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May 23, 2005

Via Hand Delivery

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RE: Response to Audit Report - Docket No. 040951-WS - Joint Application for Approval of Sale of Florida Water Services Corporation's Land, Facilities, and Certificates in Brevard, Highlands, Lake, Orange, Pasco, Polk, Putnam, a portion of Seminole, Volusia, and Washington Counties to Aqua Utilities, Inc. - Audit Control No. 04-247-3-1

Dear Jennifer:

By memorandum dated March 15, 2005, Florida Water Services Corporation ("Florida Water") was provided a copy of the Audit Report prepared and filed in the above referenced docket that was opened to consider the joint application for approval of the transfer of the Florida Water systems in the named counties to Aqua Utilities Florida, Inc. ("Aqua"). While Florida Water does not take issue with the majority of adjustments suggested in the Audit Report, Florida Water submits this response in order to clarify and address certain specific "exceptions" contained in the Report. As set forth below, Florida Water is concerned that the "exceptions" could be interpreted or applied to make improper adjustments to rate base. Florida Water has retained the services of Mr. Hugh Gower, who has extensive experience in accounting, and in particular utility regulatory accounting and depreciation studies, to review the Audit Report and assist in responding to certain of the issues. Mr. Gower's initial observations are included in this response.

The first two items discussed below [Exceptions 5 and 14] are easily resolved since the auditors simply lacked the necessary documentation at the time the Audit Report was prepared. As discussed below, for each of these items the appropriate documentation is enclosed with this response. We believe this information should conclusively resolve those Exceptions. With respect to Exception 18, Florida Water has not been able to fully discern the auditor's position or recommendations. Because this is a potentially significant issue, the Company will, through this response, attempt to delineate some key concepts that should help to put this issue in proper context.

Exception Number 5 - Putnam County-Beecher's Point UPIS Additions

Exception Number 5 in Section II of the Audit Report is actually comprised of two parts. Florida Water does not take exception to the second part of Exception 5 which states that incorrect overhead rates were applied to UPIS in the amount of ($49,154) with an offset to Accumulated Depreciation of $3,067 for a net adjustment of ($46,087). However, Florida Water would like to address the first part of Exception 5 which indicates the auditors lacked documentation for UPIS in the amount of ($42,160) with an offset to Accumulated Depreciation of $8,841 for a net proposed adjustment of ($33,319.33). In response to audit staff's indication that it did not have original source documentation to support the UPIS asset additions at the Beecher's Point Water and Wastewater Plants, that documentation is attached hereto as Exhibit A. This documentation supports the net amount of $33,319.33 reflected in the application and the auditor's proposed adjustment is unnecessary.

Exception Number 14 - CIAC

In Exception Number 14 in Section II of the Audit Report on page 19, the Auditors suggest an adjustment because the utility's CIAC balance does not reconcile with the Commission-approved CIAC balance. The recommended adjustment is an increase of CIAC in the amount of $46,878 and a corresponding increase in Amortization of CIAC in the amount of $35,795 for a net adjustment of ($11,083). However, subsequent to the time the auditors first conducted their review of this account, Florida Water discovered that there was a booking error that explains the discrepancy noted in this Exception. As reflected by the correspondence attached hereto as Exhibit B, the original entry was erroneously booked. When this entry is correctly booked, there is no inconsistency or any unreconciled difference with the Commission's Order PSC-00-1659-PAA-WU. Correctly booking this entry results in a net increase in rate base of $36,100 for this exception as shown in Exhibit B. (This amount does not include the ($11,083) net adjustment discussed above.)

Exception Number 18 - Depreciation

After spending considerable time reviewing Exception 18 on pages 23-25 of the Audit Report and the related disclosures, Florida Water is puzzled as to the basis for the auditors' Exception and unclear as to their recommendation. We have requested the auditors' work papers and hopefully that documentation will help us better understand the basis and reasoning for this Exception. In the meantime, Florida Water believes the following comments are relevant to the issues raised in the Audit Report:

- Consistent with the recommendations of the Commission staff in its management audit of Southern State's Utilities, Inc., Florida Water undertook a company-wide effort to update its books and implement a continuing property records system. Florida Water followed the methodology prescribed by the Uniform System of Accounts and standard accounting practices in updating its plant inventory records and establishing a continuing property records system;
- Florida Water utilizes the uniform depreciation rates prescribed by the Commission for systems throughout the state. These uniform depreciation rates which were ordered by the Commission to be applied to all of the more than 140 utility systems included in Florida Water's last rate case, Docket No. 950495-WS.
- The uniform depreciation rates prescribed by the Commission do not apply to individual assets, but to groups of assets. The depreciation rates are based on average service lives within a group, which inherently means that some assets will be retired before the average service life and some will be retired after the average service life used for depreciation;
- Debit balances in the Accumulated Reserve Accounts arise from the use of uniform depreciation rates based on average service lives of classes of assets. In other words, when the actual life of plant assets is shorter than the average service life used for depreciation, a debit balance results;
- The Audit Report isolates a few accounts with debit accumulated reserve balances and suggests adjustments that are not consistent with basic regulatory and accounting principles. In its last two rate cases, Florida Water was evaluated on a total company basis for such things as return, depreciation, taxes, allocations, customer service, administrative and general costs and general plant. Debit balances in isolated accumulated reserve accounts would have been addressed as a part of future general rate proceedings when detailed property records were available to provide the necessary data;
- The Commission should not evaluate the debit balances in a vacuum and cannot make one-sided accounting adjustments to eliminate the "depletion problem" in the depreciation reserve accounts.

Florida Water is concerned that the auditors have not fully recognized the propriety and results of the comprehensive plant inventory and original cost study (the "Fixed Asset Study") undertaken by an independent consultant on behalf of Florida Water on a company-wide basis beginning in 1996. More significantly, the Audit Report fails to recognize the full extent of the efforts undertaken in connection with this Fixed Asset Study and appears to suggest the results of the study can be disregarded. Some background regarding the Study is necessary.

Because of multiple acquisitions and the variety of systems acquired by Florida Water in the years preceding the Fixed Asset Study, there was no unitized fixed asset system in place for the company as whole. The Fixed Asset Study was undertaken to establish unitized continuing property records, improve internal accounting controls, provide retirement dispersion history needed to monitor/evaluate the service life used to book depreciation of plant in service and to better conform the Company's records to the requirements of the USOA and the Commission's orders. This undertaking was unquestionably an appropriate effort and naturally led to adjustments to bring book balances of plant accounts into agreement with the cost of assets actually in service. The Study was performed by independent professionals with the requisite technical skills, was carefully planned and executed and employed cost assignment methods consistent with the USOA instructions. The Study-related adjustments were appropriate and there is nothing in the Audit Report that suggests study error or unusual transactions such as extraordinary retirements which affect the Study outcome. The adjustments that resulted from the Study were due, in large part, to previously unrecorded retirement transactions during the time prior to the acquisition by Florida Water and the establishment of appropriate reporting procedures.

As a result of the Fixed Asset Study, adjustments were made to virtually every company account to insure that all of the assets owned by the Company were documented in accordance with NARUC standards. The adjustments made following the Study included retirement for assets that were no longer in service but for which the retirement had not been previously recorded on the books. As discussed below, it is only through a continuing property record system established from a Fixed Asset Study such as this that the Company could obtain accurate retirement data necessary to evaluate depreciation rates. Through this process, the Company was also able to confirm that it had a thorough and up-to-date inventory of all utility plant assets in service.

A simple review of the Uniform System of Accounts ("USOA") confirms that the cost assignment methods employed by the company and its consultant in connection with the Fixed Asset Study were entirely appropriate. The adjustments made as a result of the Study had no net effect on the Company's rate-base.[1] Furthermore, it appears that during the time period in question, the customers may have benefitted because the cost of service was reduced due to depreciation based on prescribed rather than the actual service lives of some plant assets. To the extent the Audit Report suggests there should be rate base adjustments as a result of the debit balances in the accumulated depreciation accounts, any such adjustments would be arbitrary and would improperly penalize the

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[1]The adjustments to the books made by Florida Water as a result of the Fixed Asset Study had no net effect on rate base because retirement entries were made appropriately as a credit to plant and a debit to reserve for depreciation. Consequently, Florida Water is concerned by the insinuation in the Audit Report that the "depletion problem" can be addressed by one-sided adjustment to reverse out the entry to the reserve for depreciation without making a similar reversing entry to plant.

Company. Moreover, such adjustments cannot be reconciled with fundamental regulatory principles, the USOA or Rule 25-30.140, Fla. Admin. Code.

On page 37 of the Audit Report, the auditors recognize that the utility made numerous retirements to utility plant in service based on the consultant's Fixed Asset Study. As noted in the Audit Report, the entries made by the Company reflect standard regulatory accounting for UPIS asset retirements. While the Audit Report concedes that the differences between the physical inventory and the general ledger which were revealed by the Fixed Asset Study may be attributed to plant retirements that had not previously been recorded, the Report fails to recognize the full scope and implications of the Fixed Asset Study and the resulting adjustments for previously unrecorded plant retirements.

The Audit Report does not identify any problems with the Fixed Asset Study or with any specific entries made as a result of that Study.[2] To the Company's knowledge, all extraordinary abandonments have been properly booked and additions to the plant accounts have been made in accordance with the USOA and subject to adequate internal accounting controls and have been audited by the Company's independent public accounting firm and internal auditor. We would also point out that all additions to plant through 1994 were audited by Commission Staff.

The Fixed Asset Study and the establishment of a continuing property record system based upon the independent consultant's report was a laudable attempt by the utility to improve its accounting system. Florida Water made significant efforts to appropriately book the multiple accounting entries that were prompted as a result of the Fixed Asset Study. The Audit Report fails to recognize that, to the extent the adjustments made to Florida Water's books following the Fixed Asset Study were done to reflect retirements that had previously been made but not booked, the end result is simply that the books now reflect what they should have shown all along.

The intent of the depreciation rule is to provide capital recovery over the anticipated average service life of the assets. The Commission establishes by rule the average service life to be used in recording depreciation. A debit balance in an accumulated depreciation account can arise when the depreciation rate or the average service life is not closely aligned with the actual life of the assets. In other words, a debit balance in the depreciation account will occur when the depreciation rate for the assets has not been timely and properly adjusted. Theoretically, a utility could come in and seek

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[2]The Audit Report does note that some original entries made to the Extraordinary Abandonment account were erroneous. These entries were ultimately corrected by Florida Water in 2003 after they were brought to the Company's attention as a result of comments from Florida Water's external auditors. Florida Water agreed with the comments and the corrections, were appropriately made and did not have any net impact upon rate base.

an adjustment of the promulgated service life. However, no such adjustments would be possible without specific data to support a change. Such data is not available until an analysis such as the Fixed Asset Study is completed.

The Audit Report fails to recognize that the retirement of an asset before the expiration of the service life used for recording depreciation of the asset is a reflection that there was inadequate depreciation in the prior years. In such situations, the investors have not been able to fully recover the capital invested in such assets. Because substantially all of the accumulated depreciation debit balance results from the correctly booked retirements, it is clear that historically there has been inadequate depreciation of the retired assets. To "write off" the resulting debit balances as appears to be suggested in the Audit Report would amount to permanent denial of recovery of investors' capital and would be improper.

It is important to keep in mind that the depreciation rates that have been historically utilized are based on Commission rule rather than a depreciation study. The information obtained through the establishment of a fixed asset system was necessary to provide information relevant to determining whether the average service life established by the Commission for the various asset classifications was up to date and appropriate. The inadequacy of depreciation rates is only revealed when all retirement entries for affected accounts have been recorded. Without a fully developed fixed asset system, there would have been no basis for the utility to seek any changes in the depreciation schedules.

While the Audit Report speculates that the debit balances could potentially be attributable to the use of cost estimates as part of the Fixed Asset Study, any such differential would be inconsequential. Moreover, the use of cost estimates where necessary during the Fixed Asset Study is approved by the USOA and Chapter 25, Fla. Admin. Code.

We are also compelled to point out that, in its recent rate cases, Florida Water has been evaluated by the Commission on a company-wide basis for return purposes. Looking at the company as a whole, Florida Water, had over 150 systems as of December 2002 with more than $600 million in utility plant in service and approximately $200 million in accumulated depreciation accounts. The company had more than 7,000 plant accounts. The depreciation reserve "depletion problem" noted in the Audit Report focuses on a limited number of accounts. A depletion problem in these accounts was only revealed on a piecemeal basis as the retirement entries were booked over a period of years. It was not until all the entries related to the Fixed Asset Study were completed that there would have been any clear indication or signal that depreciation rates may have been inadequate. Efforts to sell the company were underway not long after the final entries were made. There is no basis for the auditors' suggestion that debit balances should have been addressed at some earlier date. For Florida Water, the appropriate time to deal with such matters would have been as part of a general rate filing, not on an individual system or account basis. It would have been cost prohibitive for the company and its customers to file a rate proceeding to deal solely with individual account debit balances.

We are unclear as to what the auditors are suggesting as an appropriate remedy for the matters discussed in Exception 18. Florida Water feels strongly that the results of the Fixed Asset Study should not be used to inappropriately penalize the utility's owners. The bottom line is that the utility has now correctly recorded the retirement entries for assets previously retired. While the basis and ultimate impact of the auditors suggestions for handling the debit balances are not clearly delineated, the Commission cannot force a utility to write off its prudent investments without compensation. The investors are entitled to return of and a return on their prudent investments. Rate base cannot be unilaterally adjusted to eliminate the debit balance in the accumulated depreciation account .[3] The appropriate approach to address concerns over the future implications of depreciation reserve deficiencies would be a prospective increase in depreciation rates, not prior period adjustments which deny the recovery of investor capital. Adjustment of the depreciation rates on a going forward basis would allow the reserve to build up in the future. Any other approach would be vulnerable to a claim that investors' capital has not been preserved.

In sum, the analysis in the Audit Report regarding Exception 18 is incomplete and erroneous to the extent that it suggests adjustments to rate base should be made as the result of accumulated depreciation debit balances. Any such adjustment would result in improper permanent denial of the recovery of investors' capital.

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[3]It is important to note that a unilateral adjustment to rate base, which is alluded to in the Audit Report, would reflect only one side of the accounting entries that would be necessary to reverse the entries that led to the debit balance. For example, as noted in footnote 1 above, when the original entries were made to reconcile the Company's records with the results of the Fixed Asset Study, the plant in service account was reduced. Thus, the entries made to reconcile the utility's books with the physical inventory, which are a primary source of the accumulated debit balances in depreciation reserve accounts, have already reduced the plant in service account and cannot be reversed with a one-sided accounting entry.

As you know, we have requested copies of the auditors work papers related to Exception 18. We may have further comments after reviewing those papers. In the meantime, please call me if you have any question.

Sincerely,

J. Stephen Menton

Kenneth A. Hoffman
J. Stephen Menton

cc: Melissa Taylor, Esq.
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