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Public Service Commission

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COMMISSION
CLERK

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

DATE: September 30, 2010

TO: Office of Commission Clerk (Cole)

FROM: Division of Economic Regulation (Fletcher, Maurey) *BF*
Office of the General Counsel (Williams, Crawford) *ARW JSO* *W* *ALM*

RE: Docket No. 100400-WU, Investigation of rates of O&S Water Company, Inc. in Osceola County for possible overearnings.

AGENDA: 10/12/10 – Regular Agenda – Decision on Initiation of an Investigation of Possible Overearnings on Issue 1 - Interested Persons May Participate and Decision on Revenues held subject to Refund and Appropriate Security on Issues 2 and 3 – Participation is at the Discretion of the Commission

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Administrative

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: This item should be taken up before Docket No. 090322-WU.

FILE NAME AND LOCATION: S:\PSC\ECR\WP\100400.RCM.DOC

Case Background

O&S Water Company, Inc. (O&S or Utility) is a Class A water utility located in Osceola County. O&S serves approximately 2,186 residential customers, 29 commercial customers, and 858 irrigation customers. The Utility's service area is located in the South Florida Water Management District. According to the Utility's 2009 Annual Report, O&S reported annual operating revenues of \$1,205,487 and net operating income of \$56,008. The Utility's rate base

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was last established for the 12-month period ended June 30, 1991 by the Commission's approval of the transfer of majority organizational control of O&S.¹

The Utility's 2009 Annual Report was received on April 26, 2010. Staff's preliminary analysis indicates that O&S's achieved ROE is 19.33 percent, which is in excess of the top of its authorized range of return on equity.

This recommendation addresses: 1) opening a formal overearnings investigation of the Utility, and 2) holding revenues subject to refund under an appropriate security. The Commission has jurisdiction pursuant to Sections 367.081 and 367.082, Florida Statutes (F.S).

Additionally, at the October 12, 2010, Agenda Conference, the Commission will consider staff's recommendation in Docket No. 090322-WU to deny O&S's requested payment plan for delinquent regulatory assessment fees (RAFs) of \$127,789.

¹ See Order No. PSC-92-0204-FOF-WU, issued April 14, 1992, in Docket No. 910895-WU, In re: Application for transfer of majority organizational control of C & S Water Company's Certificate No. 510-W in Osceola County from Doug Stewart and the Estate of Jack Chernau to Douglas B. Stewart.

Discussion of Issues

Issue 1: Should the Commission initiate an investigation of O&S Water Company, Inc. for possible overearnings?

Recommendation: Yes. The Commission should initiate an investigation of O&S Water Company, Inc. for possible overearnings. (Fletcher)

Staff Analysis: The Utility's 2009 Annual Report was received on April 26, 2010. Staff's preliminary analysis indicates that O&S' achieved return on equity (ROE) is 19.33 percent, which is in excess of the top of its authorized range of return on equity. The Utility's last authorized ROE was set at 11.51 percent in its last case.² However, as stated in the case background, O&S was transferred in 1991.³ Consistent with Commission practice, the approved ROE does not survive a transfer.⁴ The Utility has an equity ratio of 1.55 percent as a percentage of investor sources of capital. Pursuant to Sections 367.081(4)(f) and 367.082(5)(b)3, F.S., staff used the Commission's current leverage formula to determine the appropriate ROE for purposes of its recommendation to initiate an investigation of possible overearnings. Based on the current Commission leverage formula⁵ and an equity ratio of 1.55 percent, the calculated ROE is 10.85 percent with a range of plus or minus 100 basis points.

² See Order No. 23853, issued December 10, 1990, in Docket No. 900238-WU, In re: Application for staff-assisted rate case in Pasco County by C.S. Water Company, Inc.

³ See Order No. PSC-92-0204-FOF-WU.

⁴ See Order Nos. PSC-07-0325- FOF-WS, issued April 16, 2007, in Docket No. 060368-WS, In re: Application for increase in water and wastewater rates in Alachua, Brevard, Highlands, Lake, Lee, Marion, Orange, Palm Beach, Pasco, Polk, Putnam, Seminole, Sumter, Volusia, and Washington Counties by Aqua Utilities Florida, Inc., PSC-06-0925-PCO-WS, issued November 6, 2006, in Docket No. 060246-WS, In re: Application for increase in water and wastewater rates in Polk County by Gold Coast Utility Corp., and PSC-06-0675-PCO-SU, issued August 7, 2006, in Docket No. 060255-SU, In re: Application for increase in wastewater rates in Pinellas County by Tierra Verde Utilities, Inc.

⁵ See Order Nos. PSC-10-0401-PAA-WS, issued June 18, 2010, and PSC-10-0446-CO-WS, issued July 13, 2010, in Docket No. 100006-WS, In re: Water and wastewater industry annual reestablishment of authorized range of return on common equity for water and wastewater utilities pursuant to Section 367.081(4)(f), F.S.

Issue 2: Should any amount of annual water revenues be held subject to refund?

Recommendation: Yes. O&S should hold the following amount subject to refund. (Fletcher)

	<u>Adjusted Test Year Revenues</u>	<u>\$ Decrease</u>	<u>Subject to Refund</u>
Water	\$1,205,487	(\$76,352)	6.33%

Staff Analysis: As stated in Issue 1, staff believes that O&S may be overearning. Pursuant to Section 367.082(5)(b)(1), (F.S.), 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. The last rate proceeding for O&S was a staff-assisted rate case as memorialized in Order No. 23853.⁶ Based on staff's review of that Order, staff believes no consistency adjustments are necessary for interim purposes. The attached accounting schedules illustrate staff's recommended rate base, capital structure, and test year operating income as shown on Schedules Nos. 1, 2, and 3, respectively.

Pursuant to Rule 25-30.433, Florida Administrative Code (F.A.C.), the averaging method used by the Commission to calculate rate base and the cost of capital for Class A utilities is the 13-month average. The Utility's 2009 Annual Report only reflects O&S's year-end financial data. As such, staff has used the simple average of 2008 and 2009. Rate base for interim purposes, as recommended by staff, is \$645,223.

Consistent with Section 367.082(5)(b), F.S., the required rate of return shall be calculated using the last authorized rate of return on equity and the test year cost rates of other sources of capital. As discussed in Issue 1, O&S was transferred in 1991. Consistent with Commission practice, the ROE does not survive a transfer. Based on the current Commission leverage formula and an equity ratio of 1.55 percent, the calculated ROE is 10.85 percent with a range of plus or minus 100 basis points in accordance with Sections 367.081(4)(f) and 367.082(5)(b)3, F.S.

Pursuant to Section 368.082(2)(b), F.S., in a proceeding for an interim decrease in rates, the Commission shall authorize the continued collection of the previously authorized rates; however, revenues collected under those rates sufficient to reduce the achieved rate of return to the maximum of the rate of return calculated in accordance with subsection (5) shall be attached and held subject to refund. In accordance with Section 368.082(2)(b), F.S., the appropriate ROE for interim purposes is 11.85 percent. Based on staff's recommended rate base, cost of capital, and net operating income, staff believes the following amount should be held subject to refund:

	<u>Adjusted Test Year Revenues</u>	<u>\$ Decrease</u>	<u>Subject to Refund</u>
Water	\$1,205,487	(\$76,352)	6.33%

⁶ Issued December 10, 1990, in Docket No. 900238-WU, In re: Application for staff-assisted rate case in Pasco County by C.S. Water Company, Inc.

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

Recommendation: The Utility should be required to open an escrow account or file a surety bond or letter of credit to guarantee any potential refund of revenues collected under interim conditions. If the security provided is an escrow account, the Utility should deposit \$6,363 into the escrow account each month. Otherwise, the surety bond or letter of credit should be in the amount of \$50,961. Further, an accurate and detailed account of all monies received should be kept by the Utility. By no later than the twentieth (20th) day of each month, the Utility shall file a report showing the amount of revenues collected each month subject to refund. Should a refund be required, the refund should be with interest and undertaken in accordance with Rule 25-30.360, F.A.C. In no instance shall maintenance and administrative costs associated with any refund be borne by the customers. These costs are the responsibility of, and should be borne by, the Utility. (Fletcher)

Staff Analysis: Pursuant to Section 367.082(2)(b), F.S., in the case of an interim decrease, the utility shall be authorized to continue collecting its previously authorized rates provided that the attached revenues held subject to refund are secured. The amount held subject to refund with interest shall be placed under bond, escrow, letter of credit or corporate undertaking pending the Commission's final action in the docket. As recommended in Issue 2, the amount of potential overearnings is \$76,352. Assuming an 8-month time frame, the potential refund amount is \$50,901. The interest component is \$60, bringing the total to \$50,961 that should be held subject to refund with interest.

As stated in the case background, at the October 12, 2010 Agenda Conference, the Commission will consider staff's recommendation in Docket No. 090322-WU to deny O&S' requested payment plan for delinquent RAFs of \$127,789. Normally, a utility may be provided an opportunity to use a corporate undertaking to secure funds held subject to refund. In this case, however, because the amount of delinquent RAFs is more than double the recommend security amount, staff recommends the Utility should be required to open an escrow account or file a surety bond or letter of credit to guarantee any potential refund of revenues collected under interim conditions.

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

The Utility should deposit \$6,363 into the escrow account each month for possible refund. The escrow agreement should also state that if a refund to the customers is required, all

interest earned on the escrow account shall be distributed to the customers, and 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 surety bond or a letter of credit, said instrument should be in the amount of \$50,961. If the Utility chooses a surety bond as security, the surety bond should state that it will be released or terminated only upon subsequent order of the Commission. 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 releasing the funds to the Utility or requiring a refund.

Regardless of the type of security provided, the Utility should keep an accurate and detailed account of all monies it receives. By no later than the twentieth (20th) day of each month, the Utility shall file a report showing the amount of revenues collected each month subject to refund. Should a refund be required, the refund shall be with interest and undertaken in accordance with Rule 25-30.360, F.A.C. Staff also recommends that in no instance shall maintenance and administrative costs associated with any refund be borne by the customers. These costs are the responsibility of, and should be borne by, the Utility.

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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 2009. (Williams, Fletcher)

Staff Analysis: If the Commission approves Issue 1 of this recommendation, this docket should remain open pending staff's investigation of the Utility's earnings for 2009.

O&S Water Company, Inc					Schedule No. 1	
Schedule of Water Rate Base						
Year Ended 12/31/09						
Description	Test Year Per Utility	Utility Adjust- ments	Adjusted Test Year Per Utility	Staff Adjust- ments	Staff Adjusted Test Year	
1 Plant in Service	\$6,211,597	\$0	\$6,211,597	\$0	\$6,211,597	
2 Land and Land Rights	2,100	0	2,100	0	2,100	
3 Non-used and Useful Components	0	0	0	0	0	
4 Accumulated Depreciation	(926,670)	0	(926,670)	0	(926,670)	
5 CIAC	(5,446,330)	0	(5,446,330)	0	(5,446,330)	
6 Amortization of CIAC	684,214	0	684,214	0	684,214	
7 Working Capital Allowance	<u>120,312</u>	<u>0</u>	<u>120,312</u>	<u>0</u>	<u>120,312</u>	
8 Rate Base	<u>\$645,223</u>	<u>\$0</u>	<u>\$645,223</u>	<u>\$0</u>	<u>\$645,223</u>	

O&S Water Company, Inc
Capital Structure-Simple Average
Year Ended 12/31/09

Schedule No. 2

Description	Total Capital	Specific Adjustments	Subtotal Adjusted Capital	Prorata Adjustments	Capital Reconciled to Rate Base	Ratio	Cost Rate	Weighted Cost	
Per Utility									
1 Long-term Debt	\$493,874	\$0	\$493,874	(\$346,408)	\$147,465	22.85%	7.63%	1.74%	
2 Short-term Debt	1,667,033	0	1,667,033	(1,169,275)	497,758	77.15%	8.14%	6.28%	
3 Preferred Stock	0	0	0	0	0	0.00%	0.00%	0.00%	
4 Common Equity	(2,222,857)	2,222,857	0	0	0	0.00%	11.85%	0.00%	
5 Customer Deposits	0	0	0	0	0	0.00%	6.00%	0.00%	
6 Deferred Income Taxes	0	0	0	0	0	0.00%	0.00%	0.00%	
7 Total Capital	<u>(\$61,951)</u>	<u>\$2,222,857</u>	<u>\$2,160,907</u>	<u>(\$1,515,683)</u>	<u>\$645,224</u>	<u>100.00%</u>		<u>8.03%</u>	
Per Staff									
8 Long-term Debt	\$493,874	\$0	\$493,874	(\$346,408)	\$147,465	22.85%	7.63%	1.74%	
9 Short-term Debt	1,667,033	0	1,667,033	(1,169,275)	497,758	77.15%	8.14%	6.28%	
10 Preferred Stock	0	0	0	0	0	0.00%	0.00%	0.00%	
11 Common Equity	(2,222,857)	2,222,857	0	0	0	0.00%	11.85%	0.00%	
12 Customer Deposits	0	0	0	0	0	0.00%	6.00%	0.00%	
13 Deferred Income Taxes	0	0	0	0	0	0.00%	0.00%	0.00%	
14 Total Capital	<u>(\$61,951)</u>	<u>\$2,222,857</u>	<u>\$2,160,907</u>	<u>(\$1,515,683)</u>	<u>\$645,224</u>	<u>100.00%</u>		<u>8.03%</u>	
						LOW	HIGH		
RETURN ON EQUITY						<u>9.85%</u>	<u>11.85%</u>		
OVERALL RATE OF RETURN						<u>8.03%</u>	<u>8.03%</u>		

O&S Water Company, Inc.							Schedule No. 3	
Statement of Water Operations								
Year Ended 12/31/09								
Description	Test Year Per Utility	Utility Adjust- ments	Adjusted Test Year Per Utility	Staff Adjust- ments	Staff Adjusted Test Year	Revenue Increase	Revenue Requirement	
1 Operating Revenues:	<u>\$1,205,487</u>	<u>\$0</u>	<u>\$1,205,487</u>	<u>\$0</u>	<u>\$1,205,487</u>	<u>(\$76,352)</u> -6.33%	<u>\$1,129,135</u>	
Operating Expenses								
2 Operation & Maintenance	\$908,087	\$0	\$908,087	\$0	\$908,087		\$908,087	
3 Depreciation	175,165	0	175,165	0	175,165		16,284	
4 Amortization	(158,881)	0	(158,881)	0	(158,881)		0	
5 Taxes Other Than Income	156,419	0	156,419	0	156,419	(3,436)	152,983	
6 Income Taxes	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	
7 Total Operating Expense	<u>\$1,080,790</u>	<u>\$0</u>	<u>\$1,080,790</u>	<u>\$0</u>	<u>\$1,080,790</u>	<u>(\$3,436)</u>	<u>\$1,077,354</u>	
8 Operating Income	<u>\$124,697</u>	<u>\$0</u>	<u>\$124,697</u>	<u>\$0</u>	<u>\$124,697</u>	<u>(\$72,917)</u>	<u>\$51,780</u>	
9 Rate Base	<u>\$645,223</u>		<u>\$645,223</u>		<u>\$645,223</u>		<u>\$645,223</u>	
10 Rate of Return	<u>19.33%</u>		<u>19.33%</u>		<u>19.33%</u>		<u>8.03%</u>	