



Public Service Commission

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TALLAHASSEE, FLORIDA 32399-0850

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DATE: JUNE 27, 2002

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

FROM: DIVISION OF ECONOMIC REGULATION (KYLE, BOUTWELL, DRAPER, MERCHANT) *ES* *DM*
OFFICE OF THE GENERAL COUNSEL (JAEGER) *ALM*

RE: DOCKET NO. 020567-WS - INVESTIGATION OF POSSIBLE
OVEREARNINGS BY LAKE GROVE UTILITIES, INC. IN LAKE COUNTY

AGENDA: 07/09/02 - REGULAR AGENDA - DECISION ON SETTING REVENUES
SUBJECT TO REFUND - INTERESTED PERSONS MAY PARTICIPATE ON
ISSUE 1 ONLY - PARTICIPATION IS LIMITED TO COMMISSIONERS
AND STAFF ON ISSUES 2 - 3

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\ECR\WP\020567WS.RCM

CASE BACKGROUND

Lakes Groves Utilities, Inc. (Lake Groves or utility) is a Class B utility providing water and wastewater service to approximately 2,248 water and 2,088 wastewater customers in Lake County. According to its 2001 annual report, the utility's operating revenue was \$750,622 for water and \$520,309 for wastewater and the net operating income was \$324,624 for water and \$265,888 for wastewater.

Lake Groves was issued an original certificate pursuant to Order No. 24283, in Docket No. 900957-WS, issued March 25, 1991. The initial rates and charges of the utility were set in Order No. 24283, using a return on common equity (ROE) of 13.51%, and this rate was to be used by Lake Groves in future proceedings involving such things as calculation of allowance for funds used during

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construction (AFUDC) and interim rates. The utility has never filed for a rate case; therefore, rate base has never been established for this utility.

Pursuant to Order No. PSC-99-0164-FOF-WS (the transfer order), issued January 26, 1999, in Docket No. 980958-WS, the Commission approved the transfer of majority organizational control of Lake Groves to Utilities, Inc. In the transfer order, the Commission ordered Utilities, Inc. to adopt and use the rates, classification, and regulations of Lake Groves. Accordingly, staff is recommending the use of 13.51% as the mid-point and 14.51% as the upper limit of the range of approved returns of equity for interim purposes.

Based on staff's review of the utility's 2001 Annual Report, Lake Groves achieved a 35.19% overall rate of return on its water rate base. This equates to a 76.26% ROE, which exceeds the utility's approved ROE. The utility achieved an 8.37% overall rate of return on its wastewater rate base, which equates to an 11.54% ROE. Staff believes it is necessary and appropriate to initiate an investigation into the potential water overearnings of this utility.

The Commission has jurisdiction pursuant to Sections 367.081, 367.082 and 367.121, Florida Statutes.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission initiate an overearnings investigation of Lake Groves Utilities, Inc.?

RECOMMENDATION: Yes. The Commission should initiate an investigation of the utility for possible overearnings. The test year for the investigation should be the year ended December 31, 2001. The docket should remain open pending the Commission's completion of the investigation. (KYLE)

STAFF ANALYSIS: Section 367.082, Florida Statutes, authorizes the Commission to initiate an investigation of a utility's earnings

upon a preliminary demonstration that the utility is earning a rate of return which is outside the range of reasonableness. To the extent that the achieved rate of return exceeds the required rate of return, the Commission may require revenues to be collected subject to refund during the investigation.

Staff's preliminary analysis, based on the review of the utility's 2001 Annual Report, indicates that during 2001 the utility's water system earned a 35.19% overall rate of return, while the wastewater system earned an 8.37% overall rate of return. Using the utility's capital structure from the annual report and the maximum of the range of the utility's last authorized return on equity (14.51%), staff has calculated an overall rate of return of 9.19%. The utility achieved a 35.19% overall rate of return on its water rate base, which equates to a 76.26% ROE, which exceeds the ROE authorized for Lake Groves by Order No. 24283. The utility's achieved overall rate of return of 8.37% on its wastewater rate base equates to an 11.54% ROE. The combined overall rate of return for both water and wastewater was 14.42%, which equates to a combined 26.12% ROE.

Staff believes that a full investigation of this utility's earnings for water service is appropriate. The test year for the investigation should be the year ended December 31, 2001. This docket should remain open pending the completion of the Commission's investigation of the utility's earnings.

ISSUE 2: Should any amount of annual water revenue be held subject to refund, and, if so, what is the appropriate amount ? -

RECOMMENDATION: Yes. The utility should hold annual water revenues of \$397,548, or 52.96%, subject to refund, based on the following:

| | |
|---------------------------|-----------|
| Revenue Requirement | \$353,074 |
| 2001 Test Year Revenue | \$750,622 |
| Amount Subject to Refund | \$397,548 |
| Percent Subject to Refund | 52.96% |

No wastewater revenues should be held subject to refund. (KYLE)

STAFF ANALYSIS: Pursuant to Section 367.082, Florida Statutes, in determining whether an interim decrease is appropriate, the Commission shall determine, on a prima facie basis, if the utility's achieved rate of return exceeds its required rate of return. The achieved rate of return for interim purposes shall be calculated by applying appropriate adjustments consistent with those used in the utility's most recent rate proceeding, and annualizing any rate changes that occurred during the interim test year. The required rate of return is calculated by taking the test year cost of capital and using the maximum of the range of the last authorized ROE. Staff has reviewed the utility's annual report to determine if the utility's reported rate base, cost of capital and net operating income amounts are consistent with the interim statute.

Rate Base

Lake Groves is a Class B utility. Chapter 25-30.433(2), Florida Administrative Code, specifies that working capital for Class B and C utilities shall be calculated using the formula method (one-eighth of operation and maintenance expenses). The utility has presented working capital using the formula method in the annual report and no adjustment is necessary.

Based on our review, no further adjustments to rate base are necessary. Staff's adjusted water rate base and wastewater rate base are attached as Schedule 1.

Cost of Capital

Lake Groves has not had a rate proceeding since the transfer of majority organizational control to Utilities, Inc. In its 2001 Annual Report, the utility reflected a last authorized ROE of 13.51%. This was the ROE established for Lake Groves by Order No. 24283 in Docket No. 900957-WS. This ROE was based upon the leverage formula which was in effect at the time, and was intended to allow the utility to earn a fair rate of return when the utility reached 80% of its projected capacity. The order also stated that the approved ROE was to be used in future proceedings involving such things as calculation of AFUDC and interim rates.

Based on the above, and in accordance with Section 367.082(5)(b), Florida Statutes, staff believes that it is appropriate to use the ROE approved by Order No. 24283 of 13.51%, with a range of 12.51% to 14.51%. Using the maximum of the range and the reported cost rates for other components in the utility's capital structure yields a 9.60% overall cost of capital for interim purposes. Schedule 2 reflects staff's adjusted cost of capital.

Net Operating Income

Pursuant to Section 367.082(5)(b)(1), Florida Statutes, any rate changes implemented during the interim test year shall be annualized. Staff notes that no rate changes were implemented during the recommended test year; therefore, no annualizing adjustments are necessary.

Staff has recalculated income tax expense based on the adjusted rate base, cost of capital and operating income amounts. After making the above staff adjustments, staff recommends that the test year net operating income should be \$325,655 for water and \$266,424 for wastewater. This reflects an achieved overall rate of return of 35.19% for water and 8.37% for wastewater. The calculations of water and wastewater net operating income are attached as Schedules 3-A and 3-B respectively.

Revenue Requirement

Using the required rate of return for interim decrease purposes of 9.60%, staff recommends that the water revenue requirement should be \$353,074. This reflects a decrease of

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\$397,548 (or 52.96%) from the adjusted test year operating revenues of \$750,622. Accordingly, staff believes that annual water revenues in the amount of \$397,548 should be held subject to refund pending the Commission's final determination of Lake Groves' level of earnings in this docket.

Staff's adjusted wastewater net operating income of \$266,424 generates an achieved rate of return of 8.37%, which is less than the minimum of the range of the required overall rate of return of 8.77%. Thus, staff has not recommended that any wastewater revenues be held subject to refund.

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

RECOMMENDATION: The utility should be required to file a corporate undertaking, guaranteed in writing by Utilities, Inc., to guarantee the amount subject to refund within 10 days of the effective date of the order opening this investigation. The corporate undertaking should be in the amount of \$334,000. Pursuant to Rule 25-30.360(6), Florida Administrative Code, the utility should be required to provide a report by the 20th of each month indicating the monthly and total revenue collected subject to refund. The utility should be put on notice that failure to comply in a timely manner with these requirements will result in the initiation of a show cause proceeding. (D. DRAPER, KYLE)

STAFF ANALYSIS: Pursuant to Section 367.082(2)(b), Florida Statutes, when revenues are held subject to refund and secured in a proceeding for an interim decrease, the utility is authorized to continue collecting the previously authorized rates. Staff has recommended that the amount of potential overearnings on an annual basis is \$397,548 for the water system. Assuming a 10-month time frame, the potential refund amount is approximately \$334,000.

Staff has analyzed whether Lake Groves can support a corporate undertaking in the amount of \$334,000. The criteria for a corporate undertaking include sufficient liquidity, ownership equity, profitability, and interest coverage to guarantee any potential refund. The 2000 and 2001 Annual Reports of Lake Groves' affiliated company, Utilities, Inc. of Florida (UIF), were used to determine the financial condition of the Company. Staff's analysis shows that UIF has had minimal liquidity and negative working capital for the two-year period. In addition, UIF reports insufficient interest coverage and negative income for 2001. However, for the same two-year period UIF's common equity ratio has increased and it has net positive income for the period. Based upon UIF's current level of equity relative to the amount of the corporate undertaking, and contingent upon the written guarantee of the parent, Utilities, Inc., staff recommends that the utility can support a corporate undertaking in the amount of \$334,000.

This brief financial analysis is only appropriate for deciding if the utility can support a corporate undertaking in the amount proposed and should not be considered a finding regarding staff's position on other issues in this investigation.

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The utility should keep an accurate and detailed account of all monies it receives. Pursuant to Rule 25-30.360(6), Florida Administrative Code, the utility should provide a report by the 20th day of each month indicating the monthly and total revenue collected 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. The costs are the responsibility of, and should be borne by, the utility. Finally, the utility should be on notice that failure to comply on a timely basis with the requirements of the Commission's order will result in the initiation of a show cause proceeding.

| LAKE GROVES UTILITIES, INC. SCHEDULE OF RATE BASE TEST YEAR ENDED 12/31/2001 | | SCHEDULE NO. 1 DOCKET NO. 020567-WS | |
|--|-----------------------------|--|--------------------------------|
| DESCRIPTION | TEST YEAR PER UTILITY | STAFF ADJUST- MENTS | STAFF ADJUSTED TEST YEAR |
| WATER | | | |
| 1 UTILITY PLANT IN SERVICE | \$4,095,976 | \$0 | \$4,095,976 |
| 2 LAND & LAND RIGHTS | \$0 | \$0 | \$0 |
| 3 NON-USED & USEFUL COMPONENTS | \$0 | \$0 | \$0 |
| 4 ACCUMULATED DEPRECIATION | (\$445,502) | \$0 | (\$445,502) |
| 5 CIAC | (\$3,018,671) | \$0 | (\$3,018,671) |
| 6 AMORTIZATION OF CIAC | \$274,620 | \$0 | \$274,620 |
| 7 WORKING CAPITAL ALLOWANCE | \$18,867 | \$0 | \$18,867 |
| 8 RATE BASE | <u>\$925,290</u> | <u>\$0</u> | <u>\$925,290</u> |
| WASTEWATER | | | |
| 9 UTILITY PLANT IN SERVICE | \$6,025,272 | \$0 | \$6,025,272 |
| 10 LAND | \$0 | \$0 | \$0 |
| 11 NON-USED & USEFUL COMPONENTS | \$0 | \$0 | \$0 |
| 12 ACCUMULATED DEPRECIATION | (\$496,141) | \$0 | (\$496,141) |
| 13 CIAC | (\$2,627,434) | \$0 | (\$2,627,434) |
| 14 AMORTIZATION OF CIAC | \$258,809 | \$0 | \$258,809 |
| 15 WORKING CAPITAL ALLOWANCE | \$15,067 | \$0 | \$15,067 |
| 16 OTHER | \$6,173 | \$0 | \$6,173 |
| 17 RATE BASE | <u>\$3,181,746</u> | <u>\$0</u> | <u>\$3,181,746</u> |

**LAKE GROVES UTILITIES, INC.
CAPITAL STRUCTURE
TEST YEAR ENDED 12/31/2001**

**SCHEDULE NO. 2
DOCKET NO. 020567-WS**

| DESCRIPTION | TOTAL CAPITAL | SPECIFIC ADJUSTMENTS (EXPLAIN) | PRO RATA ADJUSTMENTS | CAPITAL RECONCILED TO RATE BASE | RATIO | COST RATE | WEIGHTED COST |
|------------------------------------|--------------------|--------------------------------|----------------------|---------------------------------|------------------------|-------------|---------------|
| PER UTILITY 2001 - YEAR-END | | | | | | | |
| 1 LONG-TERM DEBT | \$1,550,741 | \$0 | \$0 | \$1,550,741 | 37.76% | 8.52% | 3.22% |
| 2 SHORT-TERM DEBT | \$529,521 | \$0 | \$0 | \$529,521 | 12.89% | 1.92% | 0.25% |
| 3 PREFERRED STOCK | \$0 | \$0 | \$0 | \$0 | 0.00% | 0.00% | 0.00% |
| 4 COMMON EQUITY | \$1,702,033 | \$0 | \$0 | \$1,702,033 | 41.44% | 13.51% | 5.60% |
| 5 CUSTOMER DEPOSITS | \$86,191 | \$0 | \$0 | \$86,191 | 2.10% | 6.00% | 0.13% |
| 6 DEFERRED INCOME TAXES | \$238,550 | \$0 | \$0 | \$238,550 | 5.81% | 0.00% | 0.00% |
| 7 DEFERRED ITC'S | \$0 | \$0 | \$0 | \$0 | 0.00% | 0.00% | 0.00% |
| 10 TOTAL CAPITAL | <u>\$4,107,036</u> | <u>\$0</u> | <u>\$0</u> | <u>\$4,107,036</u> | <u>100.00%</u> | | <u>9.19%</u> |
| PER STAFF 2001 - YEAR END | | | | | | | |
| 11 LONG TERM DEBT | \$1,550,741 | \$0 | \$0 | \$1,550,741 | 37.76% | 8.52% | 3.22% |
| 12 SHORT-TERM DEBT | \$529,521 | \$0 | \$0 | \$529,521 | 12.89% | 1.92% | 0.25% |
| 13 PREFERRED STOCK | \$0 | \$0 | \$0 | \$0 | 0.00% | 0.00% | 0.00% |
| 14 COMMON EQUITY | \$1,702,033 | \$0 | \$0 | \$1,702,033 | 41.44% | 13.51% | 5.60% |
| 15 CUSTOMER DEPOSITS | \$86,191 | \$0 | \$0 | \$86,191 | 2.10% | 6.00% | 0.13% |
| 16 DEFERRED INCOME TAXES | \$238,550 | \$0 | \$0 | \$238,550 | 5.81% | 0.00% | 0.00% |
| 17 DEFERRED ITC'S | \$0 | \$0 | \$0 | \$0 | 0.00% | 0.00% | 0.00% |
| 18 TOTAL CAPITAL | <u>\$4,107,036</u> | <u>\$0</u> | <u>\$0</u> | <u>\$4,107,036</u> | <u>100.00%</u> | | <u>9.19%</u> |
| | | | | | <u>LOW</u> | <u>HIGH</u> | |
| | | | | | RETURN ON EQUITY | 12.51% | 14.51% |
| | | | | | OVERALL RATE OF RETURN | 8.77% | 9.60% |

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| LAKE GROVES UTILITIES, INC. STATEMENT OF WATER OPERATIONS TEST YEAR ENDED 12/31/2001 | | | | SCHEDULE NO. 3-A DOCKET NO. 020567-WS | |
|--|-----------------------------|---------------------------|--------------------------------|--|------------------------|
| DESCRIPTION | TEST YEAR PER UTILITY | STAFF ADJUST- MENTS | STAFF ADJUSTED TEST YEAR | REVENUE INCREASE | REVENUE REQUIREMENT |
| 1 OPERATING REVENUES | <u>\$750,622</u> | <u>\$0</u> | <u>\$750,622</u> | <u>(\$397,548)</u> -52.96% | <u>\$353,074</u> |
| OPERATING EXPENSES: | | | | | |
| 2 OPERATION & MAINTENANCE | \$150,937 | 0 | 150,937 | | 150,937 |
| 3 DEPRECIATION | \$84,671 | 0 | 84,671 | | 84,671 |
| 4 AMORTIZATION | (\$78,355) | 0 | (78,355) | | (78,355) |
| 5 TAXES OTHER THAN INCOME | \$91,279 | 0 | 91,279 | (17,890) | 73,389 |
| 6 INCOME TAXES | <u>\$177,466</u> | <u>(\$1,031)</u> | <u>\$176,435</u> | <u>(\$142,866)</u> | <u>\$33,569</u> |
| 7 TOTAL OPERATING EXPENSES | <u>\$425,998</u> | <u>(\$1,031)</u> | <u>\$424,967</u> | <u>(\$160,755)</u> | <u>\$264,212</u> |
| 8 OPERATING INCOME | <u>\$324,624</u> | <u>\$1,031</u> | <u>\$325,655</u> | <u>(\$236,793)</u> | <u>\$88,862</u> |
| 9 RATE BASE | <u>\$925,290</u> | | <u>\$925,290</u> | | <u>\$925,290</u> |
| 10 RATE OF RETURN | <u>35.08%</u> | | <u>35.19%</u> | | <u>9.60%</u> |

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| LAKE GROVES UTILITIES, INC. STATEMENT OF WASTEWATER OPERATIONS TEST YEAR ENDED 12/31/2001 | | | | SCHEDULE NO. 3-B DOCKET NO. 020567-WS | |
|---|-----------------------------|---------------------------|--------------------------------|--|------------------------|
| DESCRIPTION | TEST YEAR PER UTILITY | STAFF ADJUST- MENTS | STAFF ADJUSTED TEST YEAR | REVENUE INCREASE | REVENUE REQUIREMENT |
| 1 OPERATING REVENUES | <u>\$520,309</u> | <u>\$0</u> | <u>\$520,309</u> | <u>\$0</u> 0.00% | <u>\$520,309</u> |
| OPERATING EXPENSES | | | | | |
| 2 OPERATION & MAINTENANCE | \$120,535 | \$0 | \$120,535 | | \$120,535 |
| 3 DEPRECIATION | \$89,376 | \$0 | \$89,376 | | \$89,376 |
| 4 AMORTIZATION | (\$74,598) | \$0 | (\$74,598) | | (\$74,598) |
| 5 TAXES OTHER THAN INCOME | \$26,753 | \$0 | \$26,753 | \$0 | \$26,753 |
| 6 INCOME TAXES | <u>\$92,355</u> | <u>(\$536)</u> | <u>\$91,819</u> | <u>\$0</u> | <u>\$91,819</u> |
| 7 TOTAL OPERATING EXPENSES | <u>\$254,421</u> | <u>(\$536)</u> | <u>\$253,885</u> | <u>\$0</u> | <u>\$253,885</u> |
| 8 OPERATING INCOME | <u>\$265,888</u> | <u>\$536</u> | <u>\$266,424</u> | <u>\$0</u> | <u>\$266,424</u> |
| 9 RATE BASE | <u>\$3,181,746</u> | | <u>\$3,181,746</u> | | <u>\$3,181,746</u> |
| 10 RATE OF RETURN | <u>8.36%</u> | | <u>8.37%</u> | | <u>8.37%</u> |