

State of Florida



Public Service Commission

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

DATE: August 11, 2005

TO: Director, Division of the Commission Clerk and Administrative Services

FROM: Division of Economic Regulation (Clapp)

RE: Docket No. 040951-WS: Joint application for approval of sale of Florida Water Services Corporation's land, facilities, and certificates in Brevard, Highlands, Lake, Orange, Pasco, Polk, Putnam, a portion of Seminole, Volusia, and Washington counties to Aqua Utilities Florida, Inc.

Docket No. 040952-WS: Joint application for approval of sale of Florida Water Services Corporation's land, facilities, and certificates for Chuluota systems in Seminole County to Aqua Utilities Florida, Inc.

Please add the attached letters from the Florida Water Services Corporation and Aqua Utilities Florida, Inc., jointly, and Office of Public Counsel regarding several issues staff requested additional input. Please add the letters to both dockets since the issues discussed are common to both.

Please note that two copies of the letters are attached.

Thank you.

DOCUMENT NUMBER-DATE

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FPSC-COMMISSION CLERK

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October 7, 2005

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VIA HAND DELIVERY

Re: Docket Nos. 040951-WS and 040952-WS

Dear Jennifer:

Our firm represents Florida Water Services Corporation ("Florida Water") and Aqua Utilities, Inc. ("Aqua"). As you know, by letter dated May 23, 2005, Florida Water responded to a number of proposed adjustments raised in the Staff Audit Report, Audit Control No. 04-247-3-1. Our May 23 letter was devoted in large part to providing the legal, regulatory and accounting support for Florida Water's objections to what appeared to be Staff's proposal to "zero out" debit balances in specific accumulated depreciation reserve accounts.

On September 21, 2005, Staff convened a meeting attended by representatives of Florida Water, Aqua and the Office of Public Counsel ("OPC"). At that meeting, Staff and representatives of OPC and Florida Water discussed certain Staff proposed adjustments including the proposed adjustments to debit depreciation reserve balances, the appropriate treatment of the regulatory asset approved by the Commission in Order No. PSC-99-1794-FOF-WS ("Order No. 99-1794"), the appropriate treatment of certain positive acquisition adjustments, and other issues such as AFPI and an AFUDC rate. At that meeting, Patti Daniel of the Commission Staff requested the parties to provide their positions concerning specific issues in a sufficiently timely manner that would allow Staff to consider such positions in developing the Staff Recommendation scheduled to be issued on October 20, 2005.

The purpose of this letter is to provide Florida Water's positions on pertinent issues as requested by Staff. We are mindful, however, that Staff has not completed its proposed final adjustments and that additional proposed adjustments offered by Staff may need to be addressed by Florida Water.

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COMMUNICATIONS SECTION

Jennifer Brubaker, Esq.

Page 2

October 7, 2005

A. Accumulated Depreciation Debit Balances

The spread sheet data provided by Staff on October 4, 2005 indicates a total proposed adjustment of \$779,829.00 due to debit accumulated depreciation balances. Of that total amount, we understand Staff's data to indicate that \$319,186.00 (\$10,798.00 for the Chuluota systems and \$308,388.00 for the remaining Florida Water plants) relates to the Fixed Asset Study physical inventory undertaken by an independent consultant on behalf of Florida Water on a company-wide basis beginning in 1996 to establish unitized continuing property records, improve internal accounting controls, provide retirement dispersion history needed to monitor/evaluate the service life used to book depreciation of plant in service and to better conform the Company's records to the requirements of the USOA and the Commission's orders. Staff evidently proposes to write-off approximately \$319,000.00 of prudent investment reflected in these debit depreciation reserve balances on the ground that these amounts relate to unidentifiable assets, *i.e.*, assets retired before termination of their average useful lives.

The remaining portion of the \$779,829.00 would appear to apply, at least in part, to the debit depreciation balances related to abandonments (interconnects) where Staff proposes to take the debit accumulated depreciation and move it to an extraordinary abandonment account.

Florida Water opposes these proposed adjustments for the following reasons:

- (1) Consistent with the recommendations of the Commission staff in its management audit of Southern States Utilities, Inc., Florida Water undertook a company-wide effort to update its books and implement a continuing property records system. Florida Water followed the methodology prescribed by the Uniform System of Accounts and standard accounting practices in updating its plant inventory records and establishing a continuing property records system.
- (2) Florida Water utilizes the uniform depreciation rates prescribed by the Commission for systems throughout the state. These uniform depreciation rates were ordered by the Commission to be applied to all of the more than 140 utility systems included in Florida Water's last rate case, Docket No. 950495-WS.
- (3) Debit balances in the Accumulated Reserve Accounts arise from the use of uniform depreciation rates based on average service lives of classes of assets. In other words, when the actual life of plant assets is shorter than the average service life used for depreciation, a debit balance results.

Jennifer Brubaker, Esq.

Page 3

October 7, 2005

- (4) The uniform depreciation rates prescribed by the Commission do not apply to individual assets, but to groups of assets. The depreciation rates are based on average service lives within a group, which inherently means that some assets will be retired before the average service life and some will be retired after the average service life used for depreciation.
- (5) The Audit Report isolates a few accounts with debit accumulated reserve balances and suggests adjustments that are not consistent with basic regulatory and accounting principles. In its last two rate cases, Florida Water was evaluated on a total company basis for such things as return, depreciation, taxes, allocations, customer service, administrative and general costs and general plant. Debit balances in isolated accumulated reserve accounts would have been addressed as a part of future general rate proceedings when detailed property records were available to provide the necessary data.
- (6) The Commission should not evaluate the debit balances in a vacuum and cannot make one-sided accounting adjustments to eliminate a so-called "depletion problem" in the depreciation reserve accounts.
- (7) As of December, 2002, there was approximately \$216 million in accumulated depreciation reserve for all Florida Water systems. The \$779,829.00 of debit accumulated depreciation reserve balance is de minimus and would not have been addressed or adjusted by the Commission as part of Florida Water's on-going operations. No such adjustments to individual debit accumulated depreciation reserve balances were made by the Commission in Florida Water's rate cases. The fact that Aqua has stepped into the shoes of Florida Water as the owner and operator of these utility systems should not trigger an arbitrary reduction in rate base when such adjustments would not have been imposed by the Commission as part of on-going utility operations.
- (8) At the September 21, 2005 meeting, Staff noted that as a part of Florida Water's 1996 projected test year used to establish rates in Docket No. 950495-WS, Florida Water earned depreciation expense on plant which has been retired and can no longer be identified as a result of the Fixed Asset Study. While this is generally true, the revenue derived as a result of such plant being included in the estimated projected 1996 rate base is, again, de minimus and amounts to roughly \$24,000.00 in revenue per year assuming a three percent composite depreciation rate. This additional revenue is substantially offset and outweighed by the fact that Florida Water earned a

Jennifer Brubaker, Esq.
Page 4
October 7, 2005

meager average overall return of 1.3% from 1997 through 2003, invested an additional \$8.6 million in plant for the systems at issue, earned no return on such investment as it was not part of the 1996 projected test year rate base used to establish rates and incurred additional O&M expenses for such additional investment which, again, was not factored into Florida Water's rates.

- (9) It also should be noted that the result of Staff's proposed adjustments would be to chill the incentive for utilities to conduct physical inventory studies to true-up physical assets to books - - a result wholly inconsistent with the recommendation of the Commission Staff in its management audit. As previously emphasized in our May 23, 2005 letter, the adjustments that resulted from the Fixed Asset Study were due, in large part, to previously unrecorded retirement transactions during the time prior to the acquisition by Florida Water and the establishment of appropriate accounting and reporting procedures. Moreover, the adjustments made as a result of the Study had no net effect on the company's rate base because retirement entries were correctly and appropriately made as a credit to plant and a debit to reserve for depreciation.
- (10) Finally, Florida Water is not aware of any prior Commission precedent that would support the Commission's proposed adjustments to reduce rate base to eliminate debit accumulated depreciation reserves.

B. Regulatory Asset

At the September 21, 2005 meeting, OPC took the position that the regulatory asset approved by the Commission in Order No. 99-1794 should not be included in Aqua's rate base. OPC's position must be rejected as the Commission already has addressed this issue. In approving Florida Water's Modified Offer of Settlement of the rate case filed in Docket No. 950495-WS, the Commission approved a component of the Settlement that established a regulatory asset in lieu of the imposition of surcharges. In so doing, the Commission held, in pertinent part:

If a system is sold... then the portion of the regulatory asset associated with the system sold or those systems in the non-jurisdictional county or counties shall remain with that system or systems.¹

¹Order No. 99-1794, at 16.

Jennifer Brubaker, Esq.

Page 5

October 7, 2005

The Commission has determined that the portion of the regulatory asset allocated to each system would travel with that system to a purchaser in the event the system was sold. As such, the Commission has ruled on this issue and OPC's position should be rejected.

C. Allowance for Funds Prudently Invested

Staff also has suggested that there appears to be an over collection of AFPI for the Chuluota systems and that it would be appropriate to credit the amount of the over collection to CIAC. Florida Water disagrees. Once again, Florida Water has been consistently viewed and treated by the Commission as one company. On a total company basis, Florida Water has experienced a significant net under collection of AFPI of approximately \$3.1 million. Moreover, when focusing only on the Chuluota systems, the Staff must be mindful that the over collection of approximately \$185,000.00 for water and wastewater plant and wastewater collection lines is offset by the under collection of \$76,000.00 for water transmission and distribution lines.

Further, Staff's focus on the over collection of AFPI for some of the Chuluota facilities while ignoring the under collection of AFPI for other Chuluota facilities as well as the total company under collection fails to take into account the substantial investment by Florida Water of approximately \$8.6 million in plant for these systems since January 1, 1997. Indeed, with respect to the Chuluota systems, Florida Water's investment post-January, 1997 amounts to approximately \$3 million or a **94% increase** over the \$3.2 million test year plant in service amount approved in Florida Water's 1995 rate case (Docket No. 950495-WS). As Staff is well aware, Florida Water earned no return of or return on these substantial investments as they were not included in rate base the last time rates were established by the Commission. The AFPI collected for the Chuluota systems helped mitigate the impact of the lack of return on or a return of the \$3 million post-rate case investment and contributed to deferring the need for a future rate filing.

In sum, it is Florida Water's position that any proposed adjustment to reduce rate base by arbitrarily eliminating debit depreciation balances is not supported by Commission precedent, is unlawful and a confiscation of investors' property. Florida Water prudently undertook the Fixed Asset Study and has correctly recorded retirement entries for assets previously retired. Clearly, the Commission cannot eliminate a utility's prudent investments without compensation. Rate base cannot and should not be unilaterally adjusted to eliminate the debit balances in the accumulated depreciation reserve account. In addition, the portions of the regulatory asset established by Florida Water with Commission approval should be included in the establishment of rate base for Aqua as required by Order No. 99-1794.

Jennifer Brubaker, Esq.

Page 6

October 7, 2005

Respectfully submitted,

A handwritten signature in black ink, appearing to read "Kenneth A. Hoffman". The signature is fluid and cursive, with a long horizontal stroke extending to the right.

Kenneth A. Hoffman

KAH/rl

cc: J. Stephen Menton, Esq.

Melissa Taylor, Esq.

Mr. Forrest L. Ludsen

Mr. Tony Isaacs

Mr. Hugh Gower

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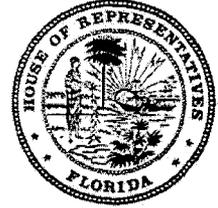
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October 10, 2005

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Re: OPC's Position on Transfer of Regulatory Assets and Accumulated Depreciation Debit Balances from Florida Water Services Corporation ("FWS") to Aqua Utilities Florida, Inc. ("Aqua Utilities"), Dockets Nos. 040951-WS and 040952-WS.

Dear Ms. Brubaker:

At the September 21, 2005 meeting, Staff requested that parties provide written comments regarding the establishment of rate base in the above transfer dockets. The following are the Office of Public Counsel's (OPC's) comments.

Transfer of Regulatory Assets

By Order No. PSC-99-1794-FOF-WS (Order No. 99-1794), issued September 14, 1999, the Commission allowed FWS to book a regulatory asset representing the surcharge revenues foregone by FWS in its last rate case, Docket No. 950495-WS. The Commission approved the \$8.5 million regulatory asset with a 30-year amortization period with amortization to **begin when the Company (FWS) filed its next rate case**. Further, the asset would be allocated among the FWS systems based on the equivalent residential connections (ERCs) included in the rate case compared to total ERCs as of December 31, 1996. If any system was sold or if a county rescinds jurisdiction, that portion of the regulatory asset would go with the system(s) and not be included for recovery in any future FWS rate case. Order No. 99-1794 protects the remaining customers of unsold FWS systems from bearing the costs of the amortization of this regulatory asset associated with the sold systems. The Order does not contemplate or authorize the buyers of FWS systems to recover surcharge revenues foregone by FWS in its last rate case. The order was silent on what action would be taken if all assets of FWS were sold.

In the rate base to be transferred in this docket, FWS has included the regulatory asset associated with the remaining systems as an intangible asset to be sold to Aqua Utilities. OPC believes that the regulatory asset should not be transferred to Aqua Utilities to be recovered in future rate cases filed by Aqua Utilities. Our arguments are addressed below.

First, the order only contemplates recovery of this regulatory asset by FWS, not by any potential purchaser of the individual systems. The language in the order was driven by the concern that customers of any surviving systems of FWS would not bear the recovery of assets belonging to systems that had been sold. This regulatory asset represents the revenues foregone by FWS in its last rate case and if FWS desired recovery it should have filed a rate case.

This intangible asset was certainly known by both parties to this sale but there is no specific mention of the asset in the purchase agreement. If recovery of this asset were important to the buyer, then OPC believes that this asset would have been specifically identified in the purchase agreement. Given that the agreement only mentions generic intangible assets, and that the sales price can be adjusted based on changes to rate base made by the Commission, OPC believes that FWS, not the buyer, has an interest in the continuation of the regulatory asset.

OPC agrees that the order states that when a system is sold that the regulatory asset goes with that system. However, OPC contends that when the settlement was proposed, the Commission was not faced with the sale of all the assets of the Company. The order clearly contemplated that the regulatory asset for any systems sold would not be charged to the ratepayers of the remaining systems in a future FWS rate case. Regardless, allowing a new owner to recover the lost profits of a prior owner is bad public policy.

Further, there are many items which belong to a particular system being sold that do not transfer to the new owner or remain with the seller after the transfer. One particular example of this is the prior owner's equity in the assets. The level of equity and debt financing to be reflected on the ongoing utility's books will be based on the buyer's management decisions. Other examples of items that belong to a system that do not survive a transfer include an acquisition adjustment from the prior owner's purchase of the assets or the deferred income taxes related to the sold assets. See FASB Statement No. 142, Goodwill and Other Intangible Assets.

Further, OPC also believes that continuing the accrual of this regulatory asset without any amortization violates generally accepted accounting principles (GAAP). It has been over 6 years since the Commission approved the regulatory asset and amortization has not begun because FWS has not filed a subsequent rate case. Such an indefinite time frame for recovery does not meet the requirement of Financial Accounting Standard Board (FASB) Statement No. 71, that revenue recognition in rates is probable. Statement 71 also states that non-amortized regulatory assets have to be measured each year for impairment. If the asset is deemed impaired it has to be written off in the year the impairment is determined. OPC believes that this asset became impaired several years ago and should have already been written off by FWS to be in compliance with GAAP. OPC does not believe that Order No. 99-1794 contemplates violation of any accounting principals. Regardless, Aqua Utilities should not purchase an asset with some indefinite time frame for inclusion in rates that OPC believes is impaired.

Jennifer Brubaker
October 10, 2005
Page 3

Based on the above, OPC believes that the regulatory asset should be removed from rate base for each of the systems purchased by Aqua Utilities.

Accumulated Depreciation Debit Balances

When FWS finalized its physical inventory, it should have reviewed its books for inappropriate balances in its accumulated depreciation accounts as a result of retirement entries. If debit balances in accumulated depreciation were found where no plant balances existed, FWS should have investigated further to determine the most-likely cause. This circumstance often occurs when a utility makes retirements without having the original cost documentation. Thus, the amount of plant retired is estimated and the estimate could be higher than the booked cost, or the utility finds that plant was recorded in a different account than where the retirement was made. Other times, an asset is retired before the end of its depreciable life or the cost of removal is higher than the original plant balance.

Once a utility determines the cause, its management should decide to either write off the debit balance in accumulated depreciation at that time or request Commission approval for some type of recovery mechanism. This is consistent with NARUC Uniform System of Accounts, Accounting Instruction 27-H (for Class A Water Utilities). To not do anything to the debit balance and just wait until the next rate case or transfer, as in this case, is improper.

Also, if in a utility's normal course of operation, it finds that it is retiring a certain plant asset faster than the assigned useful life, such as meters, the utility can petition the Commission for a shorter depreciable life. Rule 25-30.140, Florida Administrative Code, outlines the required procedures for such a request which normally is non-controversial with minimal regulatory costs.

FWS's argument that the utility was evaluated on a total-company basis in its last rate case does not hold merit. By looking at the final order in the docket, the Commission set rate base by system, not in total, including used and useful plant adjustments, operation and maintenance expenses, depreciation, and taxes. Thus, the suggestion that any debit balance in accumulated depreciation from one system, in one account, should be negated by credit balances in other systems or accounts is without merit. Without specific permission by the Commission, such accounting treatment violates the NARUC uniform system of accounts as well as financial accounting standards (FASB Statement No. 71).

Sincerely,

s/ Stephen C. Reilly
Stephen C. Reilly
Associate Public Counsel

cc: Mary Andrews Bane, Executive Director
Patti Daniel, Division of Economic Regulation
Kenneth A. Hoffman, Esquire