State of Florida

Public Service Commission

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

DATE: March 25, 1997

TO: Mr. Charles deMenzes, President, Tradewinds Utilities, Inc.

FROM: Ms. Billie Messer, Regulatory Analyst Supervisor, Division of Water and Wastewater

RE: Docket No. 961310-WU, Application for transfer of majority organizational control of Residential Water Systems, Inc., holder of Certificate No. 419-W in Marion County, to Charles deMenzes

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We appreciate your diligence in completing the application. We have reviewed your application and deficiency corrections, and have some concerns we need to discuss with you. In order to recommend that an application for transfer of majority organizational control (TMOC) be approved by the Commission, we must first make a finding that the transfer is in the public interest. An important factor in determining if the TMOC is in the public interest is the Buyer's financial ability to continue operating the utility.

After much consideration, we are of the opinion that approval of this transfer is not in the public interest and we are considering recommending that the Commission deny your application. Before making our recommendation to the Commission, we want to share our concerns with you and give you the opportunity to provide any additional information you have that may resolve our concerns if you choose to proceed with this application.

We are concerned that you will not be able to maintain the high monthly payments required to purchase the stock over an extended period of time. Our calculations of the monthly stock purchase payments, your annual income, and liquid assets are contained in Attachment A for your reference. We calculated the monthly payments necessary to purchase the stock based upon the information contained in the application and deficiency corrections. We then estimated your annual income based upon information filed with the Commission in various utility Annual Reports. Because we do not have enough information to determine your income with certainty, we have estimated your annual income under two different scenarios. Additionally, we have reviewed the Personal Financial Statement that you submitted to us to determine if any of your assets could be readily converted to cash to make the monthly stock payments.

According to the application and deficiency corrections, as part of the stock purchase you will be assuming the responsibility of paying the utility's $90,000 mortgage. The mortgage will have a balloon payment due on July 16, 2001. Although we have calculated the monthly stock payments through the end of the 30 year term, we have placed our emphasis on the first four years prior to the balloon mortgage balance becoming due. Using the highest income scenario, we have estimated that after making the stock payments you will have less than $8,894 left from which to pay all of your business expenses, personal expenses, and taxes. Under our lowest income estimate, you will not even have enough income to make the first year's stock payments, let alone cover any personal expenses or taxes.

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The inability to continue making the stock payments could ultimately have an adverse effect not only on the customers of Residential Water Systems, Inc. (Residential Water) , but also the customers of Tradewinds Utilities, Inc. (Tradewinds.) Because the utility's land in the High Pointe and Sun Tree Subdivisions, along with other utility assets, serve as collateral for the mortgage, we believe a default on the mortgage could place the customers' utility service in jeopardy. Further, the significant financial drain that this purchase will put on your resources, could reduce the amount of funds available to maintain Tradewinds. And thus, those customers could be affected by this transaction as well.

As you are aware, the Commission does not usually review a utility's rate base in TMOC proceedings. The Commission does not establish rate base in TMOC proceedings because Commission policy is that the price of stock has no impact on rate base whatsoever. Rate base will not change as the result of a stock transfer, and thus, there is no need to address it. However, due to our concern regarding your financial ability, we have reviewed the utility's rate base to determine the utility's future earnings potential and how it will affect your ability to fund the stock purchase. Based on our review, we believe there is a strong possibility that you will not be able to earn a return on your stock investment, which will subsequently impact your ability to make the necessary payments.

Your letter dated December 7, 1996, indicates that you believe the utility system is worth in excess of $526,000, based largely upon an engineering cost estimate. You also noted that the contributions-in-aid-of-construction (CIAC) shown in the utility's 1995 Annual Report was in excess of the utility plant in service, thus indicating that an accounting error had been made. Based on our review of the utility's rate base, the utility has in fact collected more CIAC than the value of utility plant in service, thus causing the utility to have a negative rate base. It is our opinion that the utility's rate base is ($179,050) at this time. Although it is possible some adjustments could be made that would increase the utility's rate base, we do not believe they will increase the utility's rate base to $526,000.

In a previous conversation with staff, you indicated that you were considering applying for a limited proceeding to adjust the utility's rate base following approval of the TMOC. We have determined that Residential Water is not eligible for a limited proceeding because the utility has not had a rate case within the last two years. If the utility requests an adjustment to its rate base or rates (other than through a price index or pass-through rate adjustment), the utility will be required to file for a full rate case proceeding to allow the Commission to fully analyze the utility's rate base, operations and maintenance expenses, and so forth. We have attached our analysis of how the Commission's policies will apply to the utility's rate base in Attachment B. We believe it is important that you understand the Commission's policies regarding setting rate base and urge you to read our analysis carefully.

We are not charged with the responsibility of protecting your personal business interests, nor do we have the right to advise you on how to conduct your business. We are, however, charged with the responsibility of protecting the customers of the utilities we regulate and ensuring that they will continue to have service of sufficient quality, along with fair, just and reasonable rates and charges. We believe the potential risk to the customers of Residential Water and Tradewinds is significant enough to warrant a decision that this transfer is not in the public interest and a recommendation that the application be denied.

As I stated in the opening of this memorandum, we wanted to share our concerns with you and give you the opportunity to provide any additional information you have that may resolve our concerns if you choose to proceed with this application. Also, any information you can provide regarding what will happen if the Commission denies this application will be helpful (e.g., Buyer and Seller will renegotiate a lower purchase price, Seller will attempt to find another Buyer, Seller will abandon the utility, etc.) Although we are currently of the opinion that this transfer is not in the public interest and should be denied, we will objectively consider any additional information that you can provide to us before making our recommendation to the Commission. Conversely, if after reviewing the attached information, you do not wish to proceed with the stock transfer, you may withdraw the application.

We are currently scheduled to present our recommendation to the Commission at the May 20, 1997 Agenda Conference. Please notify us by April 11, 1997, if you have additional information you would like for us to consider or if you decide to withdraw the application. Also, please feel free to call Martha Golden (904)413-7015 if you have any questions.

BBM/MAG
Attachments
cc: Division of Water and Wastewater (Hill, Williams, Redemann, Golden)
Division of Legal Services (Jaber, Crosby, K. Johnson)
Division of Records and Reporting

ANALYSIS OF STOCK PURCHASE PRICE VS. INCOME

CALCULATION OF MONTHLY STOCK PAYMENTS

According to the Stock Purchase Agreement (Agreement) included in the application, the total purchase price for the stock is $526,000. According the Agreement, the First Addendum to the Stock Purchase Agreement (Addendum) included in your letter dated December 7, 1996, and the Promissory Note from the First Bank of the Villages included in your letter dated February 4, 1997, the terms of the stock purchase are as follows:

1. A $50,000 down payment. $35,000 was paid upon execution of the Addendum and the $15,000 balance will be due at closing.

2. Ratification of the demand promissory notes, representing previous shareholder loans to the Corporation, and first mortgage from the First Bank of the Villages.

   A. The shareholder loans equal $24,354.67, payable at $15,000 at closing with the remaining $9,354.67 financed by the Sellers at 10% interest over 30 years.

   B. The balloon mortgage from the First Bank of the Villages is in the amount of $90,000 at a rate of 8.75% over 5 years. The monthly payments will be $795.34 until July 16, 2001, at which time the entire balance of $84,380.62 will be due.

3. $386,000 will be financed by the Sellers at 10% over 30 years.

4. Additionally, according to Item No. 9 of the Agreement, the Buyer has agreed to obtain term life insurance, with the Sellers as beneficiary, in an amount of at least 50% of the outstanding debt. Although we do not know the cost of the term life insurance, we recognize that it is an additional expense that will be incurred by the Buyer as a result of this stock purchase.

According to the information you provided in the application, we have calculated the monthly payments for the stock purchase as follows:

<u>For each month until July 16, 2001:</u>

For the $9,354.67 financed by the Sellers:	$ 82.09
For the $90,000 mortgage:	$ 795.34
For the $386,000 financed by the Sellers:	$ 3,387.43
Total per month:	$ 4,264.86
Times 12 months:	x 12
Total per year:	$51,178.32

<u>On July 16, 2001, the remaining balance of the $90,000 balloon mortgage will be due for a monthly total of:</u>

For the $9,354.67 financed by the Sellers:	$ 82.09
For the $90,000 mortgage:	$84,380.62
For the $386,000 financed by the Sellers:	$ 3,387.43
Total per month:	$87,850.14

<u>After July 16, 2001, the monthly payments will drop to the following level for the next 25 years provided the mortgage is not refinanced:</u>

For the $9,354.67 financed by the Sellers:	$ 82.09
For the $386,000 financed by the Sellers:	$ 3,387.43
Total per month:	$ 3,469.52
Times 12 months:	x 12
Total per year:	$41,634.24

CALCULATION OF ANNUAL INCOME

Based upon information contained in the 1995 Annual Reports filed with this Commission for BFF Corp., Inc. (BFF), CFAT H2O, Inc. (CFAT), Residential Water, and Tradewinds, we believe all or part of the following items may be included in your annual income:

Paid by BFF to Tradewinds for Management and Maintenance (Page F-7 of the 1995 Annual Report)	$13,440
Paid by CFAT to Tradewinds for Management Fee (Page F-7 of the 1995 Annual Report)	$10,246

Paid by Residential Water to MIRA International, Inc. for Management Services (Page F-7 of the 1995 Annual Report)	$ 8,744
Paid by Tradewinds to Charles deMenzes for Officer's Salary (Page F-2 of the 1995 Annual Report)	$22,600
Net Income for Tradewinds (Page F-3 of the 1995 Annual Report)	$ 7,042

According to Tradewinds' 1995 Annual Report (Page F-3), its net income is attributable to non utility income rather than water and wastewater revenues. It is not clear from the Annual Report whether or not the non utility income represents the income received by Tradewinds from BFF and CFAT. Therefore, we have calculated your annual income using two different sets of assumptions.

1. Assuming that you receive all of the income listed above, your annual income would equal $62,072, before deductions for business expenses, personal expenses, and taxes.

2. Assuming: (1) the non utility income shown in Tradewinds' Annual Report represents the income received from BFF and CFAT, (2) the 45% profit and 55% non utility expense split (as shown in Tradewinds' Annual Report) can be applied to the revenue received from Residential Water for Management Services, and (3) the Tradewinds' net income is split 50/50 between you and your partner, Jean Segarra, your annual income would equal $30,056, before deductions for personal expenses and taxes.

Calculation:	Net Income from Management Services for Residential Water ($8,744 * 45% profit)	$ 3,935
	Officer's Salary	$22,600
	50% of Net Income from Tradewinds	$ 3,521
	Total	$30,056

It should be noted that we intentionally did not include a return on your investment in the stock, because we do not believe you will make a return on this investment based upon our analysis of the utility's rate base and future earnings potential. Our rate base analysis is discussed in Attachment B.

LIQUIDITY

According to the Personal Financial Statement that was included in your deficiency corrections dated December 7, 1996, only the $30,000 in cash is definitely liquid at this time. However, assuming the remaining $15,000 balance of the $50,000 down payment is paid out of these cash reserves, the cash balance will drop to $15,000. Although some of the other assets listed may be liquid, we cannot determine that with certainty from the information provided. For example, the $5,000 in money market funds, securities, and individual retirement plans (IRA) are fairly liquid, but may be diminished by penalties for early withdrawal or sale at a loss. Further, whether or not these items can be viewed as liquid depends largely on your willingness to close these accounts or sell the securities. Also, the $72,000 in notes from Residential Water, Tradewinds, and miscellaneous notes will only be considered liquid assets if they have a term of less than 90 days.

Additionally, your Personal Financial Statement shows a net worth for Tradewinds of $500,000. For regulatory purposes, we will only consider your share of the utility's capital. According to the 1995 Annual Report (Page F-4), Tradewinds' total capital is $143,197. Assuming that you must split this 50/50 with your partner, your share of the capital is $71,598.50. We do not view your share of Tradewinds or MIRA International as liquid assets. But even if we did, we would only be able to consider $71,598.50 for Tradewinds, not the $500,000 shown on your financial statement. Therefore, for our purposes, we are only considering $15,000 of your total assets to be definite liquid assets available for the monthly stock payments at this time. However, even if we consider the money market funds, securities, and IRA as liquid assets, they are not of sufficient value to remedy the revenue shortfall we believe you will experience as shown below.

COMPARISON OF STOCK PURCHASE PRICE TO ANNUAL INCOME

Using the two different annual income levels we calculated above, we have calculated the difference in the annual funds needed to purchase the stock and our estimation of your annual income during the first four years of payments until the balloon mortgage balance becomes due.

	Using Highest Income Estimate	Using Lowest Income Estimate
Annual Income:	$60,072	$30,056
Stock Payments:	$51,178	$51,178
Difference:	$ 8,894	($21,122)
Plus Cash Reserves:		$15,000
Deficit:		($ 6,122)
Plus Money Market Funds, Securities, and IRA		$ 5,000
Deficit:		($ 1,122)

For each year until the balloon mortgage balance becomes due, under the highest income estimate, after all payments are made for the stock purchase, only $8,894 (or $741 per month) remains for the payment of business expenses, personal expenses, and taxes. As noted earlier, the Buyer is required to purchase term life insurance in conjunction with this stock purchase, therefore, the actual amount of income available for expenses not related to this transaction is something less than $8,894.

Using the lowest income estimate, there will not even be enough to cover the first year's worth of stock purchase payments even after depleting the cash reserves, money market funds, securities, and individual retirement account. Further, there will be no income left to cover personal expenses or taxes.

Based on the information provided in the application and various Annual Reports discussed above, we do not believe you have sufficient income and liquid assets to sustain this level of monthly stock payments over an extended period of time. Further, we believe the burden this purchase will place on your immediate cash flow will make it difficult to accumulate enough funds to pay the balance of the balloon mortgage when it comes due (assuming that you are unable to refinance the mortgage.) Because the utility property and assets are serving as collateral for the mortgage, we believe a default on the mortgage could jeopardize the customers' utility service. Additionally, we believe the drain this purchase will put on your resources, will reduce the amount of resources available to maintain Tradewinds. And thus, those customers could be affected by this transaction as well.

ANALYSIS OF RESIDENTIAL WATER SYSTEM'S RATE BASE AND FUTURE EARNINGS POTENTIAL

LIMITED PROCEEDING VS. RATE CASE

In a previous conversation with staff, you indicated that you were considering applying for a limited proceeding to adjust the utility's rate base following approval of the TMOC. We have determined that Residential Water will not be eligible for a limited proceeding. Commission policy is that we will only accept an application for a limited proceeding from a utility that has had a full blown rate case within the last two years. Further, the application will only be accepted if it has a very narrow scope and will not greatly impact the rates.

Although Residential Water applied for a staff-assisted rate case in 1992, the utility withdrew its application before the case was completed. But even if it had been completed, it was more than two years ago. Because Residential Water has never completed a rate case, it will not be eligible for a limited proceeding. In order to get a rate base or rate adjustment (other than a price index or pass-through rate adjustment), it will be necessary for the utility to apply for a full rate case. However, because the utility is still a Class C utility, it would most likely qualify for a staff-assisted rate case.

ACQUISITION ADJUSTMENT

Commission policy regarding stock transfers is that we do not regulate the price of stock. The Buyer and Seller may negotiate any stock price they like, irrespective of a utility's rate base. The Commission does not establish rate base in TMOC proceedings because Commission policy is that the price of stock has no impact on rate base whatsoever. Therefore, rate base will not change as the result of a stock transfer. The Commission has never made an acquisition adjustment to rate base based upon a stock purchase price. Therefore, your purchase price for this stock will not be considered in future rate base calculations.

UTILITY PLANT IN SERVICE

As you are aware, our Division of Auditing and Financial Analysis recently conducted an audit of the utility's books and records and determined that the utility's current rate base is ($179,050). Some of the auditor's adjustments were made because the utility did not have records to document the cost of certain plant items. If the company files for a staff-assisted rate case, an original cost study can be done which will include the physical plant that exists at the utility site but cannot be documented. However, for the purpose of determining a utility's rate base, the Commission uses the original cost of the utility components at the time they were put into service, not the current construction costs. The significance of this point is that although the engineering cost estimate you provided to us shows an estimated plant in service value of $505,803.75, it was based upon current construction costs not original costs. An original cost study will produce a lower figure. Much of the utility's plant has been in service since 1984. Thus, not only will it be valued lower than the current construction price, it is partially depreciated. Although the engineering cost estimate may be valid in some other arenas, it has very little, if any, significance from a regulatory ratemaking standpoint.

Also, a large part of the engineering cost estimate is for the utility's transmission and distribution system. According to the audit report, the utility paid developers $200 per lot for a portion of the lines. The total paid to developers for the lines is $66,470. Therefore, this is the amount that will be allowed in plant in service for the lines regardless of what the current construction cost of the lines may be. If this figure does not represent all of the lines owned by the utility, any remaining lines will be added to rate base at their original cost.

However, Rule 25-30.570(1), Florida Administrative Code, states that "if the amount of contributions-in-aid-of-Construction (CIAC) has not been recorded on the utility's books and the utility does not submit competent substantial evidence as to the amount of CIAC, the amount of CIAC shall be imputed to be the amount of plant costs charged to the cost of land sales for tax purposes if available, or the proportion of the cost of the facilities and plant attributable to the water transmission and distribution system and the sewage collection system." According to the audit report, the utility is unable to provide competent substantial evidence to support the CIAC recorded on its books. It is likely that although an original cost study would include any remaining lines at their original cost, this amount would be offset by an equal adjustment to CIAC, and thus would not serve to increase the utility's rate base.

If after conducting an original cost study, the utility still has a negative rate base, Commission policy is to set rate base at $0. In other words, the utility will have no investment upon which to earn a return.

<u>OPERATING RATIO</u>

You may be aware that the Commission has previously approved the use of an operating ratio in a staff-assisted rate case in which the utility had a zero rate base. Specifically, the Commission authorized the utility to earn a 10% return on its operation and maintenance expenses. <u>Although there is a possibility that the Commission could approve an operating margin for Residential Water, it is not likely</u>.

The Commission is currently leaning towards only using the operating ratio for utilities which are in receivership or which have been purchased after an abandonment. Further, the Commission does not look favorably on allowing an operating margin for utilities which have a negative rate base due to over-collection of CIAC. In essence, by over-collecting the CIAC, the utility owners have already recovered all of their initial investment in the plant and then some. It is not fair to the customers who have already paid more than the cost of the facilities through service availability charges, to also pay a return through the monthly service rates.

CONTRIBUTIONS-IN-AID-OF-CONSTRUCTION (CIAC)

Rule 25-30.580, Florida Administrative Code, provides the guidelines for designing a service availability policy. Subsection (1)(a) of the Rule states that the maximum amount of contributions-in-aid-of-construction, net of amortization, should not exceed 75% of the total original cost, net of accumulated depreciation, of the utility's facilities and plant when the facilities and plant are at their designed capacity. According to our calculations, the utility's current level of CIAC is 409.13%, which is well in excess of the Commission's guidelines. The customers have contributed through service availability charges 334.13% more than the original cost of the utility's facilities.

In your deficiency response dated December 7, 1996, you noted the discrepancy between the utility plant in service and CIAC shown in the utility's Annual Report. You were correct in thinking that the discrepancy between the utility plant in service and CIAC indicated a problem. However, your assumption that the discrepancy was due to an accounting error is incorrect. In fact, we believe that the utility did over-collect the CIAC, and as a result has a negative rate base.

Although the level of CIAC could change depending on the outcome of the original cost study, the magnitude of the over-contribution makes it very unlikely that the utility's CIAC level will drop back within the Commission's guidelines. Thus, it is a very real possibility that the Commission will eliminate this utility's service availability charges when it files for a rate case. Consequently, the utility owners would have to bear the full cost of any future plant additions until the utility's CIAC level drops back within the Commission's guidelines. The utility would not be able to recover any of its investment in future plant additions through service availability charges.

CAPITAL STRUCTURE

As discussed previously, the stock purchase price is comprised of a $50,000 cash down payment, repayment of shareholder loans to the utility in the amount of $24,354.67, a $90,000 utility mortgage, and $386,000 which will be financed by the Sellers. The only portions of the stock purchase price that could be considered in a rate calculation are the shareholder loans and utility mortgage. The shareholder loans could be included in the utility's capital structure as utility debt if there are debt instruments for the loans. If there are no debt instruments for the loans, they would be included in the capital structure as common equity. Also, because the $90,000 mortgage represents utility debt, it could be included in the utility's capital structure. However, because it is Commission policy to reconcile the capital structure to match the utility's rate base, the Commission may not allow the full amount of these loans if the utility does not have supporting cost documentation for the utility's facilities. It should be noted, however, that regardless of what is included in the utility's capital structure, if the rate base is $0, the utility will not earn a return.

CONCLUSION

All of this leads us to the conclusion that when this utility files for a rate case, the final outcome may be that the Commission will only approve break-even rates. Specifically, the rates will only recover the utility's operation and maintenance expenses and taxes other than income. They will not include any return on investment or an operating margin. Consequently, there will be no utility profits from which the utility can pay stock dividends, and you will not earn a return on your stock investment. Although this is the worst case scenario, in this case it happens to be a very likely scenario and one that you should be aware of. It is also a very important factor in our consideration of your financial ability to make the necessary payments to purchase the stock and continue to operate both Residential Water and Tradewinds in a satisfactory manner.