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April 17, 1998

Ms. Blanca S. Bayó, Director
Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0870

RE: Docket No. 971186-SU

Dear Ms. Bayó:

Enclosed are an original and fifteen copies of Citizens' Comments on Sanlando's Reuse Application for filing in the above-referenced docket.

Also Enclosed is a 3.5 inch diskette containing the Citizens' Comments on Sanlando's Reuse Application in WordPerfect for Windows 6.1 format. Please indicate receipt of filing by date-stamping the attached copy of this letter and returning it to this office. Thank you for your assistance in this matter.

Sincerely,

Stephen C. Reilly
Associate Public Counsel

SCR/dsb
Enclosures

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Application for Approval of Reuse Project Plan and Increase in Wastewater Rates in Seminole County by Sanlando Utilities Corporation

Docket No. 971186-SU
Filed: April 17, 1998

CITIZENS' COMMENTS ON SANLANDO'S REUSE APPLICATION

The Citizens of the State of Florida (Citizens or OPC), by and through Jack Shreve, file these comments concerning Sanlando's reuse application.

OVERVIEW

Sanlando's revised application shows a net revenue requirement of $356,684. For its Phase I of the project, i.e., no paying reuse customers, this translates into a pure gallonage charge of $.34 per 1,000 gallons, or a $1.87 base facility charge and $.14 per 1,000 gallons. For Phase II of the project, i.e., including paying reuse customers, the net revenue requirement is the same. However, the cost to retail customers is $.24 per 1,000 gallons, or a $1.40 base facility charge and $.09 per 1,000 gallons. The reuse rate would be $.22 per 1,000 gallons, or a $1,060 base facility charge and $.11 per 1,000 gallons.

CONCERNS WITH APPLICATION

The Citizens have examined Sanlando's reuse application and believe there are several areas that require adjustment. The Citizens will address each of these below and provide the Commission with our recommendation on how these issues should be resolved.

Operation and Maintenance Expenses

During the construction phase of the project, Sanlando included the operation and maintenance expense associated with running the plant. Clearly, these expenses should be removed,

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until the plant becomes operational. The operation and maintenance expenses included in the revenue requirement and rates amount to $82,443. The Citizens request that the Commission remove this expense when calculating the revenue requirement associated with the reuse project until the plant becomes operational and the expenses are actually incurred.

Allowance for Funds Used During Construction

The utility has also included allowance for funds used during construction (AFDC) in the capital cost of the project. Because customers will be paying for this project while it is being constructed, it is not necessary to add AFDC to the capital cost of the project. This overstates the cost of the project by $93,728. Although the utility has admitted in response to a Staff Interrogatory that AFDC should not have been included, it has not been removed from the capital cost and therefore, the revenue requirement and rates set forth in its application. The Citizens recommend that the Commission remove these charges when calculating the revenue requirement and rates associated with Sanlando's reuse application.

Interest Coverage Requirement

The interest coverage requirement of 1.25 times suggested by Sanlando to obtain debt financing at 9.0% is questionable for several reasons. First, the utility has produced no documentation of this requirement, despite the Staff's interrogatories asking for same. In response to Staff's Data Request 6, from letter dated March 19, 1998, the utility indicated that it has contacted no lending institutions about the possibility of financing the project.

Second, even assuming additional funds are needed to meet this alleged coverage requirement, the utility's calculations are in error. In calculating the additional funds needed for the interest coverage requirement, the utility multiplied .25 times $238,438, which is the annual cost of financing the plant, <u>including the repayment of the loan</u>. An interest coverage requirement would only apply to the interest on the loan, not the repayment of the principle. Adjusting for this error, indicates that if there is an interest coverage requirement, the amount is $48,973[1], not the $59,609 proposed by the utility. Correcting for this error produces an effective interest rate on the new debt of 11.3%, not the 12.38% proposed by the utility.

Third, it seems reasonable that if the utility went to the bank with an order from the Commission showing that the reuse project would be partially funded with ratepayers' money <u>in advance</u>, the bank would be much more lenient than with traditional construction and financing programs.

Fourth, the utility apparently claims that the need for this requirement is due to its poor capital structure, which allegedly consists of 100% debt with no equity. This capital structure is clearly not the result of actions taken by ratepayers. To the contrary, it is solely due to the actions taken by stockholders. Before the buy back of common equity, which was a related party transaction, the utility had more than $1,000,0000 in common equity and an equity ratio of 21.31%. This level of equity, would have allowed the utility to partially, if not entirely, meet a 1.25 debt coverage requirement. In addition, the rates the utility is currently collecting were based upon a capital structure that consisted of 24% common equity.

Fifth, the Citizens' believe that Sanlando can meet the interest coverage requirement, without adding $48,973 to the requested revenue increase in the instant proceeding. In response to Staff's Data Request 3, from letter dated March 19, 1998, Sanlando provided its calculation of the interest

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[1] Calculated as follows: $195,892 interest expense times .25 interest coverage requirement equals $48,973.

coverage that would result from the instant proceeding if the utility were granted its requested increase. The calculations showed that the utility's operating results would produce an interest coverage of 1.25 times. However, in performing its calculations, the utility did not take into consideration that it retired $3,279,943[2] of its existing debt in 1997 and is retiring $2,546[3] in 1998. If the associated interest, in the amount of $188,683, is removed from the utility's interest coverage calculations an interest coverage ratio of 1.99 results.

Moreover, in developing its calculations, the utility failed to take into consideration interest income and dividends of $159,648 after taxes that it recorded below the line. In the context of this case and the calculation of the interest coverage ratio it is appropriate to take this income into account. At least in part, the interest income and dividends recorded below the line is the result of relationships with affiliates. The utility has recorded on its regulated books notes receivable from affiliated companies of $1,186,345. The utility has loaned its affiliates money that was earned by providing regulated services. The interest income and dividends earned from loaning money to affiliates and making other investments should clearly be considered above the line for ratemaking purposes. Were it not for the regulated utility operations, this income and dividends could not have been earned. The utility's 1996 Annual Report to the Commission showed no nonregulated operations that would have produced this income. In addition, when the bank calculates the earned interest coverage ratio, there is no reason to believe that this income would not be included. If this

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2 See Sanlando's 1996 Annual Report to the Commission, page F-14.

3 Ibid.

income is included, the resulting earned interest coverage a ratio is 1.56 times. If both this income and the reduction in interest are considered, the resulting interest coverage ratio is 2.49 times.

Even if the utility were granted no rate increase in the instant proceeding, and the two factors just addressed are included in the interest coverage calculation an interest coverage ratio of 1.65 results. This calculation is shown below:

	Interest Expense	Return
Existing Debt	\$122,548	\$525,318
New Debt	\$195,892	\$ 0
Total	\$318,440	\$525,318

Return \$525,318/ Interest \$318,440 = Interest Coverage 1.65 times

The Citizens were unable to determine if the utility retired \$3,279,943 of its existing debt in 1997 because the utility requested an extension in the filing of its 1998 Annual Report with the Commission. Similarly, the Citizens could not determine if the utility refinanced the debt that was due to retire in 1997. If the utility did refinance this debt, then the total interest expense used in the above calculation would be higher and the interest coverage ratio lower. Nevertheless, it is unclear whether or not the interest expense on current debt would even need to be included in the interest coverage calculation. Because this debt is secured with personal guarantees from the owners it is possible that the bank issuing the new debt would not include this interest in the interest coverage calculation.

In addition, in developing its calculation of the earned interest coverage ratio the utility took a very conservative position. That is, that the bank would calculate the interest coverage ratio using net operating income. However, banks often use other interest coverage ratio calculations. For example, it is common to use a pre-tax interest coverage ratio which increases the numerator of the calculation and therefore the resulting coverage ratio. The utility has not contacted any lending institutions and therefore it is not possible to know which type of interest coverage calculation the bank might require.

At a minimum, it is clear that the Commission should not include the added $59,609 of additional income requested by the utility for purposes of meeting an interest coverage ratio of 1.25 times. This requirement can easily be met with the interest income and dividend income $159,648 recorded below the line by the utility. In summary, the Citizens recommend that the Commission reject this request.

Overearnings

As indicated above, the utility is overearning in both its wastewater and water operations. The calculations used by the utility do offset the current overearnings in its wastewater operations against the revenue requirement for the reuse project. However, no analogous offset has been made for the water operations. The Citizens recommend that the Commission reduce the revenue requirement by the excessive earnings--approximately $58,044.

Rate Case Expense

The utility is requesting rate case expense of $46,284, although the application only reflects rate case expense of $40,000. Of this amount, $36,792 relates to services provided by Guastella Associates, Inc. Mr. Guastella, Principal of the firm charges an hourly rate of $200. The Citizens believe this hourly rate to be excessive in the context of the instant proceeding and with respect to water and wastewater rate cases. The Commission has also found Mr. Guastella's rate to be excessive in the recent Palm Coast Order. In that Order the Commission reduced the rate charged by Mr. Guastella to $140 from $190 for purposes of calculating rate case expense. The Commission found:

> While we believe that PCUC's decision to retain Mr. Guastella for his expertise is reasonable, it does not automatically follow that the customers should have to bear the full costs for his services. The Commission enjoys a broad discretion with respect to allowance of rate case expense. Florida Crown Util. Servs., Inc. v. Utility Regulatory Bd. of Jacksonville, 274 So.2d 597, 598 (Fla. 1st DCA 1973). Nevertheless, it would constitute an abuse of discretion for the Commission to automatically award rate case expense without reference to the prudence of the costs incurred in the rate case proceedings. Meadowbrook Util. Sys., Inc. v. FPSC, 518 So.2d 326, 327 (Fla. 1st DCA 1987), rehearing denied, 529 So.2d 694 (Fla. 1988). Based on the foregoing, we believe it is appropriate to adjust rate case expense for an hourly rate which we believe to be more reasonable for the ratepayers of PCUC. The disallowed portion should be borne by the shareholders, whom we believe benefitted most by Mr. Guastella's expertise. We find that an adjustment downward to an hourly rate of $140, which is an approximate average of Mr. Guastella's and Mr. Seidman's hourly rates, is appropriate. Accordingly, we have decreased rate case expense by $19,450, which is approximately 389 hours charged to PCUC for work performed specifically by Mr. Guastella. Our adjustments result in an approved rate case expense total of $93,375 for services rendered by Guastella Associates, Inc. (Order, PSC-96-1338-FOF-WS, p. 75.)

The Citizens' recommend that the Commission follow the precedent set forth in the Palm Coast Order. Accordingly, using an hourly rate of $140 for Mr. Guastella's incurred and projected rate case expense produces a reduction to rate case expense of $4,380.

Staff Audit Report

Based upon the Commission's Staff's audit of the utility operations, the Citizens recommend that the Commission make several adjustments to the per books 1996 net operating income. It is important that these adjustments be made because the Staff's Audit found several expenses that are not typically allowed by the Commission when setting rates. Because the instant proceeding will set rates for the wastewater operations and possibly the water operations, it is necessary that these adjustments be made.

First, in its Audit report the Staff auditor recommends that legal expenses of $36,000 ($16,920 for wastewater) be removed from 1996 expenses. The Citizens agree with this recommendation and urge the Commission to make the same adjustment in its Order.

Second, the Staff Audit found a nonrecurring expense for the $20,000 charged to the wastewater operating account Contractual Service-Other. In the Audit the Staff Auditor indicated that this expense will not be incurred in the future and therefore recommended that this expense account be reduced by $20,000. The Citizens agree with this recommendation and urge the Commission to make this adjustment.

Third, the Staff Audit identified $2,943 and $2,507 of expenses for the water and wastewater operations which were out-of-period expenses. The Commission's policy is to remove out-of-period expenses from a test year when setting rates. Therefore, the Citizens recommend that the Commission remove these expenses from 1996 expenses when setting rates in this proceeding.

Fourth, the Staff Audit found rate case expense included in 1996 operating expenses. As the Audit notes, rate case expense is to be amortized over a four-year period. Accordingly, the Citizens recommend that the Commission reduce test year expenses by $2,476.76 for the water operations and by $2,196 for the wastewater operations to reflect a 4-year amortization of this expense.

Fifth, the Staff Audit Report indicates that the utility rents office space from an affiliate. The Staff auditor's investigation showed that the utility was paying in excess of the going rate for office rent. The utility is paying $25.87 per square foot while the Staff's investigation indicated that the going rate for comparable office space is $12.18 per square foot. Based upon the difference between the going rate and the rate paid by Sanlando, the Staff auditor recommends reducing 1996 expenses by $79,053. The Citizens agree with this recommendation and urge the Commission to reduce 1996 expenses by this amount.

Sixth, the Staff Audit also found that the utility paid $81,600 in management fees to an affiliated party. The Audit indicated that the utility maintained that the fees were estimations. Furthermore, the Audit indicated that there were no documents supporting the fees. Likewise the Audit did not indicate what types of services were rendered for this management fee. The auditor did not make a recommendation concerning how these expenses should be treated. Until this information is furnished by the utility the Commission should not include any of these fees in test year expenses. The Commission should include only those portions of these fees which can be explained and justified by the utility.

Finally, the Staff Audit found that the utility booked $28,094.57 of expenses in 1996 for a nonrecurring cost study. The study addressed the feasibility of routing water from Lake Brantley to the Cove Lake System. The engineering firm that conducted the study concluded that the project was too environmentally sensitive to implement. The Staff auditor recommended that the cost of the project be amortized over a reasonable period of time. The Commission's policy is to amortize nonrecurring costs over a period of five years. Accordingly, the Citizens recommend that the Commission reduce 1996 wastewater expenses by $22,476.

Projection Period and Revenue

The utility has failed to recognize that during the period that the rates will be in effect, the project will not be completed. Until the project is complete[4], which could be by mid-2001, it will

[4]There are several uncertainties associated with the construction start date, therefore it is unknown at this time when the project will be complete.

over recover its revenue requirement. This occurs for two reasons. First, the utility failed to calculate the revenue requirement using year-end customers consistent with the use of a year-end rate base. Second, in calculating the revenue requirement, the utility failed to account for customer growth that will occur during construction of the project. Unless some adjustment is made to account for this fact, the utility will over recover its revenue requirement during the construction phase of the project. The Citizens recommend that the Staff take this into consideration by projecting customer growth and usage to at least the mid-point of the construction period, which will probably be year end 1999. This projection should then be used to determine test year revenue for purposes of developing the rates in the instant proceeding.

Conclusion

The Citizens are in basic agreement with Sanlando's proposal to finance the construction of the reuse facilities with borrowed funds, with this cost being recovered from wastewater and reuse rates. However, having had the opportunity to review Sanlando's reuse application, the Citizens have found several instances where the utility has overstated the needed revenue increase to finance the construction of the proposed reuse project. Wherefore, the Citizens urge the Commission to make the adjustments recommended in these comments.

Respectfully submitted,

JACK SHREVE
Public Counsel

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Attorneys for the Citizens
of the State of Florida

CERTIFICATE OF SERVICE
DOCKET NO. 971186-SU

I HEREBY CERTIFY that a true and correct copy of the foregoing Citizens' Comments on Sanlando's Reuse Application has been furnished by U.S. Mail or *hand-delivery to the following parties on this 17th day of April, 1998:

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