

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Petition for approval of Cast Iron/Bare
Steel Pipe Replacement Rider (Rider CI/BSR),
by Peoples Gas System.

DOCKET NO. 110320-GU
ORDER NO. PSC-12-0476-TRF-GU
ISSUED: September 18, 2012

The following Commissioners participated in the disposition of this matter:

RONALD A. BRISÉ, Chairman
LISA POLAK EDGAR
ART GRAHAM
EDUARDO E. BALBIS
JULIE I. BROWN

ORDER APPROVING TARIFFS

BY THE COMMISSION:

BACKGROUND

On December 14, 2011, Peoples Gas System (Peoples) filed a petition for approval of a Cast Iron/Bare Steel Pipe Replacement Rider (Rider) to recover the cost of accelerating the replacement of cast iron and bare steel distribution pipes on its system through a surcharge on customers' bills. Gas utilities have been urged by the U.S. Department of Transportation (USDOT) to replace these older facilities as a safety measure. This Commission approved \$1 million dollars in rate base for the 2009 projected test year for replacement of these pipes in Peoples' last rate case.¹ Through the Rider, Peoples seeks approval of an annually adjusted per therm surcharge to capture the cost of replacement of cast iron and bare steel pipes over a 10-year period. This accelerated recovery period would increase Peoples' capital expenditures for replacement of the facilities from \$1 million to approximately \$8 million annually, with the \$7 million of additional revenue requirement to be recovered annually through the Rider. The \$1 million currently included in rate base would be excluded from recovery through the Rider.

On March 23, 2012, the Office of Public Counsel (OPC) intervened in this case.² In March, June, and July 2012, Peoples provided responses to five sets of data requests, which included certain modifications and revisions to Peoples' petition. Most notably, Peoples agreed to use the actual overall cost of capital, including the allowed return on equity from Peoples' last rate case, reflected in the most recent December earnings surveillance report. In its petition, Peoples had originally proposed to use the overall cost of capital from the last rate case. On June 26, 2012, Peoples filed a letter agreeing to waive the 8-month clock with the understanding that we would consider this petition at our August 14, 2012, Agenda Conference, which we did.

¹ Order No. PSC-09-0411-FOF-GU, issued June 9, 2009, in Docket No. 080318-GU, In re: Petition for a Rate Increase by Peoples Gas System.

² OPC's intervention was acknowledged in Order No. PSC-12-0138-PCO-GU.

DOCUMENT NUMBER DATE

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FPSC-COMMISSION CLERK

On July 31, 2012, Peoples filed a letter agreeing to implement the Rider and its tariffs on January 1, 2013, instead of July 2012, as requested in the petition. The letter included revised tariffs that contain the following modifications from the tariffs originally filed with the petition: (1) January 1, 2013, effective date; (2) Use of actual overall cost of capital reflected in the most recent December earnings surveillance report; (3) The annual true-up will be based on seven months of actual data and five months of projected data; and (4) certain minor clarifications. These tariff sheets supersede and replace the tariff sheets that accompanied the petition. At our Agenda Conference, as OPC suggested, Peoples agreed to identify and report any Operations and Maintenance (O&M) and depreciation expense savings in its annual petitions for recovery of the Rider surcharge, beginning with the second annual petition.

We have jurisdiction over this matter pursuant to Sections 366.03, 366.04, 366.05 and 366.06, Florida Statutes (F.S.). For the reasons outlined below, we approve Peoples' proposed Rider and associated tariff sheets. Peoples shall file its annual surcharge petitions by September 1 of each year, starting in 2013. Peoples shall also file quarterly reports on the progress of the replacement program.

DECISION

Overview of the Proposed Program

Peoples has had a replacement program in place since 2000. From December 2000 to December 2010, Peoples states that it replaced approximately 200 miles of cast iron and bare steel mains. Peoples requested the Rider to accelerate the replacement of its cast iron and bare steel pipes. Specifically, Peoples proposed to replace bare steel and cast iron mains, service lines, and regulator stations. Peoples asserted that it will evaluate meters on an individual basis to determine whether they need to be replaced. Cast iron pipes currently comprise approximately one percent, or 156 miles, of Peoples' distribution system. Bare steel pipes comprise approximately four percent, or 411 miles, of Peoples' system, for a total of 567 miles that need to be replaced. Peoples' distribution system includes a total of 11,164 miles of pipe. Of the 567 miles of remaining facilities to be replaced, Peoples plans to replace approximately 57 miles, or ten percent, annually over a 10-year period. Peoples explained that it believes that a 10-year time frame is a reasonable projection to complete the replacement program, after consideration of several factors including customer rate impact, and contractor and employee availability and workload.

As mentioned above, we approved \$1 million dollars in rate base for the 2009 projected test year for replacement of these facilities in Peoples' last rate case, allowing Peoples to earn a return on and recover the depreciation and ad valorem expenses associated with the \$1 million investment through base rates. We note that base rates were not increased to recover a return or any related expenses on any capital investments made in 2010 or 2011. Peoples states that with \$1 million per year targeted for the replacement of the pipes, it would take over 70 years to replace all of them, and this amount is therefore insufficient to replace all of the targeted pipes in a timely manner. Thus, Peoples seeks approval of an annually adjusted cast iron/bare steel surcharge (surcharge) on customers' bills to capture the cost of replacement over a 10-year

period. This accelerated recovery period would increase Peoples' capital investment for replacement from \$1 million to approximately \$8 million annually, with the \$7 million of additional investment to be recovered through the surcharge. Peoples will annually exclude recovery of \$1 million before any other capital investments are included for purposes of recovery through the Rider.

Peoples proposed to administer the surcharge with the filing of an annual petition for approval of the projected revenue requirement to be recovered during the following calendar year. The revenue requirement would be calculated and trued up each year. Peoples states that we will have the opportunity to thoroughly review and audit Peoples' filings. The revenue requirement will be allocated to the customer classes using the same methodology that was used for the allocation of mains and services in the cost of service study used in Peoples' most recent rate case.

The collection of the surcharge established each year will continue until Peoples files a rate case. Peoples proposes that during a rate case, the replaced infrastructure would be rolled into Peoples' overall rate base, and the surcharge would be "reset to zero." The surcharge would terminate when all applicable cast iron and bare steel pipes have been replaced and included in rate base through one or more rate cases.

In addition to meeting safety concerns, Peoples states that the proposed Rider will provide an economic development boost to the areas where cast iron and bare steel replacements are made through the use of local labor. Peoples will use a combination of internal employees and external contractors to perform the accelerated replacements.

Residential Customer Bill Impact

In its July 31, 2012 letter, Peoples filed a revised Exhibit E reflecting the projected impact on a residential customer's bill. The current monthly bill for a residential customer who uses 20 therms is \$37.55 (including July 2012 PGA and Gross Receipts Tax). The projected monthly bill impact for a residential customer who uses 20 therms is \$0.05 in 2013, and increases to \$0.80 in 2022, assuming no rate cases in that time frame. The calculation assumes incremental capital expenditures of \$7 million annually. Staff notes that the customer impact increases annually as the return on the unamortized investment increases over time as the investment grows until the investment is embedded in rate base and recovered through base rates.

Safety Concerns

Peoples states that its petition is in response to growing concerns by the Pipeline Hazardous Materials and Safety Administration (PHMSA) of the USDOT regarding the use of cast iron and unprotected bare steel, as expressed in Secretary LaHood's letter to each state governor dated March 28, 2011.³ The PHMSA was created in 2004 and is responsible for

³ A copy of the letter is included in Peoples' response to staff's second data request No. 4, filed March 12, 2012.

pipeline safety nationwide. Secretary LaHood also appeared at the National Association of Regulatory Utility Commissioners in 2011 expressing concerns about the aged infrastructure.

The PHMSA issued advisory bulletins regarding cast iron usage in distribution systems as early as 1991. In the latest advisory bulletin (ADB-2012-05) PHMSA asked the operators and state pipeline safety representatives to consider the following:

Request, review and monitor operator cast iron replacement plans and programs, actively encourage operators to develop and continually update and follow their plans, and consider establishment of mandated replacement programs.

Establish accelerated leakage survey frequencies or leak testing considering the results from failure investigations and environment risk factors.

Focus pipeline safety efforts on identifying the highest risk pipe.

Use rate adjustments and flexible rate recovery mechanisms to incentivize pipeline rehabilitations, repair and replacement programs.

Strengthen pipeline safety inspections, accident investigations and enforcement actions.

Safety Concerns Regarding Cast Iron Pipe

Cast iron pipe is subject to “graphitization” or graphitic softening. Cast iron is an alloy made of iron and carbon, the carbon being in the form of graphite. With this composition, when the iron dissolves out due to corrosion, only the graphite is left. This causes the pipe and similar equipment such as fittings to become mechanically unsound. Cast iron loses its ductility or ability to bend when the pipe material becomes “graphitized”, which leads to cracks. When graphitization corrosion occurs, the graphite pipe may still last for many years if it is not subjected to any mechanical forces or pressure changes.

The method used to join cast iron pipe segments presents a separate cause for concern. The joints are made by either mechanical couplings, threaded couplings, or by sealing the bell and spigot joints with jute and lead wool. Natural gas used by the industry today in Florida is a much dryer gas than that used in the past. The dryer gas increases the potential of leakage as the materials used as a caulking in the bell and spigot joints dry out.

Any movement of the earth caused by excavation, heavy road traffic, or other outside forces can cause a failure. Leakage can gravitate in sewer drains or under pavement or other dense material that will not allow gas to vent into the atmosphere. If the gas gravitates and collects in an occupied structure, which has been the case in some accidents in other states, loss of life can occur.

Safety Concerns Regarding Bare Steel Pipe

Bare steel pipe is subject to corrosion. Corrosion causes pitting in the steel, which reduces the structural integrity of the pipeline. Corrosion left undetected or uncorrected can lead to structural failure and release of gas. According to Peoples' petition, Peoples installed bare steel pipeline beginning around 1940 and ended in 1970. The age of the bare steel is now 42 to 72 years.

PHMSA recognized the threat of corrosion on bare steel pipe, and as a result amended Part 192.455, Code of Federal Regulations (CFR), to prohibit the installation of bare steel pipeline after July 31, 1971, unless the operator could demonstrate by tests, investigation, or experience in the area using, at a minimum, soil resistivity measurements and tests for corrosion accelerating bacteria, that a corrosive environment does not exist.

Steel pipeline installed after August 1, 1971, uses protective coatings developed to help insulate the pipeline from the corrosive environment. Where there are nicks or "holidays" in the coating, cathodic protection is required under the amended Part 192.455, CFR, to reduce corrosion. Cathodic protection consists of an electric current applied to the pipeline in such a manner as to cause metals to be deposited on the pipeline instead of being eroded from it.

Method of Determining the Order of Pipeline Replacement

PHMSA urged the states in its latest advisory regarding cast iron to consider replacing the highest risk pipes first. Staff believes this same methodology should be carried out throughout the replacement of both cast iron and bare steel pipe.

Peoples stated that it would prioritize the replacement of cast iron and bare steel using the following factors:

- a. The Distribution Integrity Management Program (DIMP)
- b. Leak incident rates
- c. Pressure under which the pipeline is operating
- d. Areas of significant construction (municipal improvement projects, etc.)
- e. Age of pipeline

The DIMP program is a comprehensive plan of pipeline risk assessments that we believe will appropriately provide guidance to Peoples in determining which pipes should be replaced first based on the risk to the residents located near the pipelines. Also, using historical leak incident rates, Peoples can assess which pipes are in need of replacement sooner than other less corroded pipes. Peoples states that polyethylene pipe will be used for the replacement pipes, and in some cases Peoples will use coated steel to maintain system integrity and operational requirements.

Quarterly Reports

Peoples has agreed to file quarterly reports with us on the progress of its replacement program. The reports shall include information such as location of the replacements, the mileage and type of pipeline replaced, the type of material used, and the date the replacement pipe was put into service. This information is included in the safety reports our staff provides to PHMSA.

What Other States Are Doing

Twenty-four states have established programs for the replacement of bare steel and cast iron pipelines, and several states have pending programs.⁴ States have implemented a variety of cost recovery methods for these programs. New Jersey, Kentucky, and Indiana are currently using traditional ratemaking authority to recover the costs of pipeline infrastructure replacement programs. Missouri, Kansas, and Nebraska are using specific cost recovery formulas and detailed eligibility requirements to establish pipeline replacement surcharges. Ohio has an alternative rate plan which requires the company to file an application with the proposed rates, summary of the proposed plan, a comparison of the typical before and after customer bill, and any waiver requests. Texas uses an interim rate adjustment method, and Virginia has adopted a separate rider, allowing for the recovery of certain costs associated with eligible infrastructure replacement projects

Determination of Revenue requirement

Peoples projects \$8 million in total annual replacement costs, with \$7 million to be recovered through the Rider. The assumptions for the \$8 million annual investment are based upon Peoples' linear miles of cast iron and steel pipe to be replaced, multiplied by the projected costs associated with replacing the pipe, using contractor pricing for Peoples' east and west regions. Peoples' total projected cost to replace all remaining cast iron and bare steel pipe amounts to \$72.8 million, including a 10 percent contingency. Peoples states that the complexity of the work in certain urban areas may increase the replacement costs significantly, whereas the costs may be lower in less densely populated areas. Peoples cautions that these costs are only estimates, and the actual costs could be more or less than estimated. However, in the annual filings, Peoples will true-up the costs, and only request recovery of actual dollars incurred.

As we mentioned above, Peoples may experience potential cost reductions in future O&M expenses as a result of replacing the cast iron and bare steel pipes. Peoples explained that as the replacements progress, it expects reductions in the expenses associated with unprotected structure leak surveys, electrical surveys, and maintenance repair expenses. While Peoples cannot accurately quantify the expected O&M savings at this point, any reductions will be quantified and reflected in Peoples' next rate case proceeding, and Peoples has agreed to identify and report any O&M and depreciation expense savings in its annual surcharge petitions, beginning the second year.

⁴ Source: American Gas Association Natural Gas Rate Round-Up, May 2011 and <http://opsweb.phmsa.dot.gov/pipelineforum/pipeline-systems/state-pipeline-system/state-replacement-programs/>.

Through the surcharge, Peoples proposes to recover the return on, depreciation expense, and ad valorem tax expense associated with the capital expenditures for replacements in excess of \$1 million. Peoples is not proposing to recover any O&M related expenses, which Peoples asserts should be minimal. Each expense component is discussed in more detail below.

Return

Peoples has agreed to use the actual overall cost of capital, including the allowed return on equity from Peoples' last rate case, reflected in the most recent December 2011 earnings surveillance report. Relying on a more current overall cost of capital more accurately aligns current costs with current cost recovery and sends a more precise price signal. For future annual filings Peoples shall use the most currently available December earnings surveillance report.

Peoples provided an updated net operating income multiplier to be applied to the revenue requirement associated with the equity component of the Rider. Using the more current capital structure reflected on Peoples' December 2011 earnings surveillance report reduces the "Total Equity Cost Rate" from 8.4987 percent to 8.1153 percent and the "Total Debt Cost Rate" from 3.2907 percent to 3.1459 percent.

Ad Valorem Taxes

As a result of the increased capital investments associated with Peoples' proposed Rider, Peoples will incur additional ad valorem taxes. Peoples provided an updated Exhibit C to its Petition that uses the current composite millage rates associated with the forty counties that will be affected by the Rider. We have evaluated Peoples' revised calculation of the aggregate millage rate to be used for the Rider and we find it to be accurate and reasonable. We find that the appropriate ad valorem tax rate is 17.88 mills, or approximately 1.79 percent. Yearly variations in the millage rates can be addressed in the annual filings.

Depreciation

Peoples proposed to use the applicable depreciation rates from its 2011 depreciation study, we find that this is appropriate.⁵ The costs of the cast iron and bare steel pipe being replaced are recovered through the cost of removal component in Peoples' currently approved depreciation rates. Thus, the cost of removal will not be recovered through the Rider. The applicable depreciation rates are presented below.

| Account No. | Investment | Remaining Life Depreciation Rate |
|-------------|------------------|-------------------------------------|
| 37600 | Mains Steel | 4.2% |
| 37602 | Mains Plastic | 3.1% |
| 38000 | Services Steel | 6.6% |
| 38002 | Services Plastic | 5.0% |
| 38300 | House Regulator | 3.6% |

⁵ Order No. PSC-12-0217-PAA-GU, issued April 24, 2012, in Docket No. 110232-GU, In re: Petition for approval of 2011 Depreciation Study by Peoples Gas System.

Procedure for Setting the Surcharge

For ease of administration and to avoid customer confusion, it will be more efficient to implement Peoples' tariffs containing the surcharges effective January 2013. Peoples has agreed to this implementation date.

Peoples shall file annual petitions to revise the surcharges to be effective the following calendar year by September 1 of each year, starting in 2013. The annual filings shall include the following three components:

1. A final true-up showing the actual replacement costs and actual surcharge revenues for the most recent 12-month historical period from January 1 through December 31 that ends prior to the annual petition filing; including the final over- or under-recovery for the final true-up period;
2. An actual/estimated true-up showing seven months of actual and five months of projected costs and revenues;
3. A projection showing 12 months of projected Rider revenue requirement for the period beginning January 1 following the annual filing.

The prevailing commercial paper rate of interest shall be applied to all over- and under-recoveries. We note that our staff and interested parties will have the opportunity to thoroughly review Peoples' replacement pipeline expenditures during the annual approval process of the surcharges and request additional information if necessary.

CONCLUSION

It is clear to us that we have the authority under our broad ratemaking powers found in Sections 366.04, 366.05, and 366.06, F.S., to establish this type of surcharge to recover a discreet set of costs incurred in response to unusual, urgent circumstances. For example, in Action Group v. Deason, 615 So. 2d 683 (Fla. 1993), the Florida Supreme Court upheld our approval of a 15-year rate rider charged to customers in a specific service area to retire the existing debt of a bankrupt system that Florida Power Corporation (now Progress Energy Florida, Inc.) had purchased. The Court stated that we had the authority under Section 366.04(1), F.S., to fix "just, reasonable, and compensatory rates, charges, fares, tolls, or rentals", and the authority under Section 366.05(1), F.S., to prescribe "fair and reasonable rates and charges [and] classifications," which authority, the Court stated, was to be construed liberally. See also Section 366.041(2), F.S., which provides that the "power and authority herein conferred upon the commission shall ... be construed liberally to further the legislative intent that adequate service be rendered by public utilities." In Docket No. 041291-EI, In re: Petition for authority to recover prudently incurred storm restoration costs related to 2004 storm season that exceed storm reserve balance, by Florida Power & Light Co.,⁶ we approved a surcharge to cover FPL's unanticipated storm restoration costs for a period of three years. Likewise, in Docket No. 041272-EI, In re: Petition

⁶ Order No. PSC-05-0937-FOF-EI, issued September 21, 2005.

for approval of storm cost recovery clause for recovery of extraordinary expenditures related to Hurricanes Charley, Frances, Jeanne, and Ivan, by Progress Energy Florida, Inc.,⁷ we approved a two-year surcharge to recover Progress's storm costs. Here, we are approving a similar surcharge, for a discreet period, in response to unusual circumstances.

While PHMSA has not yet mandated the replacement of cast iron and unprotected bare steel, Congress has required biennial reports on the replacement. We find that replacement of these types of pipelines is in the public interest to improve the safety of Florida's natural gas infrastructure, and reduce the possibility of loss of life and destruction of property should an incident occur. Given the length of time these pipelines have been installed and the leak history due to corrosion, it is appropriate to approve the proposed accelerated replacement program. Without the Rider, it is reasonable to expect that Peoples will have to file for more frequent base rate proceedings to recover the expenses of the program. The annual filings will provide us with the oversight to ensure that projected expenses are trued-up and only actual costs are recovered. The Rider and its associated surcharges will terminate when all replacements have been made and the revenue requirement has been rolled into rate base. For these reasons, we approve the proposed Rider and its associated tariff sheets.

Based on the foregoing, it is

ORDERED by the Florida Public Service Commission that the Petition for approval of Cast Iron/Bare Steel Pipe Replacement Rider (Rider CI/BSR), by Peoples Gas System is approved, effective January 1, 2013. It is further

ORDERED that if a protest is filed within 21 days of issuance of the Order, the tariff shall remain in effect with any charges held subject to refund pending resolution of the protest. It is further

ORDERED that if no timely protest is filed, this docket shall be closed upon the issuance of a Consummating Order.

⁷ Order No. PSC-05-0748-FOF-EI, issued July 14, 2005.

By ORDER of the Florida Public Service Commission this 18th day of September, 2012.



ANN COLE
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Copies furnished: A copy of this document is provided to the parties of record at the time of issuance and, if applicable, interested persons.

MCB

NOTICE OF FURTHER PROCEEDINGS

The Florida Public Service Commission is required by Section 120.569(1), Florida Statutes, to notify parties of any administrative hearing or judicial review of Commission orders that is available under Sections 120.57 or 120.68, Florida Statutes, as well as the procedures and time limits that apply. This notice should not be construed to mean all requests for an administrative hearing or judicial review will be granted or result in the relief sought.

Mediation may be available on a case-by-case basis. If mediation is conducted, it does not affect a substantially interested person's right to a hearing.

The Commission's decision on this tariff is interim in nature and will become final, unless a person whose substantial interests are affected by the proposed action files a petition for a formal proceeding, in the form provided by Rule 28-106.201, Florida Administrative Code. This petition must be received by the Office of Commission Clerk, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, by the close of business on October 9, 2012.

In the absence of such a petition, this Order shall become final and effective upon the issuance of a Consummating Order.

Any objection or protest filed in this docket before the issuance date of this order is considered abandoned unless it satisfies the foregoing conditions and is renewed within the specified protest period.