

State of Florida



Public Service Commission

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TALLAHASSEE, FLORIDA 32399-0850

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COMMISSION  
CLERK

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DATE: JANUARY 24, 2002

TO: DIRECTOR, DIVISION OF THE COMMISSION CLERK &  
ADMINISTRATIVE SERVICES (BAYÓ)

FROM: DIVISION OF ECONOMIC REGULATION (S. JONES, MERCHANT)  
DIVISION OF LEGAL SERVICES (ESPINOZA)

*dg. MUM*  
*JRE Hart*

RE: DOCKET NO. 011189-WS INVESTIGATION INTO THE AUTHORIZED  
RETURN ON EQUITY (ROE) OF ALAFAYA UTILITIES, INC. IN  
SEMINOLE COUNTY; LAKE GROVES UTILITIES, INC. IN LAKE  
COUNTY; MILES GRANT WATER AND SEWER COMPANY IN MARTIN  
COUNTY; AND UTILITIES, INC. OF LONGWOOD IN SEMINOLE  
COUNTY.

AGENDA: 02/05/02 - REGULAR AGENDA - PROPOSED AGENCY ACTION -  
INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\ECR\WP\011189WS.RCM

CASE BACKGROUND

This recommendation addresses whether the Commission, on its own motion, should conduct a limited proceeding to establish a new authorized return on equity (ROE) for four Florida subsidiaries of Utilities, Inc. These subsidiaries are Alafaya Utilities, Inc. (Alafaya), Lake Groves Utilities, Inc. (Lake Groves), Miles Grant Water and Sewer Company (Miles Grant), and Utilities, Inc. of Longwood (Longwood). The Commission has jurisdiction pursuant to Section 367.0822, Florida Statutes.

Alafaya

Alafaya is a Class A wastewater-only utility located in Seminole County. Water service is provided in the area by the City

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of Oviedo. Alafaya provided wastewater service to approximately 5,574 customers in 2000. According to the 2000 annual report, Alafaya's annual operating revenues were \$1,794,453 and its net operating income was \$336,816.

#### Lake Groves

Lake Groves is a Class B water and wastewater utility located in Lake County. Lake Groves served approximately 1,617 water and 1,594 wastewater customers in 2000. The annual report for 2000 showed that annual operating revenues for the Lake Groves system were \$1,073,853 and the net operating income was \$369,719.

#### Miles Grant

Miles Grant is a Class B water and wastewater utility located in Martin County. Miles Grant served approximately 1,271 water and 1,205 wastewater customers in 2000. According to the 2000 annual report, Miles Grant's annual operating revenues were \$582,431 and its net operating income was \$172,162.

#### Longwood

Longwood is a Class B wastewater-only utility located in Seminole County. Longwood provided wastewater service to approximately 1,815 customers in 2000. According to the 2000 annual report, Longwood's annual operating revenues were \$665,949 and its net operating income was \$104,974.

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DISCUSSION OF ISSUES

ISSUE 1: Should the Commission, on its own motion, conduct a limited proceeding in order to update the authorized return on equity for Alafaya, Lake Groves, Miles Grant and Longwood?

RECOMMENDATION: Yes. Each utility's authorized ROE should be updated in order to establish a more appropriate return on a going-forward basis. (S. JONES)

STAFF ANALYSIS: The current authorized ROE for the four subsidiaries of Utilities, Inc. in this docket range from 13.34% to 15.60%. Alafaya's current authorized ROE of 15.60% was established in Docket No. 850209-SU, by Order No. 14841, issued September 3, 1985. Lake Groves' current authorized ROE of 13.51% was established in Docket No. 900957-WS, by Order No. 24283, issued March 25, 1991. Miles Grant's current authorized ROE of 13.95% was established in Docket No. 890978-SU, by Order No. 22079, issued October 23, 1989. Longwood's current authorized ROE of 13.34% was established in Docket No. 871059-SU, by Order No. 20779, issued February 20, 1989.

Staff recommends that the Commission should conduct a limited proceeding to update the authorized ROE for these utilities on a going-forward basis. The current midpoints of the ROE for these utilities exceed the maximum of the range of the 12.05% ROE allowed by the current leverage formula by 129 to 355 basis points. Staff will discuss the individual earnings levels for each utility in Issue 2.

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**ISSUE 2:** What is the appropriate ROE for Alafaya, Lake Groves, Miles Grant, and Longwood?

**RECOMMENDATION:** Each utility's ROE should be decreased to 11.05%, with a range of 10.05% to 12.05%, based on the current leverage formula. This recommended ROE should be effective as of the date the Commission's proposed agency action (PAA) order is final and should be applied to any future proceedings of each utility, including, but not limited to, price index rate adjustments, interim rates, and overearnings. (S. JONES)

**STAFF ANALYSIS:** The basis for staff's recommendation is the filed 2000 annual reports for all four subsidiaries. Staff used the utility's schedules of cost of capital, operating statements, and year-end rate base to reflect each subsidiary's earnings. Staff believes it is reasonable to use the debt and equity ratios in the parent's capital structure because each subsidiary's capital structure is 100% equity and no debt is issued at the subsidiary level. The customer deposits and deferred income taxes are specifically identified and reflected at each subsidiary's level. This is consistent with the ratemaking treatment used for all other Commission-regulated Utilities, Inc. subsidiaries. See Order No. PSC-98-0524-FOF-SU, issued April 16, 1998, for Mid-County Utilities, Inc., another wholly-owned subsidiary of Utilities, Inc.

Since the Utilities, Inc. debt and equity ratios are used in the capital structure for each of the four subsidiaries, the equity ratio of 46% is the same for each. Using the current leverage formula approved by Final Order No. PSC-01-2514-FOF-WS, issued December 24, 2001, in Docket No. 010006-WS, a ROE of 11.05%, with a range of 10.05 to 12.05%, should be approved on a perspective basis.

Below is staff's analysis of each subsidiary's earnings and achieved rate of return (ROR). Staff does not believe that any further investigations are required at this time.

**Alafaya**

Alafaya has not had a rate proceeding with the Commission since 1986. It has only utilized yearly price index rate adjustments since that date. It is staff's belief that an authorized ROE of 15.60% is unreasonable given today's economic climate.

In Alafaya's 2000 annual report, its achieved ROR for the wastewater system was 9.49%. Based on our review, staff believes that a minor correction to the utility's calculation of income tax is necessary. After this adjustment, the utility's achieved ROR is 8.34%. According to the capital structure presented in the annual report, the midpoint of the required ROR was 10.21%, using the last authorized ROE of 15.60%.

The 2001 leverage formula yields a revised ROE midpoint of 11.05% for Alafaya. Based on this revised ROE, staff calculated Alafaya's required ROR for 2000 to be 8.47% with a range of 8.09% to 8.85%. Alafaya's 2000 achieved ROR of 8.34% is within this range. Based on this analysis, staff does not believe that it is appropriate to initiate any further investigations at this time.

### Lake Groves

Lake Groves has not had a rate proceeding with the Commission since 1986. It has not utilized yearly price index or pass through rate increases since 1986. It is staff's belief that a ROE of 13.51% is unreasonable given today's economic climate.

Based on Lake Groves' 2000 annual report, its achieved ROR for the water and wastewater systems were 18.04% and 5.70%, respectively, with a combined achieved ROR of 9.05%. This results in a total company achieved ROE of 13.01%.

Upon staff's analysis, two corrections are necessary to the utility's calculation of its achieved ROR. These adjustments reflect the appropriate income tax expense and the reconciliation of rate base to the capital structure in the cost of capital calculation. After these staff adjustments, the utility's achieved ROR was 10.07%, which is higher than the maximum of the range of the newly authorized ROR of 9.76%. Staff is aware that the utility is undergoing major plant upgrades for both the water and wastewater systems. The 2000 annual report reflects more than \$2.8 million in construction work in progress. While it appears that Lake Groves' 2000 earnings exceeded the range of this new rate of return, staff does not believe that it is reasonable to initiate an earnings investigation at this time. Given the material changes to the utility's operations that have occurred, staff believes that it is appropriate to review the 2001 earnings from its annual report, due March 31, 2002. At that time, staff will reevaluate the earnings for this system.

Miles Grant

Miles Grant has not had a rate proceeding with the Commission since 1989. However, it has utilized yearly price index and pass through rate increases since that date. It is staff's belief that a ROE of 13.95% is unreasonable given today's economic climate.

In Miles Grant's 2000 annual report, its achieved RORs for the water and wastewater systems were 9.38% and 8.59% respectively, with a combined achieved ROR of 8.81%. Based on our review, staff believes that a minor correction to the utility's calculation of income tax is necessary. After this adjustment, the utility's combined achieved ROR is 8.44%. According to the capital structure presented in the annual report, the midpoint of the required ROR was 9.85%, using the last authorized ROE of 13.95%.

The 2001 leverage formula yields a revised ROE midpoint of 11.05% for Miles Grant. Based on this revised ROE, staff calculated Miles Grant's required ROR to be 8.69% with a range of 8.29% to 9.09%. Miles Grant's combined 2000 achieved ROR of 8.44% is within this range. Based on this analysis, staff does not believe that it is appropriate to initiate any further investigations at this time.

Longwood

Longwood has not had a rate proceeding with the Commission since 1989. However, it has utilized yearly price index rate increases since that date. It is staff's belief that a ROE of 13.34% is unreasonable given today's economic climate.

In Longwood's 2000 annual report, its achieved ROR for the wastewater system was 8.03%. Based on our review, staff believes that a minor correction to the utility's calculation of income tax is necessary. After this adjustment, the utility's achieved ROR is 7.70%. According to the capital structure presented in the annual report, the midpoint of the required ROR was 9.48%, using the last authorized ROE of 13.34%.

The 2001 leverage formula yields a revised ROE midpoint of 11.05% for Longwood. Based on this revised ROE, staff calculated Longwood's required ROR at 8.59%, with a range of 8.20% to 8.98%. Longwood's achieved ROR of 7.70% is below this range. Based on this analysis, staff does not believe that it is appropriate to initiate any further investigations at this time.

**Conclusion**

Considering the length of time since the last rate proceedings and that there is no indication of any forthcoming rate proceedings for any of these subsidiaries, staff believes it is necessary to revise the authorized ROE. Staff, therefore, recommends that the Commission update each subsidiary's ROE to reflect a more appropriate cost rate.

Staff's recommendation is to reduce the ROE to 11.05%, consistent with the current water and wastewater leverage formula. This recommended ROE should be effective as of the date the Commission's PAA order is final and should be applied to any future proceedings of these subsidiaries, including, but not limited to, price index rate adjustments, interim rates, and overearnings.

Schedules 1 through 4 reflect the cost of capital schedules for each of the four utilities. The components of the capital structure used to calculate the ROE in this proceeding are unaudited.

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**ISSUE 3:** Should this docket be closed?

**RECOMMENDATION:** If no person, whose interests are substantially affected by the proposed action, files a protest within the 21-day protest period, the PAA order will become final upon the issuance of a consummating order, upon which the docket should be closed.  
(ESPINOZA, S. JONES)

**STAFF ANALYSIS:** If no person, whose interests are substantially affected by the proposed action, files a protest within the 21-day protest period, this docket should be closed upon the issuance of a Consummating Order.



**ALAFAYA UTILITIES, INC  
 CAPITAL STRUCTURE  
 TEST YEAR ENDED 12/31/2000**

**SCHEDULE NO. 1  
 DOCKET 011189-WS**

DESCRIPTION	TOTAL CAPITAL	SPECIFIC ADJUSTMENTS (EXPLAIN)	PRO RATA ADJUSTMENTS	CAPITAL RECONCILED TO RATE BASE	RATIO	COST RATE	WEIGHTED COST	
<b>PER UTILITY 2000 - YEAR-END</b>								
1 LONG TERM DEBT	\$1,441,092	\$0	\$0	\$1,441,092	40.60%	8.56%	3.48%	
2 SHORT-TERM DEBT	\$147,050	\$0	\$0	\$147,050	4.14%	14.32%	0.59%	
3 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%	
4 COMMON EQUITY	\$1,352,862	\$0	\$0	\$1,352,862	38.11%	15.60%	5.95%	
5 CUSTOMER DEPOSITS	\$111,210	\$0	\$0	\$111,210	3.13%	6.00%	0.19%	
6 DEFERRED INCOME TAXES	\$497,277	\$0	\$0	\$497,277	14.01%	0.00%	0.00%	
7 DEFERRED ITC'S-ZERO COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%	
8 DEFERRED ITC'S-WTD. COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%	
9 OTHER	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%	
10 TOTAL CAPITAL	<u>\$3,549,491</u>	<u>\$0</u>	<u>\$0</u>	<u>\$3,549,491</u>	<u>100.00%</u>		<u>10.21%</u>	
<b>PER STAFF 2000 - YEAR-END</b>								
11 LONG TERM DEBT	\$1,441,092	\$0	\$0	\$1,441,092	40.60%	8.56%	3.48%	
12 SHORT-TERM DEBT	\$147,050	\$0	\$0	\$147,050	4.14%	14.32%	0.59%	
13 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%	
14 COMMON EQUITY	\$1,352,862	\$0	\$0	\$1,352,862	38.11%	11.05%	4.21%	
15 CUSTOMER DEPOSITS	\$111,210	\$0	\$0	\$111,210	3.13%	6.00%	0.19%	
16 DEFERRED INCOME TAXES	\$497,277	\$0	\$0	\$497,277	14.01%	0.00%	0.00%	
17 DEFERRED ITC'S-ZERO COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%	
18 DEFERRED ITC'S-WTD. COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%	
19 OTHER	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%	
17 TOTAL CAPITAL	<u>\$3,549,491</u>	<u>\$0</u>	<u>\$0</u>	<u>\$3,549,491</u>	<u>100.00%</u>		<u>8.47%</u>	
					<b>LOW</b>	<b>HIGH</b>		
RETURN ON EQUITY					10.05%	12.05%		
OVERALL RATE OF RETURN					<u>8.09%</u>	<u>8.85%</u>		

LAKE GROVES UTILITIES, INC.  
 CAPITAL STRUCTURE  
 TEST YEAR ENDED 12/31/2000

SCHEDULE NO. 2  
 DOCKET 011189-WS

DESCRIPTION	TOTAL CAPITAL	SPECIFIC ADJUSTMENTS (EXPLAIN)	PRO RATA ADJUSTMENTS (1)	CAPITAL RECONCILED TO RATE BASE	RATIO	COST RATE	WEIGHTED COST
<b>PER UTILITY 2000 - YEAR-END</b>							
1 LONG TERM DEBT	\$1,842,134	\$0	\$0	\$1,842,134	45.30%	8.56%	3.88%
2 SHORT-TERM DEBT	\$187,973	\$0	\$0	\$187,973	4.62%	14.32%	0.66%
3 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
4 COMMON EQUITY	\$1,729,351	\$0	\$0	\$1,729,351	42.53%	13.51%	5.75%
5 CUSTOMER DEPOSITS	\$62,118	\$0	\$0	\$62,118	1.53%	6.00%	0.09%
6 DEFERRED INCOME TAXES	\$244,611	\$0	\$0	\$244,611	6.02%	0.00%	0.00%
7 DEFERRED ITC'S-ZERO COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
8 DEFERRED ITC'S-WTD. COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
9 OTHER	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
10 TOTAL CAPITAL	<u>\$4,066,187</u>	<u>\$0</u>	<u>\$0</u>	<u>\$4,066,187</u>	<u>100.00%</u>		<u>10.38%</u>
<b>PER STAFF 2000 - YEAR-END</b>							
11 LONG TERM DEBT	\$1,842,134	\$0	\$8,494	\$1,850,628	45.31%	8.56%	3.88%
12 SHORT-TERM DEBT	\$187,973	\$0	\$867	\$188,840	4.62%	14.32%	0.66%
13 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
14 COMMON EQUITY	\$1,729,351	\$0	\$8,625	\$1,737,976	42.55%	11.05%	4.70%
15 CUSTOMER DEPOSITS	\$62,118	\$0	\$0	\$62,118	1.52%	6.00%	0.09%
16 DEFERRED INCOME TAXES	\$244,611	\$0	\$0	\$244,611	5.99%	0.00%	0.00%
17 DEFERRED ITC'S-ZERO COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
18 DEFERRED ITC'S-WTD. COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
19 OTHER	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
17 TOTAL CAPITAL	<u>\$4,066,187</u>	<u>\$0</u>	<u>\$18,750</u>	<u>\$4,084,173</u>	<u>100.00%</u>		<u>9.33%</u>

Note 1: Company's cost of capital schedule did not agree with its rate base.

	<b>LOW</b>	<b>HIGH</b>
RETURN ON EQUITY	<u>10.05%</u>	<u>12.05%</u>
OVERALL RATE OF RETURN	<u>8.91%</u>	<u>9.76%</u>

**MILES GRANT WATER AND SEWER COMPANY  
 CAPITAL STRUCTURE  
 TEST YEAR ENDED 12/31/2000**

**SCHEDULE NO. 3  
 DOCKET 011189-WS**

DESCRIPTION	TOTAL CAPITAL	SPECIFIC ADJUSTMENTS (EXPLAIN)	PRO RATA ADJUSTMENTS	CAPITAL RECONCILED TO RATE BASE	RATIO	COST RATE	WEIGHTED COST
<b>PER UTILITY 2000 - YEAR-END</b>							
1 LONG TERM DEBT	\$828,886	\$0	\$0	\$828,886	42.43%	8.56%	3.63%
2 SHORT-TERM DEBT	\$84,581	\$0	\$0	\$84,581	4.33%	14.32%	0.62%
3 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
4 COMMON EQUITY	\$778,138	\$0	\$0	\$778,138	39.83%	13.95%	5.56%
5 CUSTOMER DEPOSITS	\$13,950	\$0	\$0	\$13,950	0.71%	6.00%	0.04%
6 DEFERRED INCOME TAXES	\$247,978	\$0	\$0	\$247,978	12.69%	0.00%	0.00%
7 DEFERRED ITC'S-ZERO COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
8 DEFERRED ITC'S-WTD. COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
9 OTHER	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
10 TOTAL CAPITAL	<u>\$1,953,533</u>	<u>\$0</u>	<u>\$0</u>	<u>\$1,953,533</u>	<u>100.00%</u>		<u>9.85%</u>
<b>PER STAFF 2000 - YEAR-END</b>							
11 LONG TERM DEBT	\$828,886	\$0	\$0	\$828,886	42.43%	8.56%	3.63%
12 SHORT-TERM DEBT	\$84,581	\$0	\$0	\$84,581	4.33%	14.32%	0.62%
13 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
14 COMMON EQUITY	\$778,138	\$0	\$0	\$778,138	39.83%	11.05%	4.40%
15 CUSTOMER DEPOSITS	\$13,950	\$0	\$0	\$13,950	0.71%	6.00%	0.04%
16 DEFERRED INCOME TAXES	\$247,978	\$0	\$0	\$247,978	12.69%	0.00%	0.00%
17 DEFERRED ITC'S-ZERO COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
18 DEFERRED ITC'S-WTD. COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
19 OTHER	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
17 TOTAL CAPITAL	<u>\$1,953,533</u>	<u>\$0</u>	<u>\$1</u>	<u>\$1,953,534</u>	<u>100.00%</u>		<u>8.69%</u>
					<b>LOW</b>	<b>HIGH</b>	
RETURN ON EQUITY					<u>10.05%</u>	<u>12.05%</u>	
OVERALL RATE OF RETURN					<u>8.29%</u>	<u>9.09%</u>	

UTILITIES, INC. OF LONGWOOD  
 CAPITAL STRUCTURE  
 TEST YEAR ENDED 12/31/00

SCHEDULE NO. 4  
 DOCKET 011189-WS

DESCRIPTION	TOTAL CAPITAL	SPECIFIC ADJUSTMENTS (EXPLAIN)	PRO RATA ADJUSTMENTS	CAPITAL RECONCILED TO RATE BASE	RATIO	COST RATE	WEIGHTED COST
<b>PER UTILITY 2000 - YEAR-END</b>							
1 LONG TERM DEBT	\$542,721	\$0	\$0	\$542,721	41.52%	8.56%	3.55%
2 SHORT-TERM DEBT	\$55,380	\$0	\$0	\$55,380	4.24%	14.32%	0.61%
3 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
4 COMMON EQUITY	\$509,493	\$0	\$0	\$509,493	38.98%	13.34%	5.20%
5 CUSTOMER DEPOSITS	\$27,201	\$0	\$0	\$27,201	2.08%	6.00%	0.12%
6 DEFERRED INCOME TAXES	\$172,199	\$0	\$0	\$172,199	13.18%	0.00%	0.00%
7 DEFERRED ITC'S-ZERO COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
8 DEFERRED ITC'S-WTD. COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
9 OTHER	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
10 TOTAL CAPITAL	<u>\$1,306,994</u>	<u>\$0</u>	<u>\$0</u>	<u>\$1,306,994</u>	<u>100.00%</u>		<u>9.48%</u>
<b>PER STAFF 2000 - YEAR-END</b>							
11 LONG TERM DEBT	\$542,721	\$0	\$0	\$542,721	41.52%	8.56%	3.55%
12 SHORT-TERM DEBT	\$55,380	\$0	\$0	\$55,380	4.24%	14.32%	0.61%
13 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
14 COMMON EQUITY	\$509,493	\$0	\$0	\$509,493	38.98%	11.05%	4.31%
15 CUSTOMER DEPOSITS	\$27,201	\$0	\$0	\$27,201	2.08%	6.00%	0.12%
16 DEFERRED INCOME TAXES	\$172,199	\$0	\$0	\$172,199	13.18%	0.00%	0.00%
17 DEFERRED ITC'S-ZERO COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
18 DEFERRED ITC'S-WTD. COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
19 OTHER	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
17 TOTAL CAPITAL	<u>\$1,306,994</u>	<u>\$0</u>	<u>\$0</u>	<u>\$1,306,994</u>	<u>100.00%</u>		<u>8.59%</u>
					<b>LOW</b>	<b>HIGH</b>	
RETURN ON EQUITY					<u>10.05%</u>	<u>12.05%</u>	
OVERALL RATE OF RETURN					<u>8.20%</u>	<u>8.98%</u>	