FLORIDA PUBLIC SERVICE COMMISSION
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M E M O R A N D U M

August 22, 1996

TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYO)

FROM: DIVISION OF AUDITING & FINANCIAL ANALYSIS (JONES, LESTER, MERTA, C. ROMIG, L. ROMIG)
DIVISION OF ELECTRIC & GAS (BULECZA-BANKS, MAKIN)
DIVISION OF LEGAL SERVICES (ERSTLING)

ALM PL DM JS JDJ APC

RE: DOCKET NO. 960930-GU - ST. JOE NATURAL GAS COMPANY - INVESTIGATION INTO EARNINGS FOR 1994, 1995, AND 1996 OF ST. JOE NATURAL GAS COMPANY

AGENDA: 09/03/96 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: S:\PSC\AFA\WP\960930.RCM
ATTACHMENTS 1 THROUGH 5 NOT AVAILABLE

CASE BACKGROUND

St. Joe Natural Gas Company, Inc. (St. Joe or the Company) is a local gas distributor that serves approximately 3,090 residential, commercial, and industrial customers in Port St. Joe, Mexico Beach, and the unincorporated areas of Gulf County. St. Joe has one very large industrial customer, Stone Container Company (formerly St. Joe Paper Company), that takes approximately 66 percent of St. Joe's volume equating to a 75 percent contribution to revenues. St. Joe's residential and commercial rates are significantly lower than those charged by any other local distribution company in Florida.

As a result of the Commission's ongoing earnings surveillance program, Staff was made aware of the high level of St. Joe's earnings, based on the June 30, 1994 report. Accordingly, Staff sent a letter, dated September 1, 1994, to St. Joe requesting that the Company agree to a 12.00% return on equity (ROE) earnings cap for 1994, to resolve the matter concerning any potential overearnings. St. Joe agreed to this earnings cap with the added condition that any 1994 excess earnings be deferred and commingled with 1995 earnings before the Commission determines the appropriate disposition of any excess earnings. By Order No. PSC-95-0017-FOF-GU dated January 5, 1995, the Commission ordered a 12.00% ROE earnings cap for St. Joe for 1994 and 1995. In addition, the Commission ordered that the overearnings for 1994 and 1995 be commingled before determination of disposition by the Commission. Based on an audit of each year and further review, Staff has calculated overearnings of $183,339 and $77,979 for 1994 and 1995, respectively.

The Company and Staff met to discuss the possible resolution of this matter. The Office of Public Counsel was invited to attend. On August 8, 1996, St. Joe hand-delivered its proposal to resolve the overearnings for 1994 and 1995. In addition, the Company agrees that any 1996 earnings determined by the Commission to be in excess of the maximum authorized levels will be handled in the same manner as the 1994 and 1995 overearnings.

DISCUSSION OF ISSUES

ISSUE 1: What is the appropriate Rate Base for 1994 and 1995?

RECOMMENDATION: The appropriate rate base is $3,988,277 for 1994 and $4,149,535 for 1995. (MERTA, C. ROMIG)

STAFF ANALYSIS: Based on the adjustments discussed below, the appropriate rate base is $3,988,277 for 1994 and $4,149,535 for 1995.

Adjustment 1: Cash - The Company made an adjustment to its cash balance in working capital to add $107,452 in 1994 and $101,132 in 1995. Because St. Joe incorrectly assumed that the interest expense on debt is "non-utility," the Company incorrectly added back amounts to cash that consisted primarily of interest expense that was paid. Staff recommends that these adjustments be reversed to reflect the correct treatment of the cash that was used to pay interest. The unadjusted amounts on the books tie to the bank statements. Therefore, Staff recommends that cash be reduced by $107,452 for 1994 and by $101,132 for 1995.

Adjustment 2: Accrued Interest - The Company made adjustments to remove $5,394 in accrued interest in 1994 and $5,285 in 1995. Staff recommends that these adjustments be reversed since Commission practice is to include accrued interest in working capital. Therefore, working capital should be reduced by $5,394 in 1994 and $5,285 in 1995.

Adjustment 3: Accrued Taxes - The Company made adjustments to increase its regulated accrued taxes by $44,606 and $39,141 for 1994 and 1995, respectively. These adjustments were based on its incorrect assumption that the interest expense on debt is "non-utility" as disclosed in the discussion of Adjustment 1 above. In Adjustment 12, Staff decreased income tax expense by $66,046 for 1994 and by $63,038 for 1995, to reflect the correct treatment of the interest and the reconciliation adjustment and to reflect Staff's other adjustments to revenues and expenses. To reflect the accrued tax effect of the foregoing, Staff increased accrued taxes by $33,023 for 1994 and by $31,519 for 1995. These rate base/working capital increases represent the simple average of Staff's recommended $66,046 decrease for 1994 and its $63,038 decrease for 1995 to income taxes that are addressed as NOI adjustments in Adjustment 12 and primarily reverse the Company's adjustments.

In summary, Staff recommends that rate base should be reduced by $79,823 for 1994 and by $74,898 for 1995. The rate bases and adjustments for 1994 and 1995 are on Attachments 1 and 3, respectively.

ISSUE 2: What are the appropriate overall rates of return for 1994 and 1995 for measuring overearnings?

RECOMMENDATION: For 1994, the appropriate overall rate of return is 10.77% based on the 1994 average capital structure as adjusted by Staff. For 1995, the appropriate overall rate of return is 10.63% based on the 1995 average capital structure as adjusted by Staff. For both years, the appropriate return on equity (ROE) is 12.0%. (LESTER)

STAFF ANALYSIS: St. Joe Forest Products Company (SJFP) guarantees a note for St. Joe. SJFP also agreed to purchase a minimum of $91,947 of gas each month. SJFP makes the monthly note payments of $39,396, which offset payments for gas. The terms of the note state that if the cost of gas used by SJFP falls below the required note payment, the amount by which the note payment exceeds the cost of gas will be applied to prepaid gas and will be offset by future gas purchases after the final note payment. Interest on this prepaid gas accrues annually at the prime rate.

Adjustment 4: St. Joe recorded the balance of prepaid gas as a deferred credit and included it in common equity. Staff believes that the deferred credit is similar to long-term debt since interest is paid on it and since the terms of the agreement indicate it is debt. Therefore, the deferred credit should be removed from common equity and included as a separate line item in the capital structure for 1994 and 1995, with the interest rate calculated by dividing accrued interest by the average balance of the deferred credit.

Adjustment 5: St. Joe removed an amount for non-utility working capital specifically from equity in reconciling capital structure and rate base. Staff notes that the Commission's practice is to remove non-utility investment specifically from equity in reconciling capital structure and rate base because non-utility investment, such as investment in a non-regulated subsidiary, typically would be more risky than an investment in the utility. However, this is not so with non-utility working capital. Therefore, Staff reversed the Company's equity adjustment for 1994 and 1995 working capital and spread the capital structure adjustment pro rata over all sources of capital except accumulated deferred income taxes, which are specifically identified.

Adjustment 6: Staff used St. Joe's average capital structures for 1994 and 1995 as reported in its earnings surveillance reports. In 1995, the Company made an adjustment to remove $52,569 of unrecovered gas cost from working capital. However, the Company neglected to remove this amount from its capital structure, which resulted in its capital structure not reconciling to its rate base. To correct this error, Staff made a pro rata adjustment of $52,569 over all sources of capital except accumulated deferred income taxes.

__Adjustment 7:__ Staff used a 12.0% ROE for 1994 and 1995. By Order No. PSC-95-0017-FOF-GU, dated January 5, 1995, the Commission ordered an earnings cap of 12.0% ROE for St. Joe for 1994 and 1995.

With these adjustments, the overall rates of return for 1994 and 1995 for measuring overearnings are 10.77% and 10.63%, respectively. The capital structures for 1994 and 1995 are on Attachments 2 and 4, respectively.

ISSUE 3: What is the appropriate Net Operating Income for 1994 and 1995?

RECOMMENDATION: The appropriate net operating income is $541,908 for 1994 and $488,761 for 1995. (L. ROMIG, MERTA, C. ROMIG)

STAFF ANALYSIS: Based on the adjustments discussed below, the appropriate net operating income is $541,908 for 1994 and $488,761 for 1995.

Adjustment 8: Director Fees - The Company expensed $28,800 for director fees in 1994 and 1995, or $7,200 each for its four directors. One of the four directors, the company President, is also paid a salary.

The Commission, in Order No. PSC-95-0964-FOF-GU, issued August 8, 1995, denied West Florida Natural Gas the allowance of directors' fees for those directors who are already compensated through the payment of salaries. Therefore, expenses should be reduced by $7,200 for 1994 and 1995.

Adjustment 9: Rent Revenues - St. Joe's non-utility operation paid St. Joe $2,520 in 1994 and 1995 for rent, in lieu of allocating office space. The rental income was recorded below-the-line. All plant, including the corresponding non-utility plant, is recorded above-the-line. For this reason, Staff recommends that the revenue from the rent be recorded above-the-line. Therefore, revenue should be increased by $2,520 in 1994 and 1995.

Adjustment 10: Interest on Cash - The Company earns interest, which is recorded below-the-line, on its cash account. When an interest-bearing account is included in working capital, the Commission has either ordered the interest recorded above-the-line or has removed the cash from working capital and left the interest below-the-line. In Order No. PSC-95-0518-FOF-GU, the Commission directed Florida Public Utilities Gas Division to record the interest, earned on the cash included in rate base, above-the-line. Therefore, Staff recommends St. Joe record the interest earned on the cash included in rate base above-the-line and that revenue be increased by $7,854 in 1994 and by $5,189 in 1995.

Adjustment 11: House Piping Expense - St. Joe recorded $20,974 and $22,661 in below-the-line expenses for 1994 and 1995 respectively for house piping and venting. The Commission has allowed other companies, City Gas and West Florida Natural Gas, to record this type of expense above-the-line for recovery in base rates or through the conservation cost recovery mechanism.

Therefore, Staff believes it is appropriate to accord St. Joe comparable treatment for these costs and recommends increasing operating expenses by $20,974 and $22,661 for 1994 and 1995, respectively.

<u>Adjustment 12</u>: Income Taxes - Staff decreased income taxes by $66,046 for 1994 and by $63,038 for 1995. In calculating its income tax expense, the Company neglected to include interest expense in its calculation. The "reconciled to rate base" interest is $172,114 for 1994 and $159,768 for 1995. The result of including the interest is a decrease to income taxes of $64,767 for 1994 and $60,121 for 1995. Further, Staff's other adjustments to NOI decrease NOI by $3,400 and $7,752 and decrease income tax expense by $1,279 and $2,917, for 1994 and 1995 respectively. Accordingly, for 1994, the total decrease to income tax expense is $66,046 and for 1995, the total decrease to income tax expense is $63,038.

In summary, Staff believes that St. Joe's achieved NOI should be increased by $62,646 for 1994 and by $55,286 for 1995. The NOI and adjustments for 1994 and 1995 are on Attachments 1 and 3, respectively.

ISSUE 4: What is the appropriate amount of the 1994 and 1995 overearnings?

RECOMMENDATION: The amount of overearnings is $183,339 for 1994 and $77,979 for 1995, for a total of $261,318. (L. ROMIG)

STAFF ANALYSIS: Based on the above recommendations in Issues 1 through 3, the Company's overearnings for 1994 and 1995 are $183,339 and $77,979, respectively, for a total of $261,318. The amount of overearnings has been accepted by the Company, the disposition of which is discussed in Issue 5.

The calculation of the overearnings for 1994 and 1995 are on Attachments 1 and 3, respectively.

ISSUE 5: Should the Commission accept St. Joe Natural Gas Company's proposal to dispose of the 1994 and 1995 overearnings and accept the Company's proposed disposition of possible 1996 overearnings?

RECOMMENDATION: Yes, the Commission should accept St. Joe Natural Gas Company's proposals. (L. ROMIG)

STAFF ANALYSIS: The Staff and the Company have met to discuss the Company's overearnings for 1994 and 1995 and the disposition of same. As a result, the Company submitted its proposal (Attachment 5) to dispose of overearnings for 1994 and 1995 and potential overearnings for 1996.

In summary, the Company proposes:

1. To amortize, off the books, over a 25-year period beginning January 1, 1997, $261,318 in excess earnings for 1994 and 1995.

2. If the Company files with the Commission, a petition to increase its rates, that has the effect of increasing revenues, then the Company agrees to refund over a 60-month period commencing with the new rate change, the remaining unamortized balance of excess earnings to be established at the conclusion of the rate proceeding, without interest.

3. The refund procedures will not apply where the Company petitions to restructure its rates such that the resulting rate changes have no effect on the Company's total revenues.

4. In the event the Company's earnings for the calendar year 1996 are determined by the Commission to be in excess of maximum authorized levels, the excess earnings will be administered in accordance with the procedures established for the 1994 and 1995 overearnings.

Upon review of the Company's proposal, Staff recommends that it be approved by the Commission for the reasons that follow.

1. St. Joe's situation is unique in that it has the lowest rates in the State of Florida for residential natural gas customers and its largest customers have negotiated contracts.

2. The Company has cash flow problems in view of its construction program.

3. In its proposal, the Company agrees to a cap on its 1996 earnings.

4. The proposal provides for a potential refund.

5. If overearnings were recorded as CIAC, rate base would be reduced thereby exacerbating overearnings.

6. The proposal provides an incentive not to file for a rate increase, thereby minimizing rate case costs being borne by its existing customers.

7. Even if St. Joe does succeed in justifying increased rates, the Company's proposal lessens the impact of a rate increase for a five-year period.

8. The proposal will not hinder the completion of the main line extension to the City of Wewahitchka and the Gulf Correctional Institute, outside of Wewahitchka.

For the reasons enumerated above, Staff believes that St. Joe's circumstances are unique. Further, Staff believes that the terms of the Company's proposal for its treatment of its 1994, 1995 and 1996 overearnings are reasonable. Moreover, because of the unique circumstances of this Company, Staff believes that there is no ideal solution for this Company and given that the Company's situation is unique, Staff believes that the Company's proposal is the best alternative. Therefore, Staff recommends that the Company's proposal as submitted, be accepted. The Company's proposal is included as Attachment 5.

ISSUE 6: Should this docket be closed?

RECOMMENDATION: Yes, this docket should be closed if no substantially affected person timely files a protest within the 21 day protest period to the Commission's proposed agency action. (ERSTLING)

STAFF ANALYSIS: Staff recommends that this docket be closed if no substantially affected person timely files a protest.

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ST. JOE NATURAL GAS COMPANY
DOCKET NO. 960930-GU

ATTACHMENT 1
22-Aug-96

CALCULATION OF 1994 EXCESS REVENUE

Adj. No.			
	NET OPERATING INCOME PER ESR		$479,262
	Staff Adjustments:		
8	Director Fees	$7,200	
9	Rent Revenues	2,520	
10	Interest on Cash	7,854	
11	House Piping Expense	(20,974)	
12	Income Taxes	66,046	
	Total Adjustments		62,646
	Adjusted NOI		$541,908
	RATE BASE PER ESR		$4,068,100
	Staff Adjustments:		
1	Nonreg Cash	($107,452)	
2	Accrued Interest	(5,394)	
3	Accrued Taxes	33,023	
	Total Adjustments		(79,823)
	Adjusted Rate Base		$3,988,277
	ROR @ 12.00% ROE		x 10.77%
	Maximum allowed NOI		429,704
	Achieved NOI		541,908
	Excess NOI		112,204
	NOI Multiplier		x 1.6340
	1994 Excess Revenue		183,339
	Interest		0
	TOTAL 1994 EXCESS REVENUE		$183,339

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ATTACHMENT 2
22-Aug-96

1994 CAPITAL STRUCTURE

	PER BOOKS	ADJUSTMENTS COMPANY SPECIFIC	STAFF SPECIFIC	TOTAL BEFORE PRO RATA	PRO RATA	STAFF ADJUSTED	RATIO (%)	COST RATE (%)	WEIGHTED COST (%)
LONG TERM DEBT	1,727,451			1,727,451	(20,679)	1,706,772	42.79%	9.85%	4.22%
SHORT TERM DEBT				0	0	0	0.00%	10.00%	0.00%
DEFERRED CREDIT			42,330	42,330	(507)	41,823	1.05%	4.27%	0.04%
CUSTOMER DEPOSITS	27,974			27,974	(335)	27,639	0.69%	8.00%	0.06%
COMMON EQUITY	2,214,919	32,294	(74,624)	2,172,589	(26,008)	2,146,581	53.82%	12.00%	6.46%
DEFERRED INCOME TAXES	65,462			65,462		65,462	1.64%		0.00%
TAX CREDITS-ZERO COST				0		0	0.00%		0.00%
TAX CREDITS-WEIGHTED COST				0		0	0.00%		0.00%
TOTAL	4,035,806	32,294	(32,294)	4,035,806	(47,529)	3,988,277	100.00%		10.77%

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ATTACHMENT 3
22-Aug-96

CALCULATION OF 1995 EXCESS REVENUE

Adj. No.			
	NET OPERATING INCOME PER ESR		$433,475
	Staff Adjustments:		
8	Director Fees	$7,200	
9	Rent Revenues	2,520	
10	Interest on Cash	5,189	
11	House Piping Expense	(22,661)	
12	Income Taxes	63,038	
	Total Adjustments		55,286
	Adjusted NOI		$488,761
	RATE BASE PER ESR		$4,224,433
	Staff Adjustments:		
1	Nonreg Cash	($101,132)	
2	Accrued Interest	(5,285)	
3	Accrued Taxes	31,519	
	Total Adjustments		(74,898)
	Adjusted Rate Base		$4,149,535
	ROR @ 12.00% ROE		x 10.63%
	Maximum allowed NOI		441,037
	Achieved NOI		488,761
	Excess NOI		47,724
	NOI Multiplier		x 1.6340
	1995 Excess Revenue		77,979
	Interest		0
	TOTAL 1995 EXCESS REVENUE		$77,979

ST. JOE NATURAL GAS COMPANY
DOCKET NO. 960930-GU

ATTACHMENT 4
22-Aug-96

1995 CAPITAL STRUCTURE

	PER BOOKS	ADJUSTMENTS COMPANY SPECIFIC	ADJUSTMENTS STAFF SPECIFIC	TOTAL BEFORE PRO RATA	PRO RATA	STAFF ADJUSTED	RATIO (%)	COST RATE (%)	WEIGHTED COST (%)
LONG TERM DEBT	1,412,820			1,412,820	(32,353)	1,380,467	33.27%	9.85%	3.28%
SHORT TERM DEBT	115,385			115,385	(2,642)	112,743	2.72%	10.00%	0.27%
DEFERRED CREDIT			174,762	174,762	(4,002)	170,760	4.12%	6.06%	0.25%
CUSTOMER DEPOSITS	27,755			27,755	(636)	27,119	0.65%	8.00%	0.05%
COMMON EQUITY	2,573,608	32,902	(207,664)	2,398,846	(54,933)	2,343,913	56.49%	12.00%	6.78%
DEFERRED INCOME TAXES	114,533			114,533		114,533	2.76%		0.00%
TAX CREDITS-ZERO COST				0		0	0.00%		0.00%
TAX CREDITS-WEIGHTED COST				0		0	0.00%		0.00%
TOTAL	4,244,101	32,902	(32,902)	4,244,101	(94,586)	4,149,535	100.00%		10.63%

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August 8, 1996

VIA HAND DELIVERY

Mr. Timothy J. Devlin, Director
Division of Auditing & Financial Analysis
Florida Public Service Commission
2540 Shumard Oak Boulevard
Gerald L. Gunter Building, Room 215J
Tallahassee, Florida 32399-0850

Re: Inquiry into the Level of Earnings of St. Joe Natural Gas Company, Inc.

Dear Mr. Devlin:

Based on our discussions earlier today, this letter modifies and supersedes our letter to you of August 7, 1996. As part of its earnings surveillance program, Commission staff has identified potential excess earnings relative to our client, St. Joe Natural Gas Company, Inc. (the "Company"), for the calendar years 1994 and 1995. This earnings review merits special analysis given the Company's unique operating and rate characteristics. As you are aware, the geographic location of the Company severely limits its expansion opportunities, yet the Company has been able to maintain the lowest residential gas rates in the state. In recognition of these unique characteristics and in order to expeditiously resolve this matter without resort to litigation, the Company proposes the following:

1. The Company agrees for purposes of settlement that there are $261,318.00 in excess earnings for the calendar years 1994 and 1995 ("Excess Earnings").

2. Excess Earnings identified in Paragraphs 1 and 4 shall be maintained off the books and amortized (i.e., reduced in equal monthly increments) over a 25 year period beginning January 1, 1997 (the "Amortization Period"). In the event the Company files with the Commission a petition to increase its rates that has the effect of increasing revenues ("Aggregate Rate Increase Proceeding"), the Company agrees to refund over a 60 month period, commencing with the new rate change, the remaining

Mr. Timothy Devlin
August 8, 1996
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Net Refund, if any, shall be without interest and established at the conclusion of the Aggregate Rate Increase Proceeding.

3. The Net Refund procedures will not apply where the Company petitions to restructure its rates such that the resulting rate changes have no effect on the Company's total revenues.

4. In the event that the Company's earnings for the calendar year 1996 are determined by the Commission to be in excess of maximum authorized levels, the Company will administer those excess earnings in accordance with the Net Refund procedures set forth herein.

5. This settlement proposal is contingent upon Commission approval without modification. If this proposal is not approved in its entirety by the Commission it shall be null, void and of no further binding effect.

6. Commission approval of this proposal will close out the Commission's review of the Company's earnings for the calendar years 1994 and 1995, and all prior periods. Calendar year 1996 remains subject to audit, review and adjustment.

The Company respectfully requests that the Staff prepare a recommendation to the Commission for approval of the foregoing proposal at the earliest practicable time. Please contact the undersigned should you have any questions.

Sincerely,

HOLLAND & KNIGHT

D. Bruce May

DBM/sms
cc: Public Counsel
Mr. Stuart Shoaf

TAL-90234