FLORIDA PUBLIC SERVICE COMMISSION
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Tallahassee, Florida 32399-0850

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MEMORANDUM

October 23, 1997

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

FROM: DIVISION OF AUDITING & FINANCIAL ANALYSIS (REVELL, DRAPER, LESTER) DM JS
DIVISION OF ELECTRIC & GAS (GING)
DIVISION OF LEGAL SERVICES (KEATING) WCK RVE

RE: DOCKET NO. 971228-EI - FLORIDA PUBLIC UTILITIES COMPANY - INVESTIGATION INTO THE 1996 EARNINGS OF FLORIDA PUBLIC UTILITIES COMPANY - MARIANNA DIVISION

AGENDA: 11/04/97 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: S:\PSC\AFA\WP\971228.RCM
ATTACHMENTS 1 AND 2 NOT AVAILABLE
R:\PSC\AFA\123\971228.WK4 - ATTACHMENTS 3-5

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## CASE BACKGROUND

On May 7, 1996, Florida Public Utilities Company - Marianna Division ("Marianna" or "Company") submitted a letter to the Staff of the Florida Public Service Commission (Staff) in which it agreed to cap the earnings of the Marianna Division at 11.85% for calender year 1996. (Attachment 1) The disposition of any excess earnings was left to the discretion of the Commission. The Company, however, did reserve the right to request alternative dispositions such as additional contributions to its storm damage reserve or the reduction of any depreciation reserve deficiencies.

Due to the Commission's continuing earnings surveillance program, it was noted by Staff that the earnings of the Marianna Division of Florida Public Utilities Company on the Earnings Surveillance Report were within five basis points of the maximum authorized return on equity (ROE) of 11.85%. As a result, Staff conducted an earnings audit of the Company's books and records, and the audit report was issued July 10, 1997. The Company's response to the audit was received on July 30, 1997.

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FPSC-RECORDS/REPORTING

On October 3, 1997, the Company submitted a letter agreeing with the Staff's calculation of 1996 excess earnings of $36,143, plus interest of $1,005. The Company requested that the total amount of $37,148 be contributed to the Storm Damage Reserve in Marianna. (Attachment 2)

## DISCUSSION OF ISSUES

ISSUE 1: What is the appropriate amount of rate base for Florida Public Utilities Company-Marianna Division for determining the amount of excess earnings for 1996?

**RECOMMENDATION**: The appropriate rate base for the Marianna Division for 1996 is $12,393,035. (REVELL)

**STAFF ANALYSIS**: Per the December 1996 Earnings Surveillance Report, the Company reported a total "FPSC Adjusted" rate base of $12,389,266. Based on the adjustment discussed below, the Staff recommends that the appropriate rate base is $12,393,035. (Attachment 3)

Provision for rate refund: Marianna did not overearn in 1995, but the Company estimated that Marianna would overearn by $49,000 in 1996. The Company reduced revenues $49,000 to cover the estimated 1996 overearnings. (An adjustment for this item is addressed below.) The 13-month average of this amount, or $3,769, was included by the Company in working capital. In order to accurately determine 1996 overearnings, the $3,769 should be removed from working capital, which results in an increase in working capital.

**ISSUE 2**: What is the appropriate overall rate of return for Florida Public Utilities Company-Marianna Division for determining the amount of excess earnings for 1996?

**RECOMMENDATION**: For measuring excess earnings, the appropriate overall rate of return for the Marianna Division is 8.67% based on the ROE cap of 11.85% and a 13-month average capital structure for the period ending December 31, 1996. (DRAPER)

**STAFF ANALYSIS**: Staff began with the 13-month average capital structure from the Company's earnings surveillance report for the period ending December 31, 1996. In its earnings surveillance report, the Company removed its investment in Flo-Gas entirely from common equity in a manner consistent with previous cases. The Company specifically identified deferred taxes, investment tax credits and customer deposits.

Staff specifically included the amount of $3,769 as deferred revenue in the capital structure with an effective interest rate of 5.70%. This amount represents excess earnings for the 1996 year. The cost rate on deferred revenue is the 30 day commercial paper rate as per Rule 25-6.109, Florida Administrative Code. The treatment of excess earnings as an item in the capital structure is consistent with the treatment of deferred revenue in the recent earnings review of Tampa Electric Company (see Order No. PSC-97-0436-FOF-EI, issued April 17, 1997). In Order No. PSC-94-0170-FOF-EI, issued February 10, 1994, the Commission established the return on common equity for Marianna as 10.85% with a range from 9.85% to 11.85%. Using the top of the range of 11.85%, Staff calculated the weighted average cost of capital as 8.67%. (Attachment 4) This is the rate of return used to measure excess earnings.

ISSUE 3: What is the appropriate net operating income for Florida Public Utilities Company-Marianna Division for determining the amount of excess earnings for 1996? (REVELL)

RECOMMENDATION: The appropriate net operating income for the Marianna Division for 1996 is $1,097,132. (REVELL)

STAFF ANALYSIS: Per the December 1996 Earnings Surveillance Report, the Company reported an "FPSC Adjusted" net operating income of $1,068,684. Based on the adjustments discussed below, the Staff recommends that the appropriate net operating income is $1,097,132. (Attachment 3)

Under allocation of medical self insurance expense: Per Audit Exception 4, the Company made an error of $11,880 in the allocation of medical self insurance expenses between the Marianna Division and Flo-Gas. Flo-Gas is a wholly-owned unregulated subsidiary of Florida Public Utilities Company. This error caused the expense for Marianna to be lower than it actually was by this amount. To reflect the proper charges for Marianna, expenses should be increased by $11,880. Per its response to the audit report, the Company agrees with this adjustment.

Interest income on cash in Working Capital: Per Audit Disclosure 2, the Company included interest earning cash in working capital but did not include the related interest income in revenues. In Order No. PSC-94-0170-FOF-EI, the Order for the Marianna Electric Division, the Commission determined that the interest income should be included in revenues if the interest bearing cash is included in working capital. Therefore, operating revenues should be increased by $1,506.

Refund Provision: The Company booked a $49,000 provision for Rate Refund in December 1996, thereby reducing the reported operating revenues for 1996. As discussed in Issue 1, Staff is reversing this amount simply to determine the total amount of excess earnings for 1996.

Revenue reduction for imputed negative interest: In the surveillance report, the Company had a negative cash position for the 13 months ending December 31, 1996. Therefore the Company made an adjustment to reduce revenues of the Marianna Division by an allocated amount of $6,795. The rationale was that if the Company had to add interest income to revenues for any interest earned on a positive cash position, it could impute negative interest earned on a negative balance of cash and make a corresponding reduction to revenues. Staff disagrees with the Company adjustment and recommends that the Company's $6,795 reduction to operating revenues be added back to operating revenues. The Company did not pay any interest on the negative balance of cash. The Company should not make reductions to revenue to take advantage of this fact. It should be noted that many companies routinely carry negative balances of cash due to aggressive cash management policies. A negative balance of cash does not necessarily indicate cash flow or other financial problems.

In its response to the audit report, the Company agrees with the statement of facts. The Company believes, however, that the interest income adjustment was reported properly based on Order PSC-94-0170-FOF-EI. Staff notes that this Order simply states that interest earned on interest bearing cash allowed in working capital is to be included in revenues; this order does not address Company adjustments to revenue for imputed negative interest.

Interest Synchronization: This is a fallout adjustment based on the reconciliation of the rate base and the capital structure due to the Staff adjustment to the rate base. In this instance, income taxes should be decreased by $130.

ISSUE 4: What is the amount of excess earnings for Florida Public Utilities Company-Marianna Division for 1996?

RECOMMENDATION: The amount of excess earnings for the Marianna Division for 1996 is $36,143 plus interest of $1,005. (REVELL)

STAFF ANALYSIS: Based on its recommendations in the above issues, Staff has determined that the excess earnings for 1996 are $36,143, plus interest of $1,005. This represents an earned ROE of 12.38%, which exceeds the maximum authorized ROE of 11.85%. (Attachment 5)

__ISSUE 5__: What is the appropriate disposition of the 1996 excess earnings for Florida Public Utilities Division-Marianna Division?

__RECOMMENDATION__: The total amount of 1996 excess earnings of $37,148, including interest, should be contributed to Marianna's Storm Damage Reserve. The booking of this amount should be effective as of January 1, 1997, for rate making, earnings surveillance, and overearnings review purposes. (REVELL)

__STAFF ANALYSIS__: The total Storm Damage Reserve for Marianna amounted to $201,527 as of December 1996. The approved level of the reserve was addressed in Order No. PSC-94-0170-FOF-EI, resulting from Marianna's last rate case. In that Order, the Commission established a storm damage reserve of $1 million, with an annual accrual of $100,000. Staff believes that the total reserve is inadequate and will continue to be for the next several years. Therefore, Staff recommends that the $37,148 of excess earnings be included in the Storm Damage Reserve.

Since the excess earnings occurred during 1996 and interest has only been calculated for that year, Staff recommends that the increase in the reserve be made effective January 1, 1997, for all regulatory purposes. This would eliminate the need for the calculation of any additional amounts of interest and would include the increased reserve in the determination of earnings for 1997.

**ISSUE 6**: Should this docket be closed?

**RECOMMENDATION**: Yes. If no person whose substantial interests are affected by the Commission's proposed agency action timely files a protest within 21 days of the issuance of the order, this docket should be closed. (KEATING)

**STAFF ANALYSIS**: Pursuant to Rule 25-22.029(4) Florida Administrative Code, any person whose substantial interests are affected by the Commission's proposed agency action shall have 21 days after issuance of the order to file a protest. If no timely protest is filed, the docket should be closed.

FLORIDA
PUBLIC UTILITIES COMPANY

P O Box 3395
West Palm Beach
FL 33402-3395

May 7, 1996

Mr Timothy J Devlin Director
Division of Auditing and Financial Analysis
FLORIDA PUBLIC SERVICE COMMISSION
2540 Shumard Oak Blvd
Tallahassee FL 32399-0865

Dear Mr. Devlin:

Florida Public Utilities Company agrees to cap its earned return on equity (ROE) for calendar year 1996 at 11.85% for the Marianna Electric Division. This cap represents the maximum authorized ROE for this division.

The calculation of the earned ROE will be based on the "FPSC Adjusted Basis" in the Earnings Surveillance Reports for December 1996, using the same adjustments approved in our last FPSC Marianna rate case. All Reasonable and prudent expenses and investment will be allowed in the calculation, but no annualized or pro forma adjustments will be allowed. The calculation is subject to fine tuning by Florida Public Utilities Company and Commission audit.

The disposition of any excess earnings shall be left to the discretion of the Commission. In addition to a direct cash refund, the Company may request consideration of other alternatives such as additional contributions to the storm damage reserve or the reduction of any depreciation reserve deficiencies.

Sincerely,

Darryl L. Troy
Vice President

cc: Jack Shreve, Office of Public Counsel
Wayne Schiefelbein, Gatlin, Woods, et al.
F Cressman, FPU
J Brown, FPU
J English, FPU
G Bachman, FPU
VPRES.DT #2 fpsc-dev-roe.dt

FLORIDA
PUBLIC UTILITIES COMPANY

October 3, 1997

Mr Timothy J Devlin Director
Division of Auditing & Financial Analysis
FLORIDA PUBLIC SERVICE COMMISSION
2540 Shumard Oak Blvd
Tallahassee FL 32399-0865

Re: 1996 Over-earnings - Marianna Electric Docket No. 97-1228-EI

Dear Mr. Devlin:

With our May 7, 1996, letter (copy enclosed) Florida Public Utilities Company (Company) agreed to cap its return on equity (ROE) for calendar year 1996 at 11.85% for our Marianna electric operations. This cap represents the maximum authorized ROE for this electric operation. In that letter, the Company also requested that the Commission consider alternatives to a cash refund of any excess earnings. The alternatives to be considered are additional contributions to the Storm Damage Reserve or the reduction in any Depreciation Reserve deficiencies.

The Florida Public Service Commission staff has determined the Marianna excess revenues for calendar year 1996 to be $36,143 with $1,005 in accrued interest. The Company accepts this figure and requests that the total of $37,148 be contributed to the Storm Damage Reserve in Marianna. We believe the Storm Damage Reserve to be deficient due to the following reasons.

1. The Company's first attempt to establish a Storm Damage Reserve was in our Marianna Rate Case, Docket No. 880558-EI (1988) Although the Company requested an annual allowance of $54,050 based on damages from Hurricane Kate, the Commission thought this was excessive and reduced the annual accrual to $17,300.

2. The Company again sought to establish a storm damage accrual in our Fernandina Beach Rate Case, Docket No. 881056-EI (1988). We again requested an annual accrual of $54,050 based on our argument in the previous Marianna case, the greater potential for loss due to a 25% larger gross plant investment and a more vulnerable coastal location. The final decision was to allow an annual accrual of $21,625 which was 25% larger than that allowed in the Marianna case.

3. In 1993, the Company again filed for rate relief in the Marianna division. In this Rate Case, Docket No. 930400-EI (1993), we requested the annual accrual be increased to $200,000 from the previous authorized level of $17,300. We also requested the Storm Damage Reserve be capped at $1 million. The reasons for this increase were the impact that Hurricane Andrew (1992) had on electric distribution property and on the insurance industry's coverage rates making it impossible to obtain coverage at a reasonable cost. The Final Order in Docket No. 930400-EI reads:

   "Accordingly, we shall establish a storm damage reserve of $1 million, with the accrual period for the reserve set at 10 years at $100,000 per year." (Order No. PSC-94-0170-FOF-EI, p.23)

4. The current accumulated Storm Damage Reserves in Marianna and Fernandina Beach are as follows:

| | Accumulated Reserve | Annual Accrual |
|---|---|---|
| Marianna | $277,000 | $100,000 |
| Fernandina Beach | 222,000 | 21,600 |

It is apparent from items (1) through (4) that there is a deficiency in the Marianna accumulated Storm Damage Reserve. We are therefore requesting the 1996 excess revenues and interest of $37,148 be transferred to the Marianna Storm Damage Reserve.

Sincerely,

Darryl L. Troy
Vice President

Enc: Letter to Mr. Devlin dated 5-7-96
cc:
J. Shreve
W. Schiefelbein
Frank Cressman
Jack English
Jack Brown
George Bachman
Mark Cutshaw
c/fpscroemar.96.dt

ATTACHMENT 3

**FLORIDA PUBLIC UTILITIES COMPANY**
**MARIANNA ELECTRIC DIVISION**
**DOCKET NO. 971228-EI**
**REVIEW OF 1996 EARNINGS**

| | As Filed FPSC Adjusted Basis | Underalloc. Medical Self Insurance [X4] | Include Interest Income on Bank Bal. [AD 2] | Provision for Rate Refund | Reverse Imputed Interest Income | Interest Reconciliation | Total Adjustments | Total Adjusted Rate Base |
|---|---|---|---|---|---|---|---|---|
| **RATE BASE** | | | | | | | | |
| Plant in Service | $20,128,766 | | | | | | 0 | $20,128,766 |
| Accumulated Depreciation | 7,469,061 | | | | | | 0 | 7,469,061 |
| Net Plant in Service | 12,659,705 | 0 | 0 | 0 | 0 | 0 | 0 | 12,659,705 |
| Property Held for Future Use | 0 | | | | | | 0 | 0 |
| Construction Work in Progress | 145,999 | | | | | | 0 | 145,999 |
| Net Utility Plant | 12,805,704 | 0 | 0 | 0 | 0 | 0 | 0 | 12,805,704 |
| Working Capital | (416,438) | | | 3,769 | | | 3,769 | (412,669) |
| Total Rate Base | $12,389,266 | $0 | $0 | $3,769 | $0 | $0 | $3,769 | $12,393,035 |
| **INCOME STATEMENT** | | | | | | | | |
| Operating Revenues | $5,483,425 | | $1,506 | $49,000 | $6,795 | | $57,301 | $5,540,726 |
| Operating Expenses: | | | | | | | 0 | 0 |
| Operation & Maintenance - Fuel | (2) | | | | | | 0 | (2) |
| Operation & Maintenance - Other | 2,226,439 | 11,880 | | | | | 11,880 | 2,238,319 |
| Depreciation & Amortization | 757,785 | | | | | | 0 | 757,785 |
| Taxes Other Than Income | 1,145,172 | | | | | | 0 | 1,145,172 |
| Income Taxes - Current | 194,705 | (4,470) | 567 | | 2,557 | (130) | (1,477) | 193,228 |
| Deferred Income Taxes (Net) | 114,627 | | | 18,450 | | | 18,450 | 133,077 |
| Investment Tax Credit (Net) | (23,985) | | | | | | 0 | (23,985) |
| (Gain)/Loss on Disposition | 0 | | | | | | 0 | 0 |
| Total Operating Expenses | 4,414,741 | 7,410 | 567 | 18,450 | 2,557 | (130) | 28,853 | 4,443,594 |
| Net Operating Income | $1,068,684 | ($7,410) | $939 | $30,550 | $4,238 | $130 | $28,448 | $1,097,132 |
| **EQUITY RATIO** | 43.52% | | | | | | 0.00% | 43.52% |
| **OVERALL RATE OF RETURN** | 8.63% | | | | | | 0.23% | 8.85% |
| **RETURN ON EQUITY** | 11.80% | | | | | | 0.58% | 12.38% |

# FLORIDA PUBLIC UTILITIES COMPANY
## MARIANNA ELECTRIC DIVISION
## DOCKET NO. 971228-EI
## REVIEW OF 1996 EARNINGS

| CAPITAL STRUCTURE<br>AS FILED - FPSC ADJUSTED | Amount | Ratio | Cost Rate | Weighted Cost |
|---|---|---|---|---|
| Long Term Debt | $4,362,060 | 35.21% | 9.97% | 3.51% |
| Short Term Debt | 1,069,402 | 8.63% | 6.19% | 0.53% |
| Preferred Stock | 114,894 | 0.93% | 4.75% | 0.04% |
| Customer Deposits | 568,107 | 4.59% | 6.30% | 0.29% |
| Common Equity | 4,273,679 | 34.50% | 11.85% | 4.09% |
| Deferred Income Taxes | 1,754,691 | 14.16% | 0.00% | 0.00% |
| Tax Credits - Zero Cost | 1,082 | 0.01% | 0.00% | 0.00% |
| Tax Credits - Weighted Cost | 245,351 | 1.98% | 10.32% | 0.20% |
| Total | $12,389,266 | 100.00% | | 8.67% |

| ADJUSTED | Amount | Adjustments<br>Specific | <br>Pro Rata | Adjusted Total | Ratio | Cost Rate | Weighted Cost |
|---|---|---|---|---|---|---|---|
| Long Term Debt | $4,362,060 | | | $4,362,060 | 35.20% | 9.97% | 3.51% |
| Short Term Debt | 1,069,402 | | | 1,069,402 | 8.63% | 6.19% | 0.53% |
| Preferred Stock | 114,894 | | | 114,894 | 0.93% | 4.75% | 0.04% |
| Customers Deposits | 568,107 | | | 568,107 | 4.58% | 6.30% | 0.29% |
| 1996 Deferred Revenue | 0 | 3,769 | | 3,769 | 0.03% | 5.70% | 0.00% |
| Common Equity | 4,273,679 | | | 4,273,679 | 34.48% | 11.85% | 4.09% |
| Deferred Income Taxes | 1,754,691 | | | 1,754,691 | 14.16% | 0.00% | 0.00% |
| Tax Credits - Zero Cost | 1,082 | | | 1,082 | 0.01% | 0.00% | 0.00% |
| Tax Credits - Weighted Cost | 245,351 | | | 245,351 | 1.98% | 10.32% | 0.20% |
| Total | $12,389,266 | $3,769 | $0 | $12,393,035 | 100.00% | | 8.67% |

**INTEREST RECONCILIATION**

| | Amount | Cost Rate | Interest Exp. | Tax Rate | Effect on Income Tax |
|---|---|---|---|---|---|
| Long Term Debt | 4,362,060 | 9.97% | 434,897 | | |
| Short Term Debt | 1,069,402 | 6.19% | 66,196 | | |
| Customer Deposits | 568,107 | 6.30% | 35,791 | | |
| 1996 Deferred Revenue | 3,769 | 5.70% | 215 | | |
| Tax Credits - Weighted Cost | 245,351 | 5.10% | 12,513 | | |
| Staff Interest Expense | | | 549,612 | | |
| Company Interest Expense | | | 549,267 | | |
| Staff Adjustment | | | (345) | 37.63% | (130) |

ATTACHMENT 5

**FLORIDA PUBLIC UTILITIES COMPANY**
**MARIANNA ELECTRIC DIVISION**
**DOCKET NO. 971228-EI**
**REVIEW OF 1996 EARNINGS**

| | | | |
|---|---|---|---|
| Adjusted Rate Base | | | $12,393,035 |
| Achieved Rate of Return | 8.85% | | |
| Maximum Rate of Return | 8.67% | | |
| Excess Rate of Return | | X | 0.18% |
| Excess Net Operating Income | | | 22,307 |
| Revenue Expansion Factor | | X | 1.6202 |
| Excess Revenues | | | $36,143 |