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DATE: SEPTEMBER 20, 2001

TO: DIRECTOR, DIVISION OF THE COMMISSION CLERK & ADMINISTRATIVE SERVICES (BAYÓ)

FROM: DIVISION OF ECONOMIC REGULATION (B. DAVIS, D. DRAPER, *RM*, *ALM*)
MERCHANT) *MM*
DIVISION OF LEGAL SERVICES (HARRIS) *MM*, *PS*

RE: DOCKET NO. 011190-SU - INVESTIGATION OF POSSIBLE OVEREARNINGS BY TIERRE VERDE UTILITIES, INC., IN PINELLAS COUNTY.
COUNTY: PINELLAS

AGENDA: 10/02/01 - REGULAR AGENDA - DECISION ON SETTING REVENUES SUBJECT TO REFUND - INTERESTED PERSONS MAY PARTICIPATE ON ISSUE 1 ONLY - PARTICIPATION IS LIMITED TO COMMISSIONERS AND STAFF ON ISSUES 2 - 3

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\ECR\WP\011190.RCM

CASE BACKGROUND

Tierre Verde Utilities, Inc. (Tierre Verde or utility) is a Class B utility providing wastewater service in Pinellas County. The utility is a wholly-owned subsidiary of Utilities, Inc.

The utility assets of Seagull Utility Company were purchased by Tierre Verde in 1992 and the certificate was transferred by Order No. PSC-93-0364-FOF-SU, issued March 9, 1993, in Docket No. 920716-SU. The utility has not had a rate proceeding since the transfer; consequently, no return on equity (ROE) has been set for Tierre Verde. As such, staff is recommending the use of the leverage formula to determine the cost of equity for interim purposes, pursuant to Sections 367.081(4)(f) and 367.082(5)(b)3,

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Florida Statutes. Based on staff's review of the utility's 2000 Annual Report, the utility achieved a 13.48% overall rate of return on its rate base. This equates to a 19.19% ROE, which exceeds the ROE calculated by the current leverage graph. Staff believes it is necessary and appropriate to initiate an investigation into the potential annual overearnings of this utility.

The Commission has jurisdiction pursuant to Sections 367.081, 367.082 and 367.121, Florida Statutes.

DISCUSSION OF ISSUES

ISSUE 1: Should the Commission initiate an overearnings investigation of Terre Verde Utilities, Inc.?

RECOMMENDATION: Yes. The Commission should initiate an investigation of the utility for possible overearnings. The test year for the investigation should be the year ended December 31, 2000. The docket should remain open pending the Commission's completion of the investigation. (B. DAVIS)

STAFF ANALYSIS: Section 367.082, Florida Statutes, authorizes the Commission to initiate an investigation of a utility's earnings upon a preliminary demonstration that the utility is earning a rate of return which is outside the range of reasonableness. To the extent that the achieved rate of return exceeds the required rate of return, the Commission may require revenues to be collected subject to refund during the investigation.

Staff's preliminary analysis, based on the review of the utility's 2000 Annual Report, indicates that during 2000 the utility's wastewater system earned a 13.48% overall rate of return. Using the utility's capital structure from the Annual Report and the return on equity calculated from the current leverage formula, staff has calculated an ROE of 9.81% and an overall rate of return of 9.24%. The utility achieved a 13.48% overall rate of return on its rate base, which equates to a 19.19% ROE, which exceeds the ROE calculated by the current leverage graph. The current leverage was approved by Order No. PSC-00-1162-PAA-WS, issued June 26, 2000, in Docket No. 000006-WS (consummated by Order No. PSC-00-1299-CO-WS issued July 18, 2000).

Staff believes that a full investigation of this utility's earnings for wastewater service is appropriate. The test year for the investigation should be the year ended December 31, 2000. This docket should remain open pending the completion of the Commission's investigation of the utility's earnings.

ISSUE 2: Should any amount of annual wastewater revenues be held subject to refund, and, if so, what is the appropriate amount?

RECOMMENDATION: Yes, the utility should hold annual wastewater revenues of \$29,488, or 5.93%, subject to refund, based on the following:

Revenue Requirement	\$467,557
2000 Test Year Revenue	\$497,045
Amount Subject to Refund	\$29,488
Percent Subject to Refund	5.93%

(B. DAVIS)

STAFF ANALYSIS: Pursuant to Section 367.082, Florida Statutes, in determining whether an interim decrease is appropriate, the Commission shall determine, on a prima facie basis, if the utility's achieved rate of return exceeds its required rate of return. The achieved rate of return for interim purposes shall be calculated by applying appropriate adjustments consistent with those used in the utility's most recent rate proceeding, and annualizing any rate changes that occurred during the interim test year. The required rate of return is calculated by taking the test year cost of capital and using the maximum of the range of the last authorized ROE. Staff has reviewed the utility's annual report to determine if the utility's reported rate base, cost of capital and net operating income amounts are consistent with the interim statute.

Rate Base

Tierre Verde is a Class B utility. Chapter 25-30.433(2), Florida Administrative Code, specifies that working capital for Class B and C utilities shall be calculated using the formula method (one-eighth of operation and maintenance expenses). The utility has presented working capital using the formula in the annual report and no adjustment is necessary.

Based on our review, no further adjustments to rate base are necessary. Staff's adjusted wastewater rate base is attached as Schedule 1.

Cost of Capital

As discussed in the case background Seagull Utility Company was transferred to Terre Verde, a subsidiary of Utilities, Inc., by a sale of assets. Order No. PSC-93-0364-FOF-SU issued on March 9, 1993, approved the transfer of certificate.

Terre Verde has not had a rate proceeding since the transfer. In its 2000 Annual Report, the utility reflected a last authorized ROE of 13.03%. This was the ROE established for Seagull in Docket No. 850883-SU, by Order No. 16781, issued on October 27, 1986.

In two other rate cases of subsidiaries of Utilities, Inc., where prior sales of assets occurred, the Commission has determined that the ROE of the prior utility did not carry over to the new company. As such, those two companies had no previously authorized ROE after the transfer. In determining interim rate increases, the Commission used the leverage formula in effect at that time, pursuant to Section 367.081(4)(f), Florida Statutes. See Order No. 20066, issued September 26, 1988, in Docket No. 870981-WS (Miles Grant Water and Sewer Company); and Order No. PSC-96-0170-FOF-WS, issued February 6, 1996, in Docket No. 951027 (Lake Placid Utilities, Inc.).

Staff notes that in Order No. PSC-95-1490-FOF-WS, issued November 30, 1995, in Docket No. 950337-WS, the Commission established Allowance for Funds Used During Construction (AFUDC)¹ rates for several of the Utilities, Inc. subsidiaries. In that docket, the Commission adjusted the requested AFUDC rate to reflect the current leverage formula for several of those systems, including Terre Verde, which did not have an authorized ROE. A docket for approval of an AFUDC rate, outside of a rate case or limited proceeding, is not, in and of itself, a rate proceeding. As such, that type of proceeding does not establish an authorized ROE to be used for interim purposes pursuant to Section 367.082(5)(b)3, Florida Statutes.

¹AFUDC is an accounting entry designed to permit the utility recovery of the cost associated with financing on-going, long-term construction activities. AFUDC is not a tariffed rate or charge.

Based on the above, staff believes that it is appropriate to use the current leverage formula approved by Order No. PSC-00-1162-PAA-WS. Using the utility's equity ratio, we have calculated an ROE of 9.81%, with a range of 8.81% to 10.81%. Using the maximum of the range and the reported cost rates for other components in the utility's capital structure, yields a 9.70% overall cost of capital for interim purposes. Schedule 2 reflects staff's adjusted cost of capital.

Net Operating Income

The utility's Annual Report reflects wastewater operating revenues totaling \$485,829 for the year ending December 31, 2000. The utility implemented 1999 and 2000 index rate adjustments during the year 2000. Pursuant to Section 367.082(5)(b)(1), Florida Statutes, any rate changes implemented during the interim test year shall be annualized. Staff has increased wastewater revenues by \$11,216 to annualize the index adjustments and made a corresponding increase to taxes other than income of \$505 for regulatory assessment fees.

In the transfer discussed previously, the utility recorded a positive acquisition adjustment, which was not approved by the Commission. While the utility's rate base reflected in its annual report does not include the acquisition adjustment, it did include \$10,086 for amortization of the acquisition adjustment as an above-the-line expense. Since this amount was not allowed by the Commission in the transfer, staff has removed the amortization from expense.

Staff has also recalculated income tax expense based on the adjusted rate base, cost of capital and operating income amounts. After making the above staff adjustments, staff recommends that the test year net operating income should be \$62,586. This reflects an achieved overall rate of return of 13.48%. The wastewater net operating income is attached as Schedule 3-A with the adjustments shown on Schedule 3-B.

Revenue Requirement

Using the required rate of return for interim decrease purposes of 9.70%, staff recommends that the wastewater revenue requirement should be \$467,557. This reflects a decrease of \$29,488 (or 5.93%) from the adjusted test year operating revenues

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of \$497,045. This represents the annual revenues that should be held subject to refund pending the Commission's final determination of Terre Verde's level of earnings in this docket.

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

RECOMMENDATION: The utility should be required to file a corporate undertaking to guarantee the amount subject to refund within 10 days of the effective date of the order opening this investigation. The corporate undertaking should be in the amount of \$25,000. Pursuant to Rule 25-30.360(6), Florida Administrative Code, the utility should be required to provide a report by the 20th of each month indicating the monthly and total revenue collected subject to refund. The utility should be put on notice that failure to comply in a timely manner with these requirements, will result in the initiation of a show cause proceeding. (D. DRAPER, B. DAVIS)

STAFF ANALYSIS: Pursuant to Section 367.082(2)(b), Florida Statutes, when revenues are held subject to refund and secured in a proceeding for an interim decrease, the utility is authorized to continue collecting the previously authorized rates. Staff has recommended that the amount of potential overearnings on an annual basis is \$29,488 for the wastewater system. Assuming a 10-month time frame, the potential refund amount is approximately \$25,000.

Staff has analyzed whether Tierre Verde can support a corporate undertaking in the amount of \$25,000. The criterion for a corporate undertaking includes sufficient liquidity, ownership equity, profitability, and interest coverage to guarantee any potential refund. The 1998, 1999 and 2000 annual reports of Tierre Verde were used to determine the financial condition of the Company. Staff's analysis shows that Tierre Verde has had minimal liquidity and marginal interest coverage for the three-year period. However, for the same period the company has reported sufficient common equity and positive income. Based upon Tierre Verde's high level of equity relative to the amount of the corporate undertaking, staff recommends that Tierre Verde can support a corporate undertaking in the amount of \$25,000.

This brief financial analysis is only appropriate for deciding if the utility can support a corporate undertaking in the amount proposed and should not be considered a finding regarding staff's position on other issues in this investigation.

The utility should keep an accurate and detailed account of all monies it receives. Pursuant to Rule 25-30.360(6), Florida Administrative Code, the utility should provide a report by the

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20th day of each month indicating the monthly and total revenue collected subject to refund. Should a refund be required, the refund should be with interest and undertaken in accordance with Rule 25-30.360, Florida Administrative Code.

In no instance should maintenance and administrative costs associated with any refund be borne by the customers. The costs are the responsibility of, and should be borne by, the utility. Finally, the utility should be on notice that failure to comply on a timely basis with the requirements of the Commission's order will result in the initiation of a show cause proceeding.

TIERRE VERDE UTILITIES, INC. SCHEDULE OF WASTEWATER RATE BASE TEST YEAR ENDED 12/31/00			SCHEDULE NO. 1 DOCKET 011190-SU
DESCRIPTION	TEST YEAR PER UTILITY	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR
1 UTILITY PLANT IN SERVICE	\$2,832,655	\$0	\$2,832,655
2 LAND	\$0	\$0	\$0
3 NON-USED & USEFUL COMPONENTS	\$0	\$0	\$0
4 ACCUMULATED DEPRECIATION	(\$1,597,537)	\$0	(\$1,597,537)
5 CIAC	(\$1,623,585)	\$0	(\$1,623,585)
6 AMORTIZATION OF CIAC	\$809,694	\$0	\$809,694
7 CWIP	\$0	\$0	\$0
8 ADVANCES FOR CONSTRUCTION	\$0	\$0	\$0
9 WORKING CAPITAL ALLOWANCE	\$43,117	\$0	\$43,117
10 OTHER	<u>\$0</u>	<u>\$0</u>	<u>\$0</u>
11 RATE BASE	<u>\$464,344</u>	<u>\$0</u>	<u>\$464,344</u>

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TIERRE VERDE UTILITIES, INC. CAPITAL STRUCTURE TEST YEAR ENDED 12/31/00						SCHEDULE NO. 2 DOCKET 011190-SU	
DESCRIPTION	TOTAL CAPITAL	SPECIFIC ADJUSTMENTS (EXPLAIN)	PRO RATA ADJUSTMENTS	CAPITAL RECONCILED TO RATE BASE	RATIO	COST RATE	WEIGHTED COST
PER UTILITY 2000 - YEAR-END							
1 LONG TERM DEBT	\$223,244	\$0	\$0	\$223,244	48.08%	8.56%	4.12%
2 SHORT-TERM DEBT	\$22,781	\$0	\$0	\$22,781	4.91%	14.32%	0.70%
3 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
4 COMMON EQUITY	\$209,576	\$0	\$0	\$209,576	45.13%	13.03%	5.88%
5 CUSTOMER DEPOSITS	\$0	\$0	\$0	\$0	0.00%	6.00%	0.00%
6 DEFERRED INCOME TAXES	\$8,743	\$0	\$0	\$8,743	1.88%	0.00%	0.00%
7 DEFERRED ITC'S-ZERO COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
8 DEFERRED ITC'S-WTD. COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
9 OTHER	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
10 TOTAL CAPITAL	<u>\$464,344</u>	<u>\$0</u>	<u>\$0</u>	<u>\$464,344</u>	<u>100.00%</u>		<u>10.70%</u>
PER STAFF 2000							
11 LONG TERM DEBT	\$223,244	\$0	\$0	\$223,244	48.08%	8.56%	4.12%
12 SHORT-TERM DEBT	\$22,781	\$0	\$0	\$22,781	4.91%	14.32%	0.70%
13 PREFERRED STOCK	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
14 COMMON EQUITY	\$209,576	\$0	\$0	\$209,576	45.13%	9.81%	4.43%
15 CUSTOMER DEPOSITS	\$0	\$0	\$0	\$0	0.00%	6.00%	0.00%
16 DEFERRED INCOME TAXES	\$8,743	\$0	\$0	\$8,743	1.88%	0.00%	0.00%
17 DEFERRED ITC'S-ZERO COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
18 DEFERRED ITC'S-WTD. COST	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
19 OTHER	\$0	\$0	\$0	\$0	0.00%	0.00%	0.00%
20 TOTAL CAPITAL	<u>\$464,344</u>	<u>\$0</u>	<u>\$0</u>	<u>\$464,344</u>	<u>100.00%</u>		<u>9.24%</u>
					<u>LOW</u>	<u>HIGH</u>	
RETURN ON EQUITY					<u>8.81%</u>	<u>10.81%</u>	
OVERALL RATE OF RETURN					<u>8.79%</u>	<u>9.70%</u>	

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TIERRE VERDE UTILITIES, INC. STATEMENT OF WASTEWATER OPERATIONS TEST YEAR ENDED 12/31/00				SCHEDULE NO. 3-A DOCKET 011190-SU	
DESCRIPTION	TEST YEAR PER UTILITY	STAFF ADJUSTMENTS	STAFF ADJUSTED TEST YEAR	REVENUE INCREASE	REVENUE REQUIREMENT
1 OPERATING REVENUES	<u>\$485,829</u>	<u>\$11,216</u>	<u>\$497,045</u>	<u>(\$29,488)</u> -5.93%	<u>\$467,557</u>
OPERATING EXPENSES					
2 OPERATION & MAINTENANCE	344,935	\$0	\$344,935		\$344,935
3 DEPRECIATION	36,279	\$0	\$36,279		\$36,279
4 AMORTIZATION	10,086	(\$10,086)	\$0		\$0
5 TAXES OTHER THAN INCOME	28,478	\$505	\$28,983	(\$1,327)	\$27,656
6 INCOME TAXES	<u>\$10,075</u>	<u>\$14,187</u>	<u>\$24,262</u>	<u>(\$10,597)</u>	<u>\$13,665</u>
7 TOTAL OPERATING EXPENSES	<u>\$429,853</u>	<u>\$4,606</u>	<u>\$434,459</u>	<u>(\$11,924)</u>	<u>\$422,535</u>
8 OPERATING INCOME	<u>\$55,976</u>	<u>\$6,610</u>	<u>\$62,586</u>	<u>(\$17,564)</u>	<u>\$45,022</u>
9 RATE BASE	<u>\$464,344</u>		<u>\$464,344</u>		<u>\$464,344</u>
10 RATE OF RETURN	<u>12.05%</u>		<u>13.48%</u>		<u>9.70%</u>

TIERRE VERDE UTILITIES, INC.		SCHEDULE NO. 3-B
ADJUSTMENTS TO OPERATING INCOME		DOCKET 011190-SU
TEST YEAR ENDED 12/31/00		
EXPLANATION	WASTEWATER	
<u>OPERATING REVENUES</u>		
1 Annualize 1999 Index		\$1,779
2 Annualize 2000 Index		<u>9,437</u>
Total		<u>\$11,216</u>
<u>AMORTIZATION EXPENSE</u>		
Remove amortization of the acquisition adjustment		<u>(\$10,086)</u>
<u>TAXES OTHER THAN INCOME</u>		
RAFs on revenue adjustments above		<u>\$505</u>
<u>INCOME TAXES</u>		
To adjust to test year income tax expense		<u>\$14,187</u>