

M E M O R A N D U M

April 30, 1996

TO: DIVISION OF RECORDS AND REPORTING

FROM: DIVISION OF AUDITING AND FINANCIAL ANALYSIS (VANDIVER) *d*

RE: DOCKET NO. 951056-WS -- PALM COAST UTILITY CORPORATION
RATE CASE AUDIT REPORT - PERIOD ENDED JUNE 30, 1995
AUDIT CONTROL NO. AUDIT CONTROL #96-037-3-1

The above-referenced audit report is forwarded. Audit exceptions document deviations from the Uniform System of Accounts, Commission rule or order, Staff Accounting Bulletin and generally accepted accounting principles. Audit disclosures show information that may influence the decision process.

The audit was prepared using a micro computer and has been recorded on one diskette. The diskette may be reviewed using IBM compatible equipment and LOTUS 1-2-3 software. There are no confidential working papers associated with this audit.

Please forward a complete copy of this report to:

Palm Coast Utility Corporation
James A Perry
2 Utility Drive
Palm Coast, FL 32137-7392

DNV/sp

Attachment

cc: Chairman Clark
Commissioner Deason
Commissioner Johnson
Commissioner Kiesling
Commissioner Garcia
Mary Andrews Bane, Deputy Executive Director/Technical
Legal Services
Division of Auditing and Financial Analysis (Devlin/Causseaux/
File Folder)
Division of Water and Wastewater (Moniz)
Orlando District Office (Dodrill)

Research and Regulatory Review (Harvey)
Office of Public Counsel

DOCUMENT NUMBER-DATE
04922 MAY-1 88
FPSC-RECORDS/REPORTING

121

Florida Public Service Commission

Audit Report

Test Year End

December 31, 1995

Field Work Completed

April 23, 1996

Palm Coast Utility Corporation

Palm Coast, Florida

Flagler County

Rate Case

Docket Number 951056-WS

Audit Control Number 96-037-3-1

Robert F. Dodrill Sr.

Robert F. Dodrill Sr.
Audit Manager

Audit Staff

Orrett L. Douse
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Minority Opinion

Yes _____ No Yes
Yes _____ No Yes

Ian J. Forbes

Ian J. Forbes
Regulatory Analyst Supervisor
Orlando District Office

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I. Executive Summary

AUDIT PURPOSE: We have applied the procedures described in Section II of this report to the appended exhibits as filed by Palm Coast Utility Corporation to support the Rate Case Docket Number 951056-WS for the actual six-month and projected six-month period ending December 31, 1995. Also, the Company's books and records were examined to determine compliance with Commission directives and to disclose any transactions or events that may influence Commission decision.

SCOPE LIMITATION: There were no scope limitations in the field work of this audit.

There are no confidential work papers associated with this report.

The last day of field work was April 23, 1996.

DISCLAIM PUBLIC USE: This is an internal accounting report prepared after performing a limited scope audit; accordingly, this document must not be relied upon for any purpose except to assist the Commission staff in the performance of their duties. Substantial additional work would have to be performed to satisfy generally accepted auditing standards and produce audited financial statements for public use.

OPINION: Subject to the procedures described in Section II, the Company books and records for the actual and projected test year ending December 31, 1995, are maintained in substantial compliance with Commission directives.

SUMMARY FINDINGS:

Exceptions:

1. RIB Land Cost Valuation
2. Misclassified Improvement Costs
3. Capitalized Rehabilitation Projects
4. Operation and Maintenance Expenses
5. Water Sold for Resale

Disclosures:

1. Sprayfield Land Cost Reconsideration
2. Effluent to Dunes Development District
3. Operating Revenues
4. Rate Case Expense Over-Recovery
5. Reuse Plant

II. Audit Scope

The opinions contained in this report are based on the audit work described below. When used in this report, **Compiled** means that audit work includes:

COMPILED - means that the audit staff reconciled exhibit amounts with the general ledger; visually scanned accounts for error or inconsistency; disclosed any unresolved error, irregularity, or inconsistency; and except as otherwise noted, performed no other audit work.

EXAMINED - means that the audit staff reconciled exhibit amounts to the general ledger; traced general ledger account balances to subsidiary ledgers; applied selective analytical review procedures; tested account balances to the extent further described; and disclosed any error, irregularity, or inconsistency observed.

RATE BASE

PLANNING: Calculated Palm Coast Rate Base and NOI Materiality levels. Completed Audit Risk Profile. Read previous audit workpapers and the resulting FPSC orders. Read previous FPSC orders and noted issues impacting the current docket. Read General Ledger Account descriptions.

UTILITY PLANT IN SERVICE: Scheduled both water and sewer year-end plant balances from the annual reports from 1989 through 1994.

LAND ADDITION: Compiled land additions from FPSC Annual Reports and traced to utility schedule of land additions since last Rate Case. Read vouchers for land purchases. Requested appraisals used for land valuation. Visited Flagler County Courthouse to verify land ownership and to obtain original cost documents.

Examined land valuation documents and recalculated original cost to utility group of corporations.

CONSTRUCTION WORK IN PROGRESS: Scheduled Material project balances from inception to closing to plant.

AFUDC: Judgementally sampled two closed out CWIP projects where the Company recorded AFUDC. Recalculated AFUDC per Commission guidelines using the Company's last approved AFUDC rate.

ACCUMULATED DEPRECIATION AND DEPRECIATION EXPENSE: Requested that Company provide Accumulated Depreciation Build-Up schedules for Water and Sewer.

CIAC (CONTRIBUTIONS-IN-AID-OF-CONSTRUCTION) AND AMORTIZATION: Requested that Utility provide a mapping of General Ledger CIAC accounts to the MFRs. Faxed PCUC - Hammock Dunes Tax Escrow Agreement to FPSC Tax Section for its review.

NET OPERATING INCOME

REVENUES: Requested monthly revenue schedule by revenue subaccount. Recomputed the revenues for the year ended December 31, 1995. Recomputed a sample of customer bills per the Utility's authorized tariffs.

OPERATIONS AND MAINTENANCE EXPENSES: Scheduled yearly expense balances from annual reports from 1989 onward for analytical review purposes. Compiled operations and maintenance accounts and determined that the accounts are accumulated and classified in accordance with Commission Rules and the Uniform System of Accounts.

Sampled operation and maintenance expenses for timeliness, accuracy, correct classification, documentation and utility relatedness. Documented actual rate case expense incurred as of the end of field work.

TAXES OTHER THAN INCOME: Compiled the Taxes Other Than Income for 1995. Examined all items in the account for the proper amount, period and classification.

COST OF CAPITAL: Compiled and scheduled the capital structure components presented using both the Company's and the parent's balances for comparison purposes. Traced the Company's debt components to the related debt instruments and determined the correct rates. Obtained a company representation concerning customer deposits.

REUSE SCHEDULES: Scanned Reuse Plant in Service - Table C in the filed Palm Coast Effluent Reuse Rate Analysis. Traced Sewer rate base balances to the MFRs.

OTHER

OUTSIDE AUDITORS' REPORT: Read copies of Arthur Anderson's 1995 Audit Workpapers noting issues for current and future FPSC Audits.

BOARD OF DIRECTORS' MINUTES: Read 1990 to 1994 BOD Consent Documents provided by PCUC.

AUDIT EXCEPTION NO. 1

SUBJECT: Noncompliance with NARUC Accounting Instruction #18.
Utility Plant - To be Recorded at Cost

FACTS:

1. Rule 25-30.115 F.A.C., requires water and sewer utilities to maintain their books and records in conformity with the 1984 NARUC Uniform System of Accounts (US of A) adopted by the National Association of Regulatory Utility Commissioners.
2. Palm Coast Utility Corporation, Inc. is a Class A Utility according to the NARUC definition found in Accounting Instruction 1.
3. The 1984 NARUC Class A Sewer Description of Account Number 101 Utility Plant in Service Paragraph B states, "This account shall include the original cost of utility plant, included in the plant accounts prescribed herein...." with "original cost" being defined at definition number 20 on page 9 as: . . . the cost of such property to the person first devoting it to public service.
4. Furthermore, Definition Number 21 defines "Person" as:

 . . . an individual, a corporation, a partnership an association, a joint stock company, a business trust or any organized group of persons whether incorporated or not, or any receiver or trustee.
5. Palm Coast Utility Corporation is and has been affiliated with ITT Incorporated as is ITT Community Development Corporation. This ITT family of corporations including ITT Land Development and others have been buying and developing land in Flagler County since the 1960s.

Audit Exception No. One (cont'd.)

6. Palm Coast Utility Corporation made two purchases of land from ITT Community Development Corporation near its existing effluent spray field - one purchase on July 12, 1991 of 81.576 acres of RIB Site Land for \$530,000 and a smaller on purchase on January 24, 1995 of 4.601 acres of buffer for \$30,136.95.

7. The Rapid Infiltration Basin (RIB) Land Site purchases are related party transactions per FASB No. 57 definition and as such, deserve additional scrutiny.

OPINION:

The ITT Group of Corporations is the "Person" who first devoted the land to Utility Service. This ITT Group of Corporations develops communities and sells land to individuals and corporations and is required by law to provide water and wastewater service. The fact that ITT set up ITT Land Development, ITT Community Development Corporation, ITT Community Construction Company and Palm Coast Utility Corporation is no reason why the Utility customer should end up paying a return on remote undeveloped land valued in excess of \$6,000 per acre.

Within this exception, the auditor plans to accomplish the following objectives.

To: Review the facts within the appraisal of the RIB Site Land.

Determine an Original Cost of the RIB Site land to the ITT Group of Corporations.

Disclose a current ITT sale at a negotiated price to a third party for land within the RIB Site neighborhood.

Establish an index which trends the original cost to the above recent sale price per acre.

And finally, revalue the RIB Site land at a trended original cost.

Audit Exception No. One (cont'd.)

HISTORY

Palm Coast Utility Corporation has been using appraisals to value its land acquisitions from ITT Corporations since its first appraisal dated May 1, 1981. In the absence of other information, the appraisals have been accepted as reasonable. Palm Coast Order No. 22843 stated that, "A review of the prior orders indicates a preference to use independent appraisals when those reports provide reasonable land values."

THE APPRAISAL

Currently, Palm Coast (the Utility) is using an appraisal to place a \$530,000 value on land that it is using as an effluent holding site. This RIB Site is located just south of and adjacent to the Utility effluent spray field. The site is also located adjacent to the Department of Environmental Protection designated wetlands of the Graham Swamp. \$530,000 for 81.576 acres equates to \$6,497 per acre.

Under the NEIGHBORHOOD DATA DISCUSSION: the appraisal states:

The subject neighborhood is located in the east-central portion of Flagler County. The neighborhood boundaries can be described as being the Palm Coast Parkway East on the North, SR-100 on the south, I-95 on the West and the Intercostal Waterway on the East.

The neighborhood is largely undeveloped, with few roadways traversing the area The neighborhood is predominantly rural in nature, with a large portion devoted to silviculture (tree farming) uses or swamp-land.

Audit Exception No. One (cont'd.)

Under LAND VALUE DISCUSSION: section, the appraisal states:

The subject parcel is unique in that one corporation owns the majority of the land within the immediate area. This landowner (ITT or its subsidiary) typically has not sold their holdings (except intercorporate transactions) during the time period associated with this appraisal assignment. For this reason, sales of similar properties in the immediate area are very limited. We therefore expanded our sales search to include areas outside the immediate neighborhood. The following sales were found and, though they differ from the subject as to various characteristics, they are considered the most comparable and indicative of value for the subject parcel.

Audit Exception No. One (cont'd.)

The appraisal used four transactions as comparables and the four are listed below with the highest and best use listed for each.

<u>PARCEL</u>	<u>HIGHEST AND BEST USE</u>
Karbowski Property	Commercial Development
McCormick Property	Commercial and Residential Development
Flagler County Property	Residential Development
School Board Property	Residential Development
ITT Subject Property	Speculative-Investment for future potential residential development

A comparison of parcel locations follows.

<u>PARCEL</u>	<u>Property Location</u>
Karbowski Property	542 feet of Frontage on SR 100 between Bunnell and the Flagler County Airport
McCormick Property	750 feet of Frontage on SR 100 across from Flagler County Airport
Flagler County Property	Southeast corner of SR-11 and Old Haw Creek Road, Bunnell, FL
School Board Property	Old Kings Road Frontage just south of SR-100 intersection
ITT Subject Property	Approximately 600 feet (on a 100 foot access easement) east of Old Kings Road, approximately two miles south of Palm Coast Parkway along Old Kings Road.

Audit Exception No. One (cont'd.)

Lastly, A comparison of proximity to utilities was made.

<u>PARCEL</u>	<u>Utility Proximity</u>
Karbowski Property	Electricity and Telephone Available Water and Sewer mains along SR-100
McCormick Property	Electricity and Telephone Nearby Water and Sewer mains along SR-100
Flagler County Property	Municipal Service Available to Site Extension and lift Station may be required.
School Board Property	Utilities were extended from SR-100 South to the property.
ITT Subject Property	Water and Sewer service are not presently extended to the subject parcel but are available approximately 1.5 miles north.

Under UTILITIES DISCUSSION, the appraisal states:

According to Robert Kelly, Palm Coast Utility Corporation, the cost of expanding water service to the subject is approximately \$223,000 plus the necessary tax gross-up of \$105,000 for a total of \$328,000. The cost of installing a sewer lift station would be approximately \$72,000 plus tax gross-up of \$34,000 for a total of \$106,000.

The appraisal did not mention the fact that the subject parcel was just south of and contiguous with land already designated as and operating as a Palm Coast Sewer effluent spray field.

Audit Exception No. One (cont'd.)

ORIGINAL COST OF LAND TO ITT GROUP

A preliminary visit to the Flagler County Courthouse was made, and it was determined that the original cost to the ITT Group would be fairly easy to obtain. It was determined from the Utility that the RIB Site 2 was located in parts of Sections 20, 29 and 52 of Township 11 South and Range 31 East.

A review of the County Tax Roll books from 1965 through 1969 indicated that all the land in these sections east of Old Kings Road was owned by Lehigh Portland Concrete Company. Beginning in 1969 an ITT Corporation "Ray-Florida Company" was the owner of record. The General Index to Official Records of Flagler County for 1968 indicated that Lehigh Portland transferred the land to Ray-Florida by way of a Warranty Deed filed December 23, 1968.

The Lehigh Portland - Ray Florida Warranty Deed was obtained, and the acreage and the sales price were extracted from the parcel descriptions and the document stamps, respectively. The per acre purchase price of \$340.76 or \$341 was calculated.

FLAGLER COUNTY APPRAISER

While one audit staff member was in the Flagler County Courthouse verifying the comparables in the RIB Site appraisal, he met the Flagler County Appraiser, Mr. Guy W. Sapp. After explaining the purpose of the audit and showing Mr. Sapp the Appraisal, Mr. Sapp had the following statement.

Those parcels listed in the appraisal are not comparable to the Sprayfield Site. (RIB Site) In fact, two of them are "DQ" which means Disqualifications as comparables for appraisal purposes because they are SALES TO GOVERNMENTAL AUTHORITIES. They are not true arm's-length sales and are never considered by county appraisers.

When a member of the audit staff mentioned that he was not an appraiser but was just reviewing the facts, Mr. Sapp said that, "You don't have to be an appraiser to see that these are not comparable pieces of property." Mr Sapp went on to say:

Audit Exception No One (cont'd.)

If you want to see a real comparable piece of property, ITT just sold some property less than a mile down the road from the Sprayfield (RIB Site) to a Michigan Corporation. This site is larger than the (RIB Site) but it has frontage on both SR-100 and on both sides of Old Kings Road which should make it more valuable on the whole. This was a true third-party sale with a negotiated price. We (the appraiser's office) have just been working up the descriptions for the books.

Mr. Sapp then asked a representative in his office to make a copy of the paperwork for me and to calculate the cost per acre. This March 7th 1996 Sale of Property in the RIB Site Neighborhood sold for \$2,390 per acre.

This ITT Sale to a Michigan Corporation (Con-Cor) was within the neighborhood boundaries described by the RIB Site Appraisal. It also is included within the land that the ITT Group purchased from Lehigh Portland Concrete, that is, the \$341 per acre land described on the previous page.

INDEXING THE ORIGINAL COST

At this point, the original \$341 an acre for the RIB Site Land was indexed up to a more current and reasonable cost per acre. Initially, to get a base line indicator, The Wall Street Journal Consumer Price Index was applied to the original cost. This Consumer Price Index yielded a per acre price less than the current ITT Sale and twice that CPI index produced a price much too high per acre. (See Schedule attached.)

Staff varied the index rate applied to the original \$341 per acre until an annual compounding rate of 7.43% yielded almost exactly the \$2,390 per acre sale price of the March 1996, ITT to Con-Cor land sale. (See Schedule attached.)

Audit Exception No. One (cont'd.)

REVALUATION OF THE RIB SITE LAND PURCHASES

Staff recommends that the \$6,497 per AC price paid for the RIB Site should be revalued to reflect a trended original cost per acre of \$1,771.48. The original trended cost for the whole 81.576 acres equals \$144,510.

The additional 4.6013 acres which was purchased to provide a wetlands buffer was purchased in 1995 for \$30.136.95 or \$6,551 per acre which should also be revalued. The trended original cost per acre in 1995 (see Schedule page 16) of \$2,359 for the 4.6013 acres of buffer strip totals \$10,857.

The following is a summary of various trend rates from 1968 to 1995:

	<u>Compounded Rate %</u>
Consumer Price Index average	.05622
RIB Site Land to Con-Cor \$2,390/AC	.0743
Twice CPI average	.11244
RIB Site Land to Appraised \$6,497/AC	.13675

Audit Exception No. One (cont'd.)

RECOMMENDATION:

Based on the related party transactions described above and the determination of a trended original cost for the land in the RIB Site neighborhood, also described above, the audit staff recommends reducing the purchase price of the 1991 RIB Site land and the 1995 buffer strip by \$385,490 and \$19,380, respectively, for a total reduction in the land account of \$404,770.

	<u>RIB SITE</u>	<u>BUFFER</u>
Palm Coast Purchase Price	\$530,000	\$30,137
Indexed Original Cost	<u>144,510</u>	<u>10,587</u>
Proposed Reduction in cost	\$385,490	\$19,280

PALM COAST UTILITY CORPORATION

INDEXING LAND COST PER ACRE PURCHASED 1968

Y/E 1968	Orig Cost=	CPI INDEX	@CPI \$341	@2XCPI \$341	INDEX 0.0743 7.43% Compounded \$341	
1969		0.054	359.16	377.56	366.08	
1970		0.057	379.63	420.60	393.28	
1971		0.044	396.34	457.62	422.50	
1972		0.034	409.81	488.74	453.89	
1973		0.062	435.22	549.34	487.61	
1974		0.11	483.10	670.19	523.84	
1975		0.091	527.06	792.17	562.77	
1976		0.057	557.10	882.48	604.58	
1977		0.065	593.31	997.20	649.50	
1978		0.077	639.00	1,150.77	697.76	
1979		0.114	711.84	1,413.14	749.60	
1980		0.134	807.23	1,791.86	805.30	
1981		0.103	890.37	2,160.98	865.13	
1982		0.06	943.79	2,420.30	929.41	
1983		0.03	972.11	2,565.52	998.46	
1984		0.035	1,006.13	2,745.11	1,072.65	
1985		0.035	1,041.35	2,937.27	1,152.35	
1986		0.016	1,058.01	3,031.26	1,237.97	
1987		0.036	1,096.10	3,249.51	1,329.95	
1988		0.04	1,139.94	3,509.47	1,428.76	RIB Site
1989		0.048	1,194.66	3,846.38	1,534.92	Indexed
1990		0.052	1,256.78	4,246.40	1,648.96	Orig Cost
1991		0.041	1,308.31	4,594.61	1,771.48	X 81.576 AC \$144,510
1992		0.029	1,346.25	4,861.09	1,903.10	
1993		0.028	1,383.94	5,133.31	2,044.50	Buffer Indexed
1994		0.025	1,418.54	5,389.98	2,196.41	Orig Cost
1995		0.041	1,476.70	5,831.96	2,359.60	X 4.601 AC= \$10,857
1996 (9/52 weeks)		0.041	1,487.18	5,914.73	2,389.95	
				6310.18	2,390.00	At Current land cost / AC
Average CP		0.0562				ITT-Con-Cor transaction
Curr. Index		0.0743				

Varied index until 1996 price per acre equaled CON-COR Michigan Contract price per acre. Used land value for each year to recalculate original cost for purchased property in NEIGHBORHOOD.

AUDIT EXCEPTION NO. 2

SUBJECT: Misclassifications of RIB Site Improvements

FACTS: Before this RIB Site land could be used for its intended purposes, the Utility paid ITT Community Construction Company for \$451,800 worth of borrow material to raise its RIB cells above the natural grade and to build up the burms of those cells.

The borrow material was included in a contract for the Rapid Infiltration Basin construction in the amount of \$1,164,011 which also included intercell piping, clearing, grubbing, sodding and landscaping of the site buffer.

In addition to the above construction contract, Palm Coast charged consulting fees, materials, engineering and AFUDC to equal the \$1,410,299.32 charged to Utility Plant in Service.

The Palm Coast Rapid Infiltration Basin (RIB) Site improvements above were charged to plant subaccount #380 (Treatment and Disposal Equipment).

OPINION: The above soft capital costs of consulting fees, materials, engineering and AFUDC total \$246,287.83.

The above additions and improvements should be classified as Structures and Improvements, and the utility charge to Equipment should be reversed.

The depreciation rates for these two accounts, Equipment and Structures are 5.56% and 3.13%, respectively. **When these rates are applied to the misclassified balance of \$1,410,299, an annual depreciation expense difference of \$34,270 is developed.**

Audit Exception No. Two (cont'd.)

It should be noted that this RIB Site Improvement is eventually to be used as Effluent Reuse Plant. (See Disclosure No. 8.)

RECOMMENDATION:

The Commission should reclassify the improvements in the amount of \$1,410,299 described above which were charged to the Equipment account to the Structures and Improvements account.

AUDIT EXCEPTION NO. 3

SUBJECT: Misclassification of Major Rehabilitations to UPIS

FACTS: Palm Coast charged \$1,103,995 in Water and Sewer plant rehabilitation projects to Construction Work in Progress.

The \$599,457 and \$504,537 worth of respective Water and Sewer Plant Rehabilitation projects were transferred to the Utility Plant in Service subaccounts by General Journal Entries.

During the audit it was noted that the test year contains expenses for a Well Rehabilitation Program.

OPINION: The project names such as "Patricia Drive Sewer Rehabilitation", "Well Program" and "Interior Rehabilitation of . . . Elevated Tank" as well as the supporting documentation indicate that these are, with one noted exception, recurring periodic expenses which should never be charged to plant.

The Well Program contained charges for Stand By Diesel Generating Equipment in the amount of \$51,041 which appear to be a proper addition to Utility Plant in Service.

The FPSC Division of Water and Wastewater Engineers should examine these projects and determine if any other capitalizations or any amortization into the test period expense is appropriate.

These projects may relate to plant that is not 100% used and useful and any resulting test year expense may be overstated.

Audit Exception No. Three (cont'd.)

RECOMMENDATION:

The above Water and Sewer totals of \$548,416 (\$599,457 minus \$51,041) and \$504,537, respectively, should be eliminated from the Palm Coast Utility Plant in Service accounts.

AUDIT EXCEPTION NO. 4

SUBJECT: Operation and Maintenance Expenses

FACTS: For the historical year ended December 31, 1995, Palm Coast Utility Corporation recorded an amount of \$1,193.83 in Account 620 - Materials and Supplies (water). The Utility was unable to provide documentary support for this amount.

The Utility recorded an amount of \$10,000 in Account 675 - Miscellaneous Expenses (water) for Florida Waterworks Association Dues. Under the Omnibus Budget Reconciliation Act of 1993, a portion (32%) of the dues paid is considered lobbying expenses.

An employee of the Utility was a speaker at a conference at Marco Island in September 1995. The Utility recorded an amount of \$705.87 in Account 675 to cover the employee's expenses.

The Utility paid an amount of \$2,500 to install Christmas lights on one of its elevated water tanks. This amount was recorded in Account 675.

The Utility accrued \$42,000 for audit fees, the actual amount was \$46,000. A final billing amount of \$4,000 was not recorded by the Utility until February 1996 in Account 632 - Contractual Services -Accounting (water).

Legal fees in the amount of \$1,780 pertaining to the sale of the Utility was recorded in Account 633 - Legal fees (water).

Audit Exception No. Four (cont'd.)

OPINION/RECOMMENDATION:

Field audit staff recommends that Operation and Maintenance Expenses - Water be decreased by \$6,276 and, Operation and Maintenance Expenses - Wastewater be increased by \$896. Based on the facts above, the following are the recommended adjustments to Operation and Maintenance Expenses:

- 1) Account 620 (water) decreased by (\$1,194) due to lack of support for the recorded expenditure.
- 2) Account 675 (water) decreased by (\$6,406) to account for \$3,200 ($\$10,000 \times 32\%$) in lobbying expenses and other non-utility amount of \$3,206 ($\$706 + 2,500$).
- 3) Account 632 (water) & 732 (w/water) increased by \$2,385 and \$1,615, respectively, to account for the increase in audit fees.
- 4) Account 633 (water) & 731 (w/water) decreased by (\$1,061) and (\$719), respectively, to account for the \$1,780 in non-utility legal fees.

AUDIT EXCEPTION NO. 5

SUBJECT: Water Sold For Resale

FACTS: Palm Coast Utility Corporation sells water to the Dunes Community Development District (DCDD). This sale is authorized by the Utility's tariff. For the period January 1995 to November 1995, DCDD was charged a base facility charge of \$193.83 for a six-inch meter and a usage charge of \$1.00 per thousand gallons. As of December 1995 the indexed rates were applied resulting in a base facility charge of \$195.79 and usage charge of \$1.01 per thousand gallons.

For the year ended December 31, 1995, sales to DCDD amounted to \$64,785. The Utility records this sale and other General Service sales in Account No. 461.2 - Metered Revenues (Commercial).

The Uniform System of Accounts (USOA) for Class "A" water utilities requires sales for resale to be recorded in Account 466. The USOA (Acct. 466) states,

- A. This account shall include the net billing for water supplied (including stand-by service) to other water utilities or to public authorities for resale purposes.
- B. Records shall be maintained so that the quantity (estimated if not metered) of water sold and the amount of revenue under each rate schedule shall be readily available.

OPINION/RECOMMENDATION:

Field audit staff recommends that the Commission orders the Utility to abide by the USOA and record sales to the Dunes Community Development District in Account No. 466 - Sales for Resale.

AUDIT DISCLOSURE NO. 1

SUBJECT: Sprayfield Land Cost

FACTS: The 1984 NARUC Class A Sewer Description of Account Number 101 Utility Plant in Service Paragraph B states, "This account shall include the original cost of utility plant, included in the plant accounts prescribed herein" with "original cost" being defined at definition number 20 on page 9 as, . . . the cost of such property to the person first devoting it to public service.

By a previous order the Palm Coast sewer effluent sprayfield was valued at appraised cost.

Order No. 22843 of Docket No. 890277 dated April 23, 1990, on page 36 states, in part:

The rate base determinations in prior proceedings for PCUC have indicated portions of the recorded land values, and there is no new submission of new information in this docket to indicate that we should reconsider these prior orders. There is no direct testimony in the case to indicate that recorded land values are unreasonable. Further, the record does not reveal the original cost basis to ICDC for land, nor what improvements should be considered prior to dedication of land to utility service. Accordingly, we find that the record does not support OPC's proposal that we reduce the booked value of land to the original cost to ICDC, adjusted for inflation.

Audit Disclosure No. 1 (cont'd.)

OPINION: Based on the facts and conclusions developed in Audit Exception No. 1, it appears that the Palm Coast Sprayfield has the same Original Cost per acre to the ITT group as the RIB Site land. The sprayfield land is next to the RIB Site and is in the same neighborhood as the recent ITT Sale of land to the Michigan Corporation discussed in Exception No.1.

Based on the same index developed in Exception No 1, the 83.3 acres of the Sprayfield has a 1985 trended original cost of \$1,152.35 per acre for a total of \$95,991. Palm Coast booked an appraised value of \$364,500 for a book-cost difference of \$268,509.

RECOMMENDATION:

The Commission should consider reducing the 1985 Sprayfield cost by \$268,509 to the trended original cost of \$95,991.

AUDIT DISCLOSURE NO. 2

SUBJECT: Effluent to Dunes Community Development District (DCDD)

FACTS: Dunes Community Development District (DCDD) has an agreement with Palm Coast Utility Corporation (PCUC) to accept 600,000 gallons per day of treated wastewater effluent and to provide wet weather storage for up to 1,000,000 gallons per day for seven days.

Palm Coast Utility Corporation paid DCDD \$558 per month for the right to dispose of 600,000 gallons per day of effluent, and \$3,341 per month for the lease of 7,000,000 gallons of wet weather storage. DCDD sells the reclaimed water to its customers for irrigation purposes.

The agreement expired March 31, 1995. The Utility has developed a 6,000,000 effluent storage tank and a Rapid Infiltration Basin (RIB) necessary to provide effluent reuse water for irrigation purposes.

DCDD installed, and maintains at its own expense, a pump station at the PCUC wastewater treatment plant along with the necessary effluent force main from the pump station to DCDD's wastewater treatment plant site.

OPINION/RECOMMENDATION:

Field audit staff is of the opinion that Palm Coast Utility Corporation should be allowed to sell reclaimed water to its customers to recover some of the costs incurred in treating and disposing of wastewater effluent to meet Department of Environmental Protection regulations regarding the collection, treatment and disposal of wastewater.

This disclosure is for informational purposes only.

AUDIT DISCLOSURE NO. 3

SUBJECT: Operating Revenues

FACTS: Palm Coast Utility Corporation had a price index filing in 1995. New water and wastewater tariffs were approved effective October 24, 1995, per Florida Public Service Commission Authority No. WS-95-0189.

The Utility applied the new rates to its December 1995 billings.

The Utility's Minimum Filing Requirements (MFRs) included six months' actual data and six months of projections for Operating Revenues.

OPINION/RECOMMENDATION:

The Utility did not apply the indexed rates per its tariff to November 1995 customer billings.

The Utility's failure to apply the new tariff in November 1995 resulted in an understatement of revenues for test year ended December 31, 1995, as follows:

<u>Water</u>	Amount <u>Per Audit</u>	Amount <u>Per G/L</u>	<u>Differ.</u>
Measured Revenues	\$5,024,225	\$4,988,428	\$35,797
Private Fire Protection	<u>138,032</u>	<u>134,824</u>	<u>3,208</u>
Sub-Total	\$5,162,257	\$5,123,252	\$39,005
 <u>Wastewater</u>			
Measured Revenues	<u>\$3,114,927</u>	<u>\$3,097,742</u>	<u>\$17,185</u>
Total Revenues	<u>\$8,277,184</u>	<u>\$8,220,994</u>	<u>\$56,190</u>

Field audit staff recommends that the Utility adjust its operating revenue as shown above.

AUDIT DISCLOSURE NO. 4

SUBJECT: Over-recovery of Rate Case Expense

FACTS: Order No. 22843 issued April 23, 1990, granted Palm Coast Utility an increase in its rates. The order also allowed the Utility a period of three years, instead of the customary four years, to recover Rate Case Expense of \$286,102 and prior unamortized Rate Case Expense of \$19,575.

Section 367.0816, F.S., states that,

. . . At the conclusion of the recovery period, the rate of the public utility shall be reduced immediately by the amount of rate case expense previously included in rates.

Palm Coast Utility Corporation did not reduce its rates at the end of the amortization period, which ended on or about April 1993.

Rule 25-30.470, F.A.C., states the methodology for calculation of rate reduction after rate case expense is amortized as follows:

The annual amount of rate case expense, which is equal to one-fourth (in this case one-third) of the total allowed rate case expense, shall be divided by the regulatory assessment fee gross up factor. The resulting number shall then be divided by the revenue requirement to determine the percentage of the rate reduction. The percentage is then multiplied against the new rates to determine the amount of the

Audit Disclosure No. 4 (cont'd.)

future rate reduction. Revised tariff sheets implementing the reduction shall be filed no later than 1 month before the end of the fourth year (in this case, third year).

OPINION/RECOMMENDATION:

Field audit staff recommends that the aforementioned facts be considered by the analyst assigned to this rate case in determining the final rates for Palm Coast Utility Corporation.

AUDIT DISCLOSURE NO. 5

SUBJECT: Reuse Plant

FACTS: Palm Coast is applying for an Effluent Reuse rate with this rate proceeding.

The Utility is proposing that \$2,935,977 or 7.47% of its Sewer Utility Plant in Service is going to be dedicated to Effluent Reuse.

OPINION: That \$2,935,977 includes the entire cost of the RIB Site land added into the Sewer Plant Account #353.4 in the amount of \$560,137. (See Exception No. 1.)

Also included are the RIB Site improvements which are the subject of the Equipment to Structures Reclassification in Exception No. 3.

If Palm Coast believes that \$2,935,977 of its Sewer Utility Plant in Service can be directly or partially dedicated to Effluent Reuse purposes, then such plant costs should not be imposed on the Sewer ratepayer.

RECOMMENDATION:

Reduce the Sewer utility plant accounts by the \$2,935,977 listed in the Effluent Rate Study "Table C". This study was filed with the Palm Coast Docket #951056-WS MFRs.

AUDIT DISCLOSURE NO. 6

SUBJECT: Capital Structure Presentation (Company)

FACTS: Palm Coast Utilities Company, Inc. filing indicates that its requested 13-month average Capital Structure includes \$12,557,692 and \$3,668,231 of long-term debt and short-term debt, respectively.

The Company's filing additionally indicates 7.24% and 7.73% as the cost rates for long-term and short-term debt.

The Company's parent, ITT Corporation, issued a letter of guarantee to South Trust Bank of Alabama, N.A., the lender, for all of the above-mentioned debt that includes the following statement:

In order to induce you to enter into the Credit Agreement, ITT Corporation, a Delaware Corporation ("ITT"), hereby irrevocably and unconditionally guarantees to you payment when due, whether by acceleration or otherwise, of the full amount of any and all liabilities of the Company to you under the Credit Agreement.

OPINION/RECOMMENDATION:

Audit staff believes that Company's outstanding debt and the cost to service such debt does not represent a true "arm's-length transaction" for "related parties" as defined in FAS 57, Par. 3 and App. B paragraph 24(f), respectively, issued March 1982 by the Financial Accounting Standards Board. The interest rates associated with this outstanding debt may be impaired because of the parents unconditional guarantees as referenced above.

Furthermore, prevailing financial accounting literature agrees that there are three components used in determining the interest cost associated with a company's liabilities:

Audit Disclosure No. 6 (cont'd.)

- 1) Pure rate of interest - the lenders required return if there were no possibilities of default and no expectation of inflation.
- 2) Credit risk of interest - the risk of non-payment by the borrower.
- 3) Inflationary risk - the expected risk associated with a loss of purchasing power of present day dollars.

The Company's cost rate for long-term and short-term debt does not include the component for "credit risk." There is no risk of non-payment to the lender because of the unconditional guarantee for repayment by the parent, ITT Corporation.

The Commission should determine whether Palm Coast Utility's outstanding debt with South Trust Bank of Alabama, N.A. is in essence the outstanding debt of the parent, ITT Corporation. Upon such a determination the Commission should require that the Company use the parent's capital structure to calculate a true market-based Cost of Capital for this rate case proceeding.

AUDIT DISCLOSURE NO. 7

SUBJECT: Capital Structure Presentation (Parent)

FACTS: Per F.A.C. 25-30.433 (4), "The averaging method used by the Commission to calculate rate base and cost of capital shall be a 13-month average for class A utilities"

Palm Coast Utility Company, Inc. is a Class A utility.

The Company's filing included its parent's capital structure which was prepared using a simple beginning and ending average for the period ending 1994.

The Company's capital structure was prepared using a 13-month average method which included six months of projected balances for the test year period ending December 1995.

On November 30, 1995, the Company's parent, ITT Corporation, was reorganized into three separate companies: ITT, ITT Hartford, and ITT Industries. The reorganization was executed as a tax-free stock for stock transaction. The Company is now a wholly-owned subsidiary of ITT Industries.

OPINION/RECOMMENDATION:

This disclosure is to be considered only if Disclosure No. 6 of this report is acted upon by the Commission.

The parent's capital structure information, as filed, is not comparable to the Company's filed information because of the difference in capital structure presentations as indicated above.

The parent's capital structure information, as filed, is obsolete because of ITT Corporation's reorganization executed on November 30, 1995.

Auditor presents the above information for informational purposes and defers any recommendations to the analyst in Tallahassee.

Schedule of Water Rate Base

Florida Public Service Commission

Company: Palm Coast Utility Corporation
 Docket No.: 951056-WS
 Schedule Year Ended: 12/31/95
 Historic [X] or Projected [X] [6 mos. actual; 6 mos. projected]

Schedule: A-1
 Page 1 of 1
 Preparer: Seidman/PCUC

Explanation: Provide the calculation of average rate base for the test year showing all adjustments. All non-used and useful items should be reported as Plant Held for Future Use [Non-Used & Useful Plant, line 3].

Line No.	(1) Description	(2) 13 Mo Avg Balance per 12/31/95	(3) Projected Year End 12/31/95	(4) Utility Adjustments	(5) Adj. Utility Balance	(6) Supporting Schedule
1	Plant in Service	62,245,032	63,505,519	(2,128,199)	61,377,320	A-5
2	Land & Land Rights	504,632	504,632	0	504,632	A-5
3	Less: Non-Used & Useful Plant	(8,602,804)	(8,602,553)	0	(8,602,553)	A-7
4	CWIP	2,641,126 *	3,992,210 *	(3,992,210)	0	A-18
5	Less: Accm. Depreciation	(19,972,299)	(20,996,438)	1,074,065	(19,922,373)	A-9
6	Less: CIAC	(15,018,572)	(16,390,083)	0	(16,390,083)	A-12
7	Accm. Amort. CIAC	2,989,160	3,241,580	0	3,241,580	A-14
8	Acquisition Adj.					
9	Accm. Amort. Acq. Adj.					
10	Advances for Construction	(2,384,793)	(2,672,139)	2,672,139	0	A-16
11	Net Debit Deferred Taxes (Used)	1,180,646	1,119,911	0	1,119,911	A-3DTAX
12	Working Capital	0	0	0	0	A-17
13	TOTAL RATE BASE	<u>23,582,128</u>	<u>23,702,638</u>	<u>(2,374,205)</u>	<u>21,328,433</u>	

* Includes both water & wastewater CWIP

Company: Palm Coast Utility Corporation
 Docket No.: 951056--WS
 Schedule Year Ended: 12/31/95
 Historic [X] or Projected [X] [6 mos. actual; 6 mos. projected]

Schedule: A-2
 Page 1 of 1
 Preparer: Seidman/PCUC

Explanation: Provide the calculation of average rate base for the test year showing all adjustments. All non-used and useful items should be reported as Plant Held for Future Use [Non-Used & Useful Plant, line 3].

Line No.	(1) Description	(2) 13 Mo Avg Balance per 12/31/95	(3) Projected Year End 12/31/95	(4) Utility Adjustments	(5) Adj. Utility Balance	(6) Supporting Schedule
1	Plant in Service	52,880,457	56,249,291	2,128,199	58,377,490	A-6
2	Land & Land Rights	938,095	1,153,532	0	1,153,532	A-6
3	Less: Non-Used & Useful Plant	19,153,039	18,345,687	426,872	18,772,560	A-7
4	CWIP	0 *	0 *	0	0	A-18
5	Less: Accm. Depreciation	(17,270,072)	(18,107,234)	(986,635)	(19,093,869)	A-10
6	Less: CIAC	(59,894,927)	(61,045,743)	0	(61,045,743)	A-12
7	Accm. Amort. CIAC	15,711,804	16,511,375	0	16,511,375	A-14
8	Acquisition Adj.					
9	Accm. Amort. Acq. Adj.					
10	Advances for Construction	(660,342)	(990,073)	405,534	(584,539)	A-16
11	Net Debit Deferred Taxes (Used)	1,898,140	1,940,403	0	1,940,403	A-3DTAX
12	Working Capital	0	0	0	0	A-17
13	TOTAL RATE BASE	<u>12,756,194</u>	<u>14,057,238</u>	<u>1,973,971</u>	<u>16,031,209</u>	

* Included in Schedule A-1, Water Rate Base

Schedule of Water Net Operating Income

Company: Palm Coast Utility Corporation
 Schedule Year Ended: 12/31/95
 Interim [] Final [X]
 Historic [X] or Projected [X] [6 mos. actual; 6 mos. projected]

Schedule: B-1
 Page 1 of 1
 Docket No.: 951056-WS
 Preparer: Seidman/PCUC

Explanation: Provide the calculation of net operating income for the test year. If amortization (Line 4) is related to any amount other than an acquisition adjustment, submit an additional schedule showing a description and calculation of charge.

Line No.	(1) Description	(2) Unadjusted 1995 Test Year	(3) Utility Test Year Adjustments	(4) Utility Adjusted Test Year	(5) Requested Revenue Adjustment	(6) Requested Annual Revenues	(7) Supporting Schedule(s)
1	OPERATING REVENUES	5,384,699	107,322	5,492,021	1,479,626	6,971,647	B-3, 4
2	Operation & Maintenance	3,026,338	(259,706)	2,766,632	37,688	2,804,319	B-3, 5
3	Depreciation, net of CIAC Amort.	1,621,374	(437,104)	1,184,270		1,184,270	B-13
4	Amortization, CIAC Tax Gross-up	(82,781)	(5,469)	(88,250)		(88,250)	
5	Taxes Other Than Income	874,220	(247,482)	626,738	66,583	693,322	B-3, 15
6	Provision for Income Taxes	(289,553)	729,112	439,558	52,071	491,629	C-1, B-3
7	OPERATING EXPENSES	5,149,597	(220,649)	4,928,948	156,342	5,085,290	
8	NET OPERATING INCOME	235,102	327,971	563,072	1,323,285	1,886,357	
9	RATE BASE	23,702,638		21,328,433		21,328,433	
10	RATE OF RETURN	0.99%		2.64%		8.84%	

Schedule of Sewer Net Operating Income

Company: Palm Coast Utility Corporation
 Schedule Year Ended: 12/31/95
 Interim Final
 Historic or Projected [6 mos. actual; 6 mos. projected]

Schedule: B-2
 Page 1 of 1
 Docket No.: 951056-WS
 Preparer: Seidman/PCUC

Explanation: Provide the calculation of net operating income for the test year. If amortization (Line 4) is related to any amount other than an acquisition adjustment, submit an additional schedule showing a description and calculation of charge.

Line No.	(1) Description	(2) Unadjusted 1995 Test Year	(3) Utility Test Year Adjustments	(4) Utility Adjusted Test Year	(5) Requested Revenue Adjustment	(6) Requested Annual Revenues	(7) Supporting Schedule(s)
1	OPERATING REVENUES	3,150,538	180,495	3,331,033	1,575,817	4,906,850	B-3, 4
2	Operation & Maintenance	2,049,154	(118,191)	1,930,963	37,688	1,968,651	B-3, 6
3	Depreciation, net of CIAC Amort.	35,244	728,836	764,080		764,080	B-14
4	Amortization, CIAC Tax Gross-up	(57,525)	(1,309)	(58,834)		(58,834)	
5	Taxes Other Than Income	258,285	116,413	374,698	70,912	445,610	B-3, 15
6	Provision for Income Taxes	131,947	(379,033)	(247,085)	616,575	369,490	C-1, B-3
7	OPERATING EXPENSES	2,417,106	346,717	2,763,822	725,175	3,488,997	
8	NET OPERATING INCOME	733,432	(166,222)	567,210	,850,643	1,417,853	
9	RATE BASE	14,057,238		16,031,209		16,031,209	
10	RATE OF RETURN	5.22%		3.54%		8.84%	

Schedule of Requested Cost of Capital
Cost on Year End Basis

Florida Public Service Commission

Company: Palm Coast Utility Corporation

Docket No.: 951056-WS

Test Year Ended: 12/31/95

Schedule Year Ended:

Historic [X] or Projected [X] [6 mos. actual; 6 mos. projected]

Schedule: D-1

Page 1 of 1

Preparer: Seidman/PCUC

Subsidiary [X] or Consolidated []

Explanation: Provide a schedule which calculates the requested Cost of Capital on a 13-month average basis. If a year-end basis is used submit an additional schedule reflecting year-end calculations.

Line No.	Class of Capital	(1) Reconciled To Requested Rate Base	(2) Ratio	(3) Cost Rate	(4) Weighted Cost
1	Long-Term Debt	11,481,418	30.73%	7.24%	2.23%
2	Short-Term Debt	4,083,124	10.93%	7.73%	0.84%
3	Preferred Stock				
4	Customer Deposits	459,257	1.23%	6.00%	0.07%
5	Common Equity	19,190,052	51.37%	11.10%	5.70%
6	Tax Credits - Zero Cost	2,145,791	5.74%	0.00%	0.00%
7	Tax Credits - Wtd. Cost				
8	Accum. Deferred Income Taxes				
9	Other (Explain)				
10	Total	37,359,641	100.00%		8.84%

NOTE: The cost rate for capital is considered the same, whether the rate base is viewed on a year end or 13 month average basis. This is because the cost rate is determined by dividing the annual interest expense by the average capital balance and applying it to either the average or year end amount.

Supporting Schedules: D-2

Recap Schedules: A-1, A-2

State of Florida

Commissioners:
SUSAN F. CLARK, CHAIRMAN
J. TERRY DEASON
JULIA L. JOHNSON
DIANE K. KIESLING
JOE GARCIA



DIVISION OF RECORDS &
REPORTING
BLANCA S. BAYO
DIRECTOR
(904) 413-6770

Public Service Commission

May 2, 1996

James A. Perry
Palm Coast Utility Corporation
2 Utility Drive
Palm Coast, Florida 32137

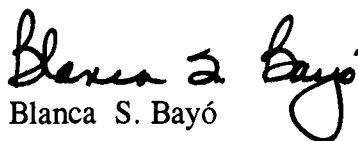
Dear Mr. Perry:

Docket No. 951056-WS -- Palm Coast Utility Corporation
Rate Case Audit Report - Period Ended June 30, 1995
Audit Control #96-037-3-1

The enclosed audit report is forwarded for your review. Any company response filed with this office within ten (10) work days of the above date will be forwarded for consideration by the staff analyst in the preparation of a recommendation for this case.

Thank you for your cooperation.

Sincerely,


Blanca S. Bayó

BSB/mas
Enclosure
cc: Public Counsel
Gatlin Law Firm