

State of Florida



Public Service Commission

CAPITAL CIRCLE OFFICE CENTER • 2540 SHUMARD OAK BOULEVARD
TALLAHASSEE, FLORIDA 32399-0850

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

DATE: November 16, 2010

TO: Office of Commission Clerk (Cole)

FROM: Division of Economic Regulation (Fletcher, Bays, Cicchetti, Donoho, Maurey, Slemkewicz)
Office of the General Counsel (Young) *BF JRB MC JS ALM @*

RE: Docket No. 100126-WU – Application for increase in water rates in Marion County by C.F.A.T. H20, Inc. *ALM JSC*

AGENDA: 11/30/10 – Regular Agenda – Decision on Interim Rates – Participation is at the Discretion of the Commission

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Brisé

CRITICAL DATES: 11/30/10 (60-Day Suspension Date – As Extended by the Utility)

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\100126.RCM.DOC

DOCUMENT NUMBER DATE

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FPSC-COMMISSION CLERK

Case Background

CFAT H2O, Inc. (CFAT or Utility) is a Class C utility providing water service to approximately 221 water customers in Marion County. CFAT is in a water use caution area of the St. Johns River Water Management District. Water rate base was last established for the Utility in 1994.¹

On September 28, 2010, CFAT filed its application for rate increase at issue in the instant docket. The Utility had several deficiencies in the Minimum Filing Requirements (MFRs). As of the filing of this recommendation, those deficiencies remain outstanding. Although the MFRs are deficient, the Commission must address CFAT's interim request within 60 days of the date of filing such request by statute. The Utility requested that the application be processed using the Proposed Agency Action (PAA) procedure and requested interim rates. The test year established for interim and final rates is the simple average period ended December 31, 2009.

CFAT requested interim rates designed to generate annual water revenues of \$89,429. This represents a revenue increase on an annual basis of \$45,850 (105.21 percent). The Utility requested final rates designed to generate annual water revenues of \$95,079. This represents a revenue increase of \$51,500 (118.18 percent).

The original 60-day statutory deadline for the Commission to suspend the Utility's requested final rates is November 27, 2010. However, by letter dated November 3, 2010, the Utility agreed to extend the statutory time frame through November 30, 2010. This recommendation addresses the suspension of CFAT's requested final rates and the Utility's requested interim rates. The Commission has jurisdiction pursuant to Sections 367.081 and 367.082, Florida Statutes (F.S.).

¹ See Order No. PSC-94-0701-FOF-WS, issued June 8, 1994, in Docket No. 931080-WS, In re: Application for transfer of Certificate Nos. 552-W and 481-S in Marion County from THE RESOLUTION TRUST CORPORATION to C.F.A.T. H2O, Inc. (While rate base was established in this Order, an authorized return on equity was not set for the Utility.)

Discussion of Issues

Issue 1: Should the Utility's proposed final water rates be suspended?

Recommendation: Yes. CFAT's proposed final water rates should be suspended. (Fletcher)

Staff Analysis: Section 367.081(6), F.S., provides that the Commission may, for good cause, withhold consent of the implementation of the requested rates within 60 days after the date the rate request is filed. Further, Section 367.081(8), F.S., permits the proposed rates to go into effect (secured and subject to refund) at the expiration of five months from the official date of filing if: (1) the Commission has not acted upon the requested rate increase; or (2) if the Commission's PAA action is protested by a party other than the Utility.

Staff has reviewed the filing and has considered the information filed in support of the rate application and the proposed final rates. Staff recommends that it is necessary to require further investigation of this information, including on-site investigations by staff accountants and engineers. Based on the foregoing, staff recommends suspension of the Utility's proposed rate increase.

Issue 2: Should an interim revenue increase be approved?

Recommendation: Yes, CFAT should be authorized to collect annual water revenues as indicated below:

	<u>Adjusted Test Year Revenues</u>	<u>\$ Increase</u>	<u>Revenue Requirement</u>	<u>% Increase</u>
Water	\$44,090	\$42,792	\$86,882	97.06%

(Fletcher)

Staff Analysis: On September 28, 2010, CFAT filed its rate base, cost of capital, and operating statements to support its requested interim increase in water rates. Pursuant to Section 367.082(1), F.S., in order to establish a prima facie entitlement for interim relief, the Utility shall demonstrate that it is earning outside the range of reasonableness on its rate of return. Pursuant to Section 367.081(2)(a), F.S., in a proceeding for an interim increase in rates, the Commission shall authorize, within 60 days of the filing for such relief, the collection of rates sufficient to earn the minimum of the range of rate of return. Based on the Utility's filing and the recommended adjustments below, staff believes that the Utility has demonstrated a prima facie entitlement in accordance with Section 367.082(1), F.S.

Pursuant to Section 367.082(5)(b)1, F.S., the achieved rate of return for interim purposes must be calculated by applying adjustments consistent with adjustments made in the Utility's most recent rate proceeding and annualizing any rate changes. Staff has reviewed CFAT's interim request, as well as Order No. PSC-94-0701-FOF-WS, in which the Commission last established rate base. Staff's recommended adjustments are discussed below. Staff has attached accounting schedules to illustrate staff's recommended rate base, capital structure, and test year operating income amounts. Rate base is labeled as Schedule No. 1-A. Capital structure is labeled as Schedule No. 2. Operating income is labeled as Schedule No. 3-A, with adjustments shown on Schedule No. 3-B.

RATE BASE

In accordance with Rule 25-30.433(2), Florida Administrative Code (F.A.C.), the Utility calculated its working capital allowance based on the formula method, which is one-eighth of operation and maintenance (O&M) expenses. As discussed below, staff is recommending O&M expense reductions of \$3,652. As such, staff recommends that CFAT's working capital allowance be reduced by \$452. Therefore, staff recommends that CFAT's rate base for purposes of determining interim rates should be \$374,815.

COST OF CAPITAL

For purposes of its interim request, CFAT used a return on equity (ROE) of 10.85 percent. Because the Commission has not previously set an ROE for CFAT, the Utility's use of the Commission's current leverage formula is appropriate pursuant to Sections 367.081(4)(f) and 367.082(5)(b)3, F.S. However, pursuant to Section 367.082(2)(a), F.S., the appropriate ROE

for purposes of determining an interim rate increase is the minimum of the ROE range. The Utility's 10.85 percent ROE represents a mid-point.² Based on the current Commission leverage formula³ and an equity ratio of 24.69 percent, the indicated ROE is 10.85 percent. With a range of plus or minus 100 basis points, the appropriate ROE for purposes of determining interim rates is 9.85 percent and the resulting overall cost of capital is 6.07 percent.

NET OPERATING INCOME

Pursuant to Section 367.082(5)(b)1, F.S., the only adjustments that should be made to the interim test year are adjustments consistent with the most recent individual rate proceeding or adjustments to annualize rate changes occurring during the interim test year. Based on its review, staff recommends an adjustment to operating revenues. Staff has increased operating revenues by \$511 to reflect the appropriate amount of annualized revenues.

Additionally, staff recommends an adjustment to operating expenses. CFAT included adjustments to increase water expenses by \$1,763 for salaries, \$360 for healthcare costs, and \$1,529 for bad debt expense. Staff believes the Utility's proposed adjustments are pro forma because they are outside the interim test year. As such, staff recommends that CFAT's pro forma expense adjustments be removed from the interim net operating income calculation.

Based on the above, staff recommends that the appropriate test year operating loss, before any revenue increase, is \$18,124.

REVENUE REQUIREMENT

Based on the above adjustments, staff recommends a revenue requirement of \$86,882. This represents an interim increase in annual revenues of \$42,792 (or 97.06 percent). This increase will allow the Utility the opportunity to recover its operating expenses and earn a 6.07 percent return on its rate base.

² Using the 10.85 percent mid-point ROE resulted in a requested interim overall cost of capital of 6.28 percent.

³ 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 3: What are the appropriate interim water rates?

Recommendation: The water service rates for CFAT in effect as of December 31, 2009, should be increased by 97.06 percent, to generate the recommended revenue increase for the interim period. The approved rates should be effective for service rendered as of the stamped approval date on the tariff sheets pursuant to Rule 25-30.475(1)(a), F.A.C. The rates should not be implemented until staff verifies that the tariff sheets are consistent with the Commission's decision, the proposed customer notice is adequate, and the required security has been filed. The Utility should provide proof of the date notice was given within 10 days after the date of notice. (Fletcher)

Staff Analysis: Staff recommends that interim water service rates for CFAT be designed to allow the Utility the opportunity to generate annual operating revenues of \$86,882. Before removal of miscellaneous revenues, this would result in an increase of \$42,792 or 97.06 percent. To determine the appropriate percentage increase to apply to the service rates, miscellaneous service revenues should be removed from the test year revenues. However, because the Utility does not have any miscellaneous service revenues, the percentage increase does not change. The calculation is as follows:

Water		
1	Total Test Year Revenues	\$44,090
2	Less: Miscellaneous Revenues	<u>0</u>
3	Test Year Revenues from Service Rates	<u>\$44,090</u>
4	Revenue Increase	\$42,792
5	% Service Rate Increase (Line 4/Line3)	<u>97.06%</u>

The interim rate increase of 97.06 percent should be applied as an across-the-board increase to the service rates in effect as of December 31, 2009. The approved rates should be effective for service rendered as of the stamped approval date on the tariff sheets pursuant to Rule 25-30.475(1), F.A.C. The rates should not be implemented until staff verifies that the tariff sheets are consistent with the Commission's decision, the proposed customer notice is adequate, and the required security has been filed. The Utility should provide proof of the date notice was given within 10 days after the date of notice.

The Utility's current rates, proposed interim and final rates, and staff's recommended interim rates are shown on Schedule No. 4.

Issue 4: What is the appropriate security to guarantee the interim increase?

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 shall deposit 97.06 percent of water revenues into the escrow account each month. Otherwise, the surety bond or letter of credit should be in the amount of \$24,980. Pursuant to Rule 25-30.360(6), F.A.C., the Utility should provide a report by the 20th 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 in accordance with Rule 25-30.360, F.A.C. (Fletcher, Buys)

Staff Analysis: Pursuant to Section 367.082, F.S., revenues collected under interim rates shall be placed under bond, escrow, letter of credit, or corporate undertaking subject to refund with interest at a rate ordered by the Commission. As recommended in Issue 2, the total annual interim increase is \$42,792. In accordance with Rule 25-30.360, F.A.C., staff has calculated the potential refund of revenues and interest collected under interim conditions to be \$24,980. This amount is based on an estimated seven months of revenue being collected from staff's recommended interim rates over the Utility's current authorized rates shown on Schedule No. 4.

The criteria for a corporate undertaking include sufficient liquidity, ownership equity, profitability, and interest coverage to guarantee any potential refund. Staff reviewed CFAT's 2007, 2008 and 2009 financial statements to determine the financial condition of the Utility. CFAT has inadequate liquidity, profitability, ownership equity, and interest coverage to guarantee any potential refund. Based on this analysis, staff recommends that CFAT be required to secure a surety bond, letter of credit, or escrow agreement to guarantee any potential refunds of water revenues. 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 proceeding.

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 should occur without the prior approval of the Commission through the Office of Commission Clerk; the account should be interest bearing; information concerning that escrow account should be available from the institution to the Commission or its representative at all times; the amount of revenue subject to refund should 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.

If the security provided is an escrow account, the Utility shall deposit 97.06 percent of water revenues into the escrow account each month. The escrow agreement should also state that if a refund to the customers is required, all interest earned on the escrow account should be distributed to the customers, and if a refund to the customers is not required, the interest earned on the escrow account should 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 \$24,980. 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. Pursuant to Rule 25-30.360(6), F.A.C., the Utility shall 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, F.A.C.

In no instance should maintenance and administrative costs associated with any refund be borne by the customers. Such costs are the responsibility of, and should be borne by, the Utility.

Docket No. 100126-WU
Date: November 16, 2010

Issue 5: Should this docket be closed?

Recommendation: No. The docket should remain open pending the Commission's PAA decision on the Utility's requested rate increase. (Fletcher, Young)

Staff Analysis: The docket should remain open pending the Commission's PAA decision on the Utility's requested rate increase.

CFAT H2O, Inc. Schedule of Water Rate Base Test Year Ended 12/31/09			Schedule No. 1-A Docket No. 100126-WS		
Description	Test Year Per Utility	Utility Adjust- ments	Adjusted Test Year Per Utility	Staff Adjust- ments	Staff Adjusted Test Year
1 Plant in Service	\$537,632	\$0	\$537,632	\$0	\$537,632
2 Land and Land Rights	19,500	0	19,500	0	19,500
3 Accumulated Depreciation	(127,972)	0	(127,972)	0	(127,972)
4 CIAC	(114,421)	0	(114,421)	0	(114,421)
5 Amortization of CIAC	55,292	0	55,292	0	55,292
6 Acquisition Adjustments	46,269	(46,269)	0	0	0
7 Working Capital Allowance	<u>0</u>	<u>5,236</u>	<u>5,236</u>	<u>(452)</u>	<u>4,784</u>
8 Rate Base	<u>\$416,300</u>	<u>(\$41,033)</u>	<u>\$375,267</u>	<u>(\$452)</u>	<u>\$374,815</u>

CFAT H2O, Inc.
 Capital Structure-Simple Average
 Test Year Ended 12/31/09

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	\$388,880	\$0	\$388,880	(\$115,867)	\$273,013	65.96%	5.69%	3.75%	
2 Short-term Debt	0	0	0	0	0	0.00%	0.00%	0.00%	
3 Preferred Stock	0	0	0	0	0	0.00%	0.00%	0.00%	
4 Common Equity	127,483	0	127,483	(37,984)	89,499	21.62%	10.85%	2.35%	
5 Customer Deposits	18,167	0	18,167	(5,413)	12,754	3.08%	6.00%	0.18%	
6 Deferred Income Taxes	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0.00%</u>	0.00%	<u>0.00%</u>	
7 Total Capital	<u>\$534,530</u>	<u>\$0</u>	<u>\$534,530</u>	<u>(\$159,264)</u>	<u>\$375,266</u>	<u>90.66%</u>		<u>6.28%</u>	
Per Staff									
8 Long-term Debt	\$388,880	\$0	\$388,880	(\$116,195)	\$272,685	65.96%	5.69%	3.75%	
9 Short-term Debt	0	0	0	0	0	0.00%	0.00%	0.00%	
10 Preferred Stock	0	0	0	0	0	0.00%	0.00%	0.00%	
11 Common Equity	127,483	0	127,483	(38,091)	89,392	21.62%	9.85%	2.13%	
12 Customer Deposits	18,167	0	18,167	(5,428)	12,739	3.08%	6.00%	0.18%	
13 Deferred Income Taxes	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0</u>	<u>0.00%</u>	0.00%	<u>0.00%</u>	
14 Total Capital	<u>\$534,530</u>	<u>\$0</u>	<u>\$534,530</u>	<u>(\$159,714)</u>	<u>\$374,816</u>	<u>90.66%</u>		<u>6.07%</u>	
						LOW	HIGH		
RETURN ON EQUITY						<u>9.85%</u>	<u>11.85%</u>		
OVERALL RATE OF RETURN						<u>6.07%</u>	<u>6.50%</u>		

CFAT H2O, Inc. Statement of Water Operations Test Year Ended 12/31/09						Schedule No. 3-A Docket No. 100126-WS	
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>\$43,579</u>	<u>\$45,850</u>	<u>\$89,429</u>	<u>(\$45,339)</u>	<u>\$44,090</u>	<u>\$42,792</u> 97.06%	<u>\$86,882</u>
Operating Expenses							
2 Operation & Maintenance	\$38,235	\$3,688	\$41,923	(\$3,652)	\$38,271		\$38,271
3 Depreciation	18,923	0	18,923	0	18,923		18,923
4 Amortization	0	0	0	0	0		0
5 Taxes Other Than Income	2,957	2,063	5,020	0	5,020	1,926	6,946
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>\$60,115</u>	<u>\$5,751</u>	<u>\$65,866</u>	<u>(\$3,652)</u>	<u>\$62,214</u>	<u>\$1,926</u>	<u>\$64,140</u>
8 Operating Income	<u>(\$16,536)</u>	<u>\$40,099</u>	<u>\$23,563</u>	<u>(\$41,687)</u>	<u>(\$18,124)</u>	<u>\$40,866</u>	<u>\$22,742</u>
9 Rate Base	<u>\$416,300</u>		<u>\$375,267</u>		<u>\$374,815</u>		<u>\$374,815</u>
10 Rate of Return	<u>(3.97%)</u>		<u>6.28%</u>		<u>(4.84%)</u>		<u>6.07%</u>

CFAT H2O, Inc. Adjustment to Operating Income Test Year Ended 12/31/09		Schedule No. 3-B Docket No. 100126-WS
Explanation	Water	
<u>Operating Revenues</u>		
1	Remove requested final revenue increase	(\$45,850)
2	To reflect the appropriate amount of annualized revenues.	<u>511</u>
	Total	<u>(\$45,339)</u>
<u>Operation and Maintenance Expense</u>		
1	Remove pro forma salaries.	(\$1,763)
2	Remove pro forma healthcare costs.	(360)
3	Remove pro forma bad debt expense.	<u>(1,529)</u>
4	Total	<u>(\$3,652)</u>
<u>Taxes Other Than Income</u>		
	RAFs on revenue adjustments above	<u>(\$2,040)</u>

CFAT H2O, Inc.		Schedule No. 4		
Water Monthly Service Rates		Docket No. 100126-WS		
Test Year Ended 12/31/09				
	Rates Prior to Filing	Utility Requested Interim	Utility Requested Final	Staff Recomm. Interim
<u>Residential Service</u>				
Base Facility Charge by Meter Size:				
5/8" x 3/4"	\$9.97	\$20.23	\$21.48	\$19.65
Gallonage Charge, per 1,000 Gallons	\$1.63	\$3.30	\$3.51	\$3.21
<u>General Service</u>				
5/8" x 3/4"	\$9.97	\$20.23	\$21.48	\$19.65
1"	\$24.93	\$50.88	\$53.77	\$49.13
1-1/2"	\$49.86	\$101.15	\$107.42	\$98.25
2"	\$79.78	\$161.84	\$171.89	\$157.21
3"	\$159.58	\$323.72	\$343.80	\$314.46
4"	\$249.33	\$492.13	\$519.73	\$491.32
Gallonage Charge, per 1,000 Gallons	\$1.63	\$3.30	\$3.51	\$3.21
<u>Typical Residential Bills 5/8" x 3/4" Meter</u>				
3,000 Gallons	\$14.86	\$30.13	\$32.01	\$29.28
5,000 Gallons	\$18.12	\$36.73	\$39.03	\$35.71
10,000 Gallons	\$26.27	\$53.23	\$56.58	\$51.77