



Public Service Commission

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

FROM: DIVISION OF ECONOMIC REGULATION (MERTA, RENDELL)
OFFICE OF THE GENERAL COUNSEL (JAEGER) *SM* *e* *Matt* *JDJ* *TJD*

RE: DOCKET NO. 030423-WU - INVESTIGATION INTO 2002 EARNINGS OF
RESIDENTIAL WATER SYSTEMS, INC. IN MARION COUNTY.
COUNTY: MARION

AGENDA: 06/03/03 - REGULAR AGENDA - DECISION ON SETTING REVENUES
SUBJECT TO REFUND - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\ECR\WP\030423.RCM

CASE BACKGROUND

Residential Water Systems, Inc. (RWS or utility), is a Class C water utility serving approximately 632 customers in Marion County in Sun Tree, High Point, Edgewood, Country Estates, Buffington Addition, Dalton Woods, and Wineberry subdivisions. According to its 2002 Annual Report, the utility reported operating revenues of \$198,018 and operating expenses of \$177,150. This resulted in a net operating income of \$20,868.

Pursuant to Order No. 12842, issued January 4, 1984, in Docket No. 830436-W, RWS was granted Certificate No. 419-W. The facility was not yet constructed; however, rate base and rates and charges were tentatively established at that time based on estimates of investment and expenses. Since its certification, docketed activity for this utility has included applications for amendment to its certificate to include additional territory in Docket Nos. 840284-WU, 950907-WU, 990698-WU and 030294-WU, respectively. In

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addition, the Commission, in Order No. PSC-98-1152-FOF-WU, issued August 25, 1998, in Docket No. 961210-WU, approved a transfer of majority organizational control from Nancy and Elaine Finney to Charles deMenzes. In addition to the mentioned docketed activities, the utility has taken advantage of price indexing and pass-through opportunities.

A review of the RWS 2002 Annual Report indicated that the utility may have exceeded its authorized rate of return. Based on results of its analysis, staff believes it is necessary and appropriate to initiate an audit of the utility's books and records and an investigation into the potential overearnings of this utility. The Commission has jurisdiction pursuant to Sections 367.081 and 367.082, Florida Statutes.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission initiate an earnings investigation of Residential Water Systems, Inc.?

RECOMMENDATION: Yes, the Commission should initiate an investigation of Residential Water Systems, Inc. to determine potential overearnings. (MERTA)

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 authorized rate of return applied to rate base, the Commission may require revenues to be collected subject to refund pending the result of the investigation. See Section 367.082(1) and (5), Florida Statutes.

Staff's preliminary analysis indicates that during 2002, the utility's water system earned a 15.25% return. Using the utility's 2002 capital structure, the maximum of the range of reasonableness for the rate of return is 5.09%. Therefore, based on the results of staff's preliminary analysis, a full investigation of this utility's earnings is appropriate.

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

RECOMMENDATION: Yes, RWS should hold annual water revenues of \$19,365 subject to refund. (MERTA)

STAFF ANALYSIS: As stated in Issue No. 1, staff believes that RWS may be overearning. Pursuant to Section 367.082(5)(b)1., Florida Statutes, the achieved rate of return for setting revenues subject to refund shall be calculated by applying appropriate adjustments consistent with those used in the utility's most recent rate proceeding. As stated in the Case Background, initial rates were set for this utility by Order No. 12842, issued January 4, 1984, in Docket No. 830436-W. The utility's investment and expenses were based on estimates because the facilities had not been constructed. The attached schedules illustrate staff's recommended rate base, capital structure, and operating income amounts, which are discussed below.

RATE BASE

Pursuant to Rule 25-30.433(4), Florida Administrative Code, the averaging method used by the Commission to calculate rate base and the cost of capital for a Class C utility is the simple beginning and end-of-year average. The utility's 2002 Annual Report reflects RWS's year-end financial data. Therefore, staff has used the simple average of 2001 and 2002 to analyze the utility's water system.

Working Capital Allowance:

Working Capital is defined as the investor-supplied funds necessary to meet operating expenses or going-concern requirements of the utility. Consistent with Rule 25-30.433(2), Florida Administrative Code, staff recommends that the one-eighth of the O&M expense formula approach be used for calculating working capital allowance. Applying that formula, staff recommends a working capital allowance of \$17,315. This represents one-eighth of the average of 2001 and 2002 O&M expenses of \$118,167 and \$158,876, respectively.

Rate Base Summary:

Based on the foregoing, staff recommends that the appropriate test year rate base is \$205,279. Rate base is shown on Schedule No. 1-A.

COST OF CAPITAL

Consistent with Section 367.082(5)(b), Florida Statutes, the required rate of return shall be calculated using the last authorized rate of return on equity, the current embedded cost of fixed-rate capital and the actual cost of other sources of capital. This section also requires that the return on equity for an interim decrease shall be calculated using the maximum of the range of the utility's last authorized return on equity. In Order No. 12842, the Commission authorized a 16.35% return on equity; however, RWS's current capital structure is 99% debt. Therefore, the overall rate of return is based on the weighted cost of debt and customer deposits.

The utility's capital structure has been reconciled with staff's recommended rate base. Staff's recommended overall rate of return is 5.09%

The overall rate of return is shown on Schedule No. 2.

OPERATING INCOME

Operating Revenue:

Section 367.082(5)(b)1., Florida Statutes, states that any rate changes which occurred during the test year must be annualized in order to calculate the achieved rate of return. On May 31, 2002, the utility implemented a price index rate adjustment. Therefore, staff has annualized revenues using the year-end number of customers and the rates in effect at year end. Based on this calculation, staff has increased revenues by \$10,927.

Taxes Other Than Income:

Taxes Other Than Income was increased by \$492 to reflect RAFs on staff's annualized revenue discussed above. In addition, staff's adjustments cause a revenue decrease of \$21,838. The revenue decrease generates a reduction in RAFs of \$983.

REVENUE REQUIREMENT

Based on staff's recommended adjustments, the revenue requirement should be \$187,108, which represents a decrease of \$21,838 or 10.45%. However, pursuant to Section 367.081(4)(d), Florida Statutes, the revenue associated with the price index rate adjustment remains subject to refund 15 months after the filing of the utility's annual report for the year the increase was implemented. As stated above, RWS implemented its price index increase, an annual increase of \$2,473, on May 31, 2002. The utility filed its 2002 Annual Report on February 12, 2003, therefore the revenues generated by the price index are subject to refund through May 12, 2004. Based on the above, staff recommends that \$19,365 (\$21,838 - \$2,473) in revenues be held subject to refund pending the final determination by the Commission.

The staff adjusted revenue, operating expenses, and revenue requirement are shown on Schedule No. 3-A.

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

RECOMMENDATION: The utility should be required to file a bond, letter of credit or escrow agreement to guarantee the amount subject to refund. The letter of credit or bond should be in the amount of \$12,910. In lieu of a letter of credit or bond, the utility should obtain an escrow agreement which requires the utility to deposit an amount monthly, as discussed below, until completion of the overearnings investigation and the resolution of the other outstanding matters as discussed previously. 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 with these requirements will result in the initiation of a show cause proceeding. (MERTA)

STAFF ANALYSIS: Pursuant to Section 367.082, Florida Statutes, when revenues are held subject to refund, the utility is authorized to continue collecting the previously authorized rates. The amount of potential overearnings on an annual basis is \$21,838. However, \$2,473 of the potential overearnings are the result of a 2002 price index. Pursuant to Section 367.081(4)(d), Florida Statutes, the revenues associated with the price index and pass-through rate adjustments are already subject to refund, and are not required to be protected by a bond or corporate undertaking. Therefore, only \$19,365 in annual water revenues, should be collected under guarantee, subject to refund with interest. Assuming a 8-month time frame, the potential refund amount is \$12,910.

Based on the above, staff has reviewed the financial data of the utility in order to determine whether RWS can support a corporate undertaking of \$12,910. The criteria for a corporate undertaking includes sufficient liquidity, ownership equity, profitability, and interest coverage to guarantee any potential refund. Staff has reviewed the 2000, 2001, and 2002 annual reports of RWS to determine the financial condition of the utility. Staff's analysis shows that RWS has adequate liquidity and interest coverage. However, the utility has negative equity and its average annual net income over the three-year period is significantly less than the amount under request. Based upon this analysis, staff recommends that RWS cannot support a corporate undertaking in the amount of \$12,910. Therefore, staff recommends that the utility

provide a letter of credit, bond, or escrow agreement to guarantee the funds collected subject to refund.

If the security provided is an escrow account, said account should be established between the utility and an independent financial institution pursuant to a written escrow agreement. The Commission should be a party to the written escrow agreement and a signatory to the escrow account. The written escrow agreement should state the following:

1. The account is established at the direction of this Commission for the purpose set forth above;
2. No withdrawals of funds shall occur without the prior approval of the Commission through the Director of the Commission Clerk and Administrative Services;
3. The account shall be interest bearing;
4. Information concerning that escrow account shall be available from the institution to the Commission or its representative at all times;
5. The amount of revenue subject to refund shall be deposited in the escrow account within seven days of receipt; and
6. Pursuant to Cosentino v. Elson, 263 So. 2d 253 (Fla 3d DCA 1972), escrow accounts are not subject to garnishments.

The utility should deposit 6.18% of water revenues collected into the escrow account each month to secure for a possible refund. The escrow agreement should also state the following:

1. If a refund to the customers is required, all interest earned on the escrow account shall be distributed to the customers; and
2. If a refund to the customers is not required, the interest earned on the escrow account shall revert to the utility.

If the security provided is a bond or a letter of credit, said instrument should be in the amount of \$12,910. If the utility chooses a bond as security, the bond should state that it will be released or should terminate only upon subsequent order of the Commission addressing overearnings or requiring a refund. If the utility chooses to provide a letter of credit as security, the letter of credit should state that it is irrevocable for the period it is in effect and that it will be in effect until a final

Commission order is rendered addressing overearnings or requiring a refund.

Irrespective of the type of security provided, 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 if it does not comply with the requirements stated in this recommendation, show cause proceedings will be initiated.

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ISSUE 4: Should this docket be closed?

RECOMMENDATION: No, this docket should remain open pending staff's investigation of the utility's earnings for 2002. (MERTA, JAEGER)

STAFF ANALYSIS: Based on staff's preliminary analysis, staff believes that the utility is overearning by \$21,838. Therefore, this docket should remain open pending an audit of the utility's books and records and staff's investigation of earnings for 2002.

RESIDENTIAL WATER SYSTEMS, INC. TEST YEAR ENDING 12/31/02 SCHEDULE OF WATER RATE BASE		SCHEDULE NO. 1-A DOCKET NO. 030423-WU	
DESCRIPTION	BALANCE PER UTILITY	STAFF ADJUST. TO UTIL. BAL.	BALANCE PER STAFF
1. UTILITY PLANT IN SERVICE	\$676,297	\$0	\$676,297
2. LAND & LAND RIGHTS	0	\$0	\$0
3. NON-USED AND USEFUL COMPONENTS	0	\$0	\$0
4. CIAC	(504,436)	\$0	(\$504,436)
5. ACCUMULATED DEPRECIATION	(173,259)	\$0	(\$173,259)
6. AMORTIZATION OF CIAC	189,362	\$0	\$189,362
7. WORKING CAPITAL ALLOWANCE	<u>0</u>	<u>\$17,315</u>	<u>\$17,315</u>
8. WATER RATE BASE	<u>\$187,964</u>	<u>\$17,315</u>	<u>\$205,279</u>

RESIDENTIAL WATER SYSTEMS, INC. TEST YEAR ENDING 12/31/02 SCHEDULE OF CAPITAL STRUCTURE				SCHEDULE NO. 2 DOCKET NO. 030423-WU				
CAPITAL COMPONENT	PER UTILITY	SPECIFIC ADJUST- MENTS	BALANCE		BALANCE PER STAFF	PERCENT OF TOTAL	COST	WEIGHTED COST
			BEFORE PRO RATA ADJUSTMENTS	PRO RATA ADJUST- MENTS				
1. COMMON STOCK	\$100	\$0	\$100					
2. RETAINED EARNINGS	(43,246)	0	(\$43,246)					
3. PAID IN CAPITAL	400	0	\$400					
4. OTHER COMMON EQUITY	<u>0</u>	<u>42,746</u>	<u>\$42,746</u>					
5. TOTAL COMMON EQUITY	(\$42,746)	\$42,746	0	0	0	0.00%	17.35%	0.00%
6. LONG TERM DEBT								
Ingersoll-Rand Financial Ser.	20,226	0	20,226	(6,101)	14,125	6.88%	3.90%	0.27%
Wachovia Bank	84,065	0	84,065	(25,359)	58,706	28.60%	8.75%	2.50%
N/P State of Florida	<u>186,648</u>	<u>0</u>	<u>186,648</u>	<u>(56,305)</u>	<u>130,343</u>	<u>63.50%</u>	<u>3.55%</u>	<u>2.25%</u>
TOTAL LONG TERM DEBT	290,939	0	290,939	(87,765)	203,174	98.97%		
7. CUSTOMER DEPOSITS	<u>3,015</u>	<u>0</u>	<u>3,015</u>	<u>(910)</u>	<u>2,105</u>	<u>1.03%</u>	6.00%	<u>0.06%</u>
8. TOTAL	<u>\$251,208</u>	<u>\$42,746</u>	<u>\$293,954</u>	<u>(\$88,675)</u>	<u>\$205,279</u>	<u>100.00%</u>		<u>5.09%</u>
RANGE OF REASONABLENESS RETURN ON EQUITY						<u>LOW</u>	<u>HIGH</u>	
						<u>16.35%</u>	<u>18.35%</u>	
OVERALL RATE OF RETURN						<u>5.09%</u>	<u>5.09%</u>	

RESIDENTIAL WATER SYSTEMS, INC. TEST YEAR ENDING 12/31/02 SCHEDULE OF WATER OPERATING INCOME			SCHEDULE NO. 3-A DOCKET NO. 030423-WU		
	TEST YEAR PER UTILITY	STAFF ADJ. PER UTILITY	STAFF ADJUSTED TEST YEAR	ADJUST. FOR INCREASE	REVENUE REQUIREMENT
1. OPERATING REVENUES	<u>\$198,018</u>	<u>\$10,927</u>	<u>\$208,945</u>	<u>(\$21,838)</u> -10.45%	<u>\$187,108</u>
OPERATING EXPENSES:					
2. OPERATION & MAINTENANCE	158,876	0	158,876	0	158,876
3. DEPRECIATION (NET)	6,145	0	6,145	0	6,145
4. AMORTIZATION	0	0	0	0	0
5. TAXES OTHER THAN INCOME	12,129	492	12,621	(983)	11,638
6. INCOME TAXES	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>
7. TOTAL OPERATING EXPENSES	<u>\$177,150</u>	<u>\$492</u>	<u>\$177,642</u>	<u>(\$983)</u>	<u>\$176,659</u>
8. OPERATING INCOME/(LOSS)	<u>\$20,868</u>		<u>\$31,304</u>		<u>\$10,449</u>
9. WATER RATE BASE	<u>\$187,964</u>		<u>\$205,279</u>		<u>\$205,279</u>
10. RATE OF RETURN	<u>11.10%</u>		<u>15.25%</u>		<u>5.09%</u>