

DOCKET NO.: 010503-WU - Application for increase in water rates for Seven Springs System in Pasco County by Aloha Utilities, Inc.

WITNESS: Direct Testimony of Stephen B. Fletcher, Appearing on Behalf of Staff

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DIRECT TESTIMONY OF STEPHEN B. FLETCHER

1
2 Q. Please state your name and professional address.

3 A. My name is Stephen B. Fletcher and my business address is 2540 Shumard
4 Oak Boulevard, Tallahassee, Florida 32399-0850.

5 Q. By whom are you employed and in what capacity?

6 A. I am employed by the Florida Public Service Commission as a Regulatory
7 Analyst III in the Division of Economic Regulation.

8 Q. How long have you been employed by the Commission?

9 A. I started working at the Commission in November 1997.

10 Q. Would you state your educational background and experience?

11 A. I received an Associate in Arts degree with honors from Tallahassee
12 Community College in August 1993. I received a Bachelor of Science degree
13 with a major in accounting and finance from Florida State University in
14 December 1996. From January 1994 to November 1997, I was Assistant Secretary
15 of Florida Horse Park, Inc., formerly known as Aqua Development Group, Inc.
16 My duties under this capacity included conducting the equestrian and resort
17 industry research to develop the business plan and included tax preparation
18 for the corporate returns. In November 1997, I was employed by the Commission
19 as a Professional Accountant in the Division of Water and Wastewater's
20 Accounting Section of the Bureau of Economic Regulation. In April 2000, I
21 became a Regulatory Analyst II in the Accounting Section of the Bureau of
22 Economic Regulation. In June 2000, my section became the File and Suspend
23 Rate Cases Section in the Division of Economic Regulation. In June 2001, I
24 became a Regulatory Analyst III in the File and Suspend Rate Cases Section in
25 the Division of Economic Regulation. I have attended various regulatory

1 seminars and Commission in-house training and professional development
2 meetings concerning regulatory matters.

3 Q. Would you explain what your general responsibilities are as a Regulatory
4 Analyst III in the File and Suspend Rate Cases Section?

5 A. This section is responsible for the financial, accounting and rates
6 review and evaluation of complex formal rate proceedings before the
7 Commission. Specifically, I am assigned to review and analyze the accounting
8 and rate issues for file and suspend rate cases, overearnings investigations
9 and limited proceedings of Class A and B water and wastewater utilities under
10 the jurisdiction of the Florida Public Service Commission. I also am
11 responsible for the review of smaller filings of Class A and B utilities, such
12 as allowance for funds used during construction (AFUDC), allowance for funds
13 prudently invested (AFPI), service availability applications, and tariff
14 filings. For the cases that I am assigned, I coordinate, prepare and present
15 staff recommendations to the Commission on the above type cases. I am also
16 responsible for preparing testimony and writing cross-examination questions
17 for hearings involving complex accounting and financial issues.

18 Q. Please list dockets for which you have performed analytical work and/or
19 prepared recommendations since joining the Commission.

20 A. I have attached a list of dockets that I have worked on since joining
21 the Commission, which is identified as Exhibit SBF-1 of my testimony.

22 Q. Can you summarize the issue for which you are providing testimony?

23 A. I am providing testimony on Aloha Utilities, Inc.'s purchased raw water
24 transactions.

25 Q. Please briefly describe your testimony regarding purchased raw water

1 | transactions.

2 | A. Aloha purchases raw water from three different entities: Tahitian
3 | Development, Inc. (Tahitian), Interphase, Inc. (Interphase), and Jack Mitchell
4 | (Mitchell). Tahitian and Interphase are both related parties to Aloha.
5 | Lynnda Speer owns 62.5% of the utility, and she owns 100% of Tahitian
6 | Development, Inc. Roy Speer, Lynnda Speer's husband, owns 100% Interphase,
7 | Inc. Mitchell is a non-related, third party. Aloha also purchases treated
8 | water from Pasco County.

9 | In its minimum filing requirements (MFRs), Aloha projected a December
10 | 31, 2001 related party purchased water expense of \$128,480 collectively for
11 | Tahitian and Interphase. Both Tahitian and Interphase charge Aloha \$0.32 per
12 | thousand gallons for raw water. Mitchell charges the utility \$0.10 per
13 | thousand gallons for raw water. These purchased water transactions are
14 | basically royalties for raw water. For reasons I will explain later, I do not
15 | believe Aloha has proven, through its MFRs or direct testimony, that the
16 | royalty fee charged by its related parties for raw water is reasonable.

17 | Q. Please provide a brief history of Aloha's purchased water transactions
18 | with Mitchell, Tahitian, and Interphase.

19 | A. According to the utility's response to a staff data request, the Seven
20 | Springs water system's Well No. 1 relates to Mitchell. Wells Nos. 3 and 4
21 | relate to Tahitian, and Wells Nos. 6 and 7 relate to Interphase. Mitchell,
22 | Tahitian, and Interphase each installed and incurred the costs of the wells
23 | themselves. This included the cost of drilling the wells and the cost of the
24 | initial equipment and structures. Aloha has paid for repairs and maintenance
25 | and some improvements since the initial installation of those wells.

1 Based on contracts provided by Aloha, the agreements for the purchase
2 of raw water date back to 1972 for Mitchell, 1977 for Tahitian, and 1978 for
3 Interphase. The 1972 agreement with Mitchell called for Aloha to pay \$0.05
4 per thousand gallons of water extracted from Mitchell's land. On October 1,
5 1975, Mitchell and Aloha executed another agreement which called for Aloha to
6 pay \$0.10 per thousand gallons of water extracted. The 1977 agreement with
7 Tahitian called for Aloha to pay \$0.10 per thousand gallons of water
8 extracted. On December 28, 1988, this agreement was amended and the charge
9 was increased to \$0.25 per thousand gallons of water extracted. On January
10 1, 1992, Tahitian and Aloha amended their agreement again and the charge was
11 increased to \$0.32 per thousand gallons of water extracted. The 1978
12 agreement with Interphase called for Aloha to pay \$0.10 per thousand gallons
13 of water extracted. This agreement was also amended and the charge increased
14 to \$0.32 per thousand gallons of water extracted. I do not know when any
15 amendments with Interphase were executed; however, staff has propounded
16 discovery on the utility in order to determine this. Further, I attached a
17 table that reflects the history of the above purchased water agreements, which
18 is identified as Exhibit SBF-2.

19 Q. Did the Commission approve the \$0.10 per thousand gallon charged by
20 Mitchell?

21 A. Yes. The Commission approved the \$0.10 per thousand gallon charge by
22 Mitchell in Order No. 8450, issued August 29, 1978, in Docket No. 770720-WS.
23 This order does not specifically discuss the charge by Mitchell; however, the
24 Commission did approve the Examiner's findings, which included the adjustment
25 to increase purchased water expense to reflect the increase from \$0.05 to \$0.10

1 per thousand gallons. Based upon my review of staff's file for Docket No.
2 770720-WS, the only support documentation for this adjustment was a one page
3 engineering working paper that stated that this rate was increasing based on
4 a new contract. Further, the related party purchased water transactions with
5 Tahitian and Interphase were not addressed either in that order or in the
6 docket file. With the exception of Docket No. 000737-WS which I discuss later,
7 the Commission has not addressed these related party transactions.

8 Q. Has the Commission ever addressed the payment of a royalty fee for raw
9 water by a utility under its jurisdiction?

10 A. Yes. In Docket No. 951029-WU, an overearnings investigation for Florida
11 Cities Water Company (FCWC), the Commission approved operating expenses for a
12 royalty fee for raw water extracted. The fee was based on a series of related
13 party transactions that began in 1973. On April 23, 1973, GAC Properties, Inc.
14 (a predecessor company to Avatar Properties Inc. and a related party of FCWC),
15 granted an easement to GAC Utilities, Inc. (a predecessor company to Avatar
16 Utilities Inc. and the parent company of FCWC) for FCWC to operate wellfields
17 and do other work necessary for delivery of water on 149 of 16,000 acres. At
18 that time, these same parties agreed on a royalty fee of \$0.03 per thousand
19 gallons to be paid by FCWC for all water pumped from the wells. On June 24,
20 1973, GAC Properties, Inc. sold the 16,000 acres to a non-related, third party
21 for \$800 per acre. This sale included a perpetual easement to FCWC through GAC
22 Utilities, Inc. to extract raw water. To test the reasonableness of the
23 royalty fee, the Commission compared the original cost of the land when first
24 devoted to public service with the cost of the royalty.

25 FCWC offered three options to compare the value of this royalty easement.

1 | First, FCWC recommended using Lee County's 1978 comparable purchase price of
2 | land for the County's own wellfield. Second, FCWC proposed the above purchase
3 | price because FCWC's ultimate water usage allowance is twice as much as Lee
4 | County's allotted capacity. Third, FCWC suggested an independent appraisal of
5 | the easement area.

6 | Order No. PSC-96-0859-FOF-WU, issued July 2, 1996, in Docket No. 951029-
7 | WU, states, in pertinent part:

8 | We find that the third approach of using a land appraisal to
9 | measure the worth of the easement provides a direct means of
10 | testing the fairness of the assessed royalty charge. . . . Using
11 | the respective weighted percentages, the total acreage assigned to
12 | FCWC is 613.75 acres. At the most conservative cost of \$800 per
13 | acre (the cost per acre in the 1973 sale to non-affiliated
14 | interests), the investment attributable to this land would be
15 | \$491,000. Based upon an 8.75% rate of return, the return is
16 | calculated to be \$42,963. With taxes estimated to be: \$8,347 for
17 | property taxes, \$8,867 for income taxes, and \$2,836 for gross
18 | receipts taxes, the total expense would be \$63,013. This is \$5,067
19 | more than the royalty expense of \$57,946 used for the 1996 test
20 | year, and equates to a cost of \$0.0326 per 1,000 gallons.

21 | Based on the above comparative analysis, the Commission found that the
22 | \$0.03 per thousand gallon royalty fee was a reasonable expenditure in relation
23 | to the value acquired.

24 | Q. Has the Commission ever addressed the royalty fees that Aloha pays
25 | Tahitian and Interphase for raw water?

1 A. Yes, the Commission addressed these royalty fees in Docket No. 000737-WS,
2 which was an overearnings investigation of the Aloha Gardens water and
3 wastewater systems and the Seven Springs water system. By Order No. PSC-01-
4 1374-PAA-WS, issued June 27, 2001, the Commission applied the same standards
5 utilized in the 1995 FCWC overearnings investigation to evaluate the
6 appropriateness of Aloha's royalty fees for raw water. Aloha maintained that
7 its related parties do not have documentation of the original cost of the well
8 and land when first devoted to the service of Aloha ratepayers. The Commission
9 found that the utility should have taken the appropriate steps to determine the
10 original cost of the land and wells as of the date the utility began extracting
11 water from these wells. This analysis was necessary to determine if the
12 utility's decision to purchase raw water was the most cost effective choice.
13 Further, the Commission stated that Aloha could have had these lands appraised
14 by an independent appraiser and retained the services of a professional
15 engineer to conduct an original cost study on the wells initially installed.
16 Without this information, the Commission found that it could not evaluate the
17 reasonableness of these royalty fees at that time.

18 Ultimately, it is the utility's burden to prove that its costs are
19 reasonable. The Commission stated that, by their very nature, related party
20 transactions require closer scrutiny. Although a transaction between related
21 parties is not per se unreasonable, it is the utility's burden to prove that
22 its costs are reasonable. Florida Power Corp. v. Cresse, 413 So. 2d 1187, 1191
23 (Fla. 1982). This burden is even greater when the transaction is between
24 related parties. In GTE Florida, Inc. v. Deason, 642 So. 2d 545 (Fla. 1994),
25 the Court established that the standard to use in evaluating affiliate

1 I believe it is important to note two distinctions between FCWC's royalty
2 easement and Aloha's raw water agreements with Tahitian and Interphase. First,
3 FCWC's royalty easement is in perpetuity; however, Tahitian and Interphase may
4 cancel the agreements upon giving Aloha 30 days written notice. Interestingly,
5 the agreement with Mitchell is perpetual in term. Second, FCWC's royalty fee
6 is fixed at \$0.03 per thousand gallons, but the agreements with Tahitian and
7 Interphase have an escalation provision for the royalty fee. According to the
8 1975 agreement with Mitchell, there is no escalation provision for the \$0.10
9 per thousand gallon charge.

10 Based on the above, I believe the Mitchell agreement is analogous to the
11 FCWC royalty easement. Also, the Mitchell agreement was an arm's length
12 transaction. As such, without any additional evidence to the contrary, I
13 believe the Mitchell charge of \$0.10 per thousand gallons is reasonable.
14 Further, according to the facts discussed above, I believe the Mitchell
15 agreement is of greater value to the utility than the related party purchased
16 water agreements.

17 Q. When you say the Mitchell agreement is of greater value than the related
18 party purchased water agreements, would you expect that the royalty fee charged
19 by the related parties would be less?

20 A. Based on my analysis in Exhibit SBF-3, I would have expected the royalty
21 fee charged by the related parties to be less than that charged by Mitchell.

22 Q. Do you believe that Aloha has met its burden of proof, in this current
23 rate case, that the royalty fee by its related parties for raw water is
24 reasonable?

25 A. No. As indicated above, Order No. PSC-01-1374-PAA-WS effectively

1 | outlined the steps the utility could have taken in order to meet its burden of
2 | proof. In its MFRs and direct testimony, the utility has failed to provide the
3 | original cost of the land and wells as of the date Aloha began purchasing water
4 | from its related parties. Without this information, a comparative analysis
5 | similar to the one that the Commission performed for FCWC in Docket 951029-WU
6 | cannot be done. I believe such an analysis is needed to evaluate the
7 | reasonableness of the royalty fee charged by the related parties.

8 | Q. Are you able to determine what the related parties should charge per
9 | thousand gallons of raw water?

10 | A. No. Without the original cost of the land and wells as of the date Aloha
11 | began purchasing water from its related parties, I am not able to determine
12 | what the appropriate royalty fee that Tahitian and Interphase should charge.

13 | Q. Should the water royalty fee charged by Tahitian and Interphase be
14 | reduced?

15 | A. Yes. As I stated above, I believe the Mitchell agreement is of greater
16 | value to the utility than the related party purchased water agreements. As
17 | such, I believe that the royalty fee charged by the related parties should at
18 | minimum be reduced to \$0.10 per thousand gallons.

19 | Q. If the Commission finds that a \$0.10 per thousand gallons royalty fee for
20 | the utility's related parties is appropriate, what would be the effect on the
21 | Seven Springs water system's operation and maintenance (O&M) expenses?

22 | A. The effect would be an \$88,330 reduction of Seven Springs water's O&M
23 | expenses. The \$88,330 amount is calculated as follows:

24 | Projected 2001 Annual Maximum Water Use Permit Pumpage
25 | of the Related Party Wells (Omitting 000's)..... 401,500

1 Multiplied by Disallowed Portion of the Per 1,000 Gallons Charge..... \$0.22

2 Reduction of Seven Springs Water's O&M Expenses..... \$88,330

3 Q. Does this conclude your testimony?

4 A. Yes, it does.

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The following is a list of dockets on which I, Stephen B. Fletcher, have performed analytical work and/or prepared recommendations since joining the Commission.

- 1) Docket No. 970536-WS - Application for limited proceeding increase in water and wastewater rates by Aloha Utilities, Inc.
- 2) Docket No. 971663-WS - Petition of Florida Cities Water Company for Limited proceeding to recover environmental litigation costs for North and South Ft. Myers Divisions in Lee County and Barefoot Bay Division in Brevard County.
- 3) Docket No. 980245-WS - Application for limited proceeding increase in water and wastewater rates in Pasco County by Aloha Utilities, Inc.
- 4) Docket No. 980992-WS - Complaint by D.R. Horton Custom Homes, Inc. Against Southlake Utilities, Inc. in Lake County Regarding Collection of Certain AFPI Charges.
- 5) Docket No. 981243-WU - Application by Marion Utilities, Inc. for Approval of Revised Service Availability Charges for Approval of Revised Service Availability Charges for Spruce Creek Service Area and New Service Availability Policy for Water Division in Marion County.
- 6) Docket No. 981456-WU - Request for Approval of Amendment to Service Availability tariffs in Marion County by Sunshine Utilities of Central Florida, Inc.
- 7) Docket No. 981609-WS -Emergency Petition by D.R. Horton Custom Homes, Inc. to Eliminate Authority of Southlake Utilities, Inc. to Collect Service Availability Charges and AFPI Charges in Lake County.
- 8) Docket No. 991643-SU - Application for Increase in Wastewater Rates in Seven Springs System in Pasco County by Aloha Utilities, Inc.
- 9) Docket No. 991890-WS - Investigation into ratemaking consideration of gain on sale from sales of facilities of Utilities, Inc. of Florida to the City of Maitland in Orange County and the City of Altamonte Springs in Seminole County.
- 10) Docket No. 000737-WS - Investigation of rates of Aloha Utilities, Inc. in Pasco County for possible overearnings for the Aloha Gardens water and wastewater systems and the Seven Springs water system.
- 11) Docket No. 010168-WU - Application for limited proceeding emergency, temporary, and permanent increase in water rates to customers in Seven Springs service area in Pasco County, by Aloha Utilities, Inc.
- 12) Docket No. 010518-WS - Notice of intent to increase water and wastewater rates in Pasco County, based upon application of provisions of Section 367.081(4)(a) & (b), F.S., by Aloha Utilities, Inc.

History Aloha's Purchased Water Agreements

<u>Entity</u>	<u>Well Nos.</u>	<u>Date of Original Agreement and Royalty Charged</u>	<u>Date of First Amended Agreement and Royalty Charged</u>	<u>Date of Second Amended Agreement and Royalty Charged</u>
Mitchell	1	March 20, 1972 5¢ per 1,000 gallons	October 1, 1975 10¢ per 1,000 gallons	N/A
Tahitian	3 and 4	September 12, 1977 10¢ per 1,000 gallons	December 28, 1988 25¢ per 1,000 gallons	January 1, 1992 32¢ per 1,000 gallons
Interphase	6 and 7	September 12, 1978 10¢ per 1,000 gallons	Pending Staff Discovery (1)	Pending Staff Discovery (1)
Note: (1) I do not know when any amendments with Interphase were executed. Staff has propounded discovery on the utility in order to determine this. However, the current royalty fee for Interphase is 32¢ per 1,000 gallons.				

Analysis of Aloha's Purchased Water Agreements

Entity	Mitchell	Tahitian	Interphase
What is the amount of acreage that the utility can install wells on?	6,700 acres (1)	30.08 acres (1)	638 acres (1)
How much is the royalty fee currently?	10¢ per 1,000 gallons	32¢ per 1,000 gallons	32¢ per 1,000 gallons
Does the agreement have an escalation provision for the royalty fee?	No	Yes	Yes
What is the term of the agreement?	Perpetual in term.	The related party may cancel upon giving the utility 30 days written notice.	The related party may cancel upon giving the utility 30 days written notice.
Does the agreement allow Aloha to construct anything else on the allotted acreage?	Yes, the agreement allows the utility to place a 10-acre plant site.	No	No
Note: (1) The only restriction is that each well site has a minimum circumference of approximately one acre.			