please do not hesitate to call me at 800-255-7429 Ext. 3213. We thank you in advance for your consideration.

Sincerely,

John Cole

John Cole
Vice President