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M E M O R A N D U M

October 23, 1997

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

FROM: DIVISION OF AUDITING & FINANCIAL ANALYSIS (L. ROMIG, DRAPER, LESTER, C. ROMIG)
DIVISION OF ELECTRIC & GAS (MAKIN)
DIVISION OF LEGAL SERVICES (KEATING) WCK RVE JOJ ALM JS

RE: DOCKET NO. 971310-GU - PEOPLES GAS SYSTEM - INVESTIGATION INTO THE 1996 EARNINGS OF PEOPLES GAS SYSTEM

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

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: S:\PSC\AFA\WP\971310.RCM
R:\PSC\AFA\123\971310.WK4 - SCHEDULE 1-2

CASE BACKGROUND

In a letter dated July 11, 1996, Peoples Gas System, Inc. (Peoples Gas or Company) stated that any revenues contributing to a return on equity in excess of 12.25% for the calendar year 1996 would be held subject to Commission jurisdiction and disposition. The Company stated that it anticipated its earnings would remain within the authorized range for the remainder of the 1996 calendar year. However, in the event that earnings were above the range, the Company urged the Commission to defer the excess earnings to a later period. According to Peoples Gas, the deferral would provide a longer period of stable rates benefitting its customers.

After auditing and reviewing the Company's surveillance report for the 1996 calendar year, Staff has determined that the Company earned in excess of 12.25%, as discussed below.

In addition to responding to the Staff's audit report, the Company also responded to several other adjustments proposed by Staff: PGA and Conservation Overrecoveries, Environmental Costs; and Intercompany Accounts Payable. The Company's position, if any, on each adjustment will be discussed separately.

DOCUMENT NUMBER-DATE
10935 OCT 23 97
FPSC-RECORDS/REPORTING

DISCUSSION OF ISSUES

ISSUE 1: What is the appropriate rate base for 1996?

RECOMMENDATION: The appropriate rate base is $249,033,703. (Schedule 1) (L. ROMIG)

STAFF ANALYSIS: Per the December 1996 Earnings Surveillance Report, the Company reported a total "FPSC Adjusted" rate base of $253,138,000. Based on the adjustments discussed below, the appropriate rate base is $249,033,703 for 1996.

Adjustment 1: **Deferred Environmental Costs** - Correction of Error - By Order No. 16313, issued July 8, 1986, in Docket No. 850811-GU, Peoples Gas was first authorized to amortize $1.2 million in estimated and projected environmental clean-up costs associated with its manufactured gas production plants over a 5 year period. The effective date of the new rates was July 18, 1986. The Company began its amortization in October 1986, which coincided with the first month of its fiscal year. Staff believes the Company should have begun the amortization in August 1986, the first full month in which the new rates were in effect, in order to have a proper matching of revenues and expenses. Therefore, Deferred Environmental Costs should be reduced $40,000, also reducing working capital.

By Order No. 23858, issued December 11, 1990, in Docket No. 891353-GU, the Company was authorized to increase its amortization of environmental clean-up costs from $240,000 to $1,248,000 annually, effective November 1, 1990. In the Company's last rate case (Docket No. 911150-GU), the Staff auditors determined that the Company made an error in calculating the amortization for the fiscal year ended September 1991 by using the wrong monthly amortization amount for 11 months of the historical test year. As a result, the Company understated 1991 expense and overstated 1996 deferred costs by $220,000.

Based on the above, Staff recommends that the Company be ordered to record additional amortization of $260,000 for years prior to 1996. In addition, Staff recommends that working capital for 1996 be reduced by $260,000 to correct these errors.

Adjustment 2: **Deferred Environmental Costs** - Based on the discussion of Adjustment 7, under Issue 3, Staff recommends that working capital be reduced by $949,297.

__Adjustment 3:__ **Conservation and Gas Overrecovery** - The Company made adjustments to remove conservation and fuel overrecoveries from working capital, thereby increasing working capital by $1,935,000 and $960,000, respectively. Based on Commission practice, recovery clause overrecoveries are included as reductions to working capital.

In its response to this Staff adjustment, Peoples takes the position that its accounting for PGA/ECCR overrecoveries is consistent with the method used in its last rate case and no Staff adjustment should be made.

Including overrecoveries in working capital is a long standing Commission practice. In Order No. 13537, Docket No. 830465-EI, the Commission reaffirmed its action in this area by stating:

> In Order No. 9273, Docket No. 74680-CI, we determined that interest should be applied to over/under recoveries in order to counter any incentive to bias projections in either direction. If the ratepayer has to provide the interest on both over/under recoveries, the Company will have no incentive to make its projections as accurate as possible.
>
> In FPL's last rate case and in subsequent rate cases involving other electric utilities, we have consistently determined that adjustment clause over recoveries should be included as a reduction to working capital.

In addition, the Commission, in Order No. PSC-93-0165-FOF-EI, Docket No. 920324-EI, stated:

> By stipulation, the Company [Tampa Electric Company] has agreed that the Commission's policy of including net over recoveries in working capital and excluding net under recoveries is the appropriate treatment. Net under recoveries, which are assets, are excluded from working capital, and net over recoveries, which are liabilities, are included. We accept and approve the stipulation. In its filing, the Company incorrectly removed both over recoveries and under recoveries.

Further, the Commission stated in Order No. PSC-94-0452-FOF-GU, Docket No. 930091-GU:

> This would result in the ratepayers providing the interest that the Company [West Florida Natural Gas Company] would return to them. By the same token, unrecovered costs should be excluded from working capital. To include those costs would allow the Company to earn a return on the under recovery plus recover the interest through the recovery clause.

Most recently, in Order No. PSC-97-0136-FOF-GU, Docket No. 970023-GU (Chesapeake Utilities), the Commission stated:

> It has been our policy that these over recoveries should be treated as cost-free liabilities which are used to reduce a utility's working capital allowance. See Docket No. 830012-A. (Tampa Electric Company) and Docket No. 960502-GU (City Gas Company). If over recoveries are not recognized in Working Capital, Rate Base is increased and the utility earns a return on the over recovery. In other words, the ratepayer provides the interest on the over recovery. By including over recoveries as a reduction to Working Capital, a Company will have an incentive to make its projections for the cost recovery clause as accurate as possible and avoid large over recoveries.

As stated in the above orders, the rationale for including overrecoveries as a reduction to working capital is 1) to provide an incentive to utilities to make their projections as accurate as possible, and 2) to protect the ratepayer from paying interest on the overrecovery.

Ratepayers pay interest to the Company on underrecoveries and the Company pays interest to ratepayers on overrecoveries at the commercial paper rate. If an overrecovery is not included in working capital, then the ratepayer is paid the commercial paper rate by the Company but at the same time, the Company is allowed to earn the overall rate of return on the increased rate base. This gives the Company a bonus instead of a penalty when cost overrecoveries occur because the overall cost of capital is higher than the commercial paper rate. Peoples' overall rate of return is

9.26% and the average commercial paper rate was 5.70%. Therefore, the Company earns more than it is paying out. For instance, in this case the Company would earn approximately $432,000 on a higher rate base and pay the customer $165,000 at the commercial paper rate. When the overrecovery is included in working capital, rate base is reduced and the Company must pay interest to the ratepayer at the commercial paper rate. Only in this case is there a penalty to the Company.

Therefore, Staff recommends that working capital be reduced $1,935,000 and $960,000 to include conservation and fuel overrecoveries, respectively.

ISSUE 2: What is the appropriate weighted average cost of capital for Peoples Gas for the period ending December 31, 1996?

RECOMMENDATION: Based on the return on equity cap of 12.25%, the appropriate weighted average cost of capital for measuring excess earnings is 9.26%. (LESTER)

STAFF ANALYSIS: Rate base is the utility's investment in plant and working capital and is primarily derived from the assets side of the balance sheet. Total capital represents the sources of capital for the Company and is primarily derived from the liabilities and common equity side of the balance sheet. In reconciling capital structure and rate base, the Company is showing its investment in rate base and how it financed that investment.

Utilities file Earnings Surveillance Reports with the capital structure reconciled to rate base. Typically, sources of funds cannot be traced to uses of funds. Funds are fungible, i.e., interchangeable. Therefore, the Commission usually reconciles differences between capital structure and rate base with pro rata adjustments over total capital. However, under certain circumstances it is appropriate to make specific adjustments to capital structure components. In these cases, specific adjustments are necessary to more accurately reflect the true cost of providing service. After all specific adjustments have been made, any additional adjustment necessary to reconcile capital structure and rate base will be made on a pro rata basis. From the reconciled capital structure, the overall rate of return is calculated and applied to rate base to calculate the allowed net operating income.

In its December 1996 Earnings Surveillance Report Summary, Peoples Gas reconciled capital structure and rate base with specific and pro rata adjustments. The pro rata adjustments were made over all sources of capital. Unusually, these pro rata adjustments were positive, meaning the beginning balance of total capital was increased to match rate base. This occurred because the Company prorated an intercompany payable, amounting to $7,724,000, over all sources of capital. This adjustment is consistent with the treatment allowed by Order No. 23858, issued December 11, 1990, in Docket No. 891353-GU. For the rate case in Docket No. 911150-GU, capital structure and rate base were reconciled with pro rata adjustments over investor sources of capital and customer deposits.

As represented in the rate case in Docket No. 891353-GU, the intercompany payable is an interest-bearing account and is the sum of all transactions that occur between Peoples Gas and any of its non-utility affiliates. This amount was not included as a liability in the calculation of working capital, therefore, it increased working capital and was reconciled to the capital structure as a pro rata increase to all sources of capital.

As discussed in Order No. 23858, issued December 11, 1990, the reason for this treatment in Docket No. 891353-GU was that the Company used the intercompany payable to balance the balance sheet for the projected test year, and the pro rata increase in capital was analogous to the pro rata decrease in capital that results when temporary cash investments are removed from working capital. Furthermore, as discussed in the staff recommendation to the Commission in Docket No. 891353-GU, filed October 4, 1990, because the intercompany payable was a balancing amount, at the time of the rate case Staff believed that the payable might not actually exist during the projected test year.

The Company believes the pro rata treatment of the intercompany payable should continue. In a letter to Staff, the Company states that the Commission has historically removed from rate base all intercompany accounts whether payables or receivables. It further states that in every rate case in the Company's history, this adjustment has been made on a pro rata basis over all sources of capital. Finally, the Company notes that specifically identifying the intercompany payable as a source of capital is completely inconsistent with the treatment prescribed in Peoples' last rate case or any previous case.

Staff believes that it is important to distinguish between an earnings review and a rate case. Although each company must file an earnings surveillance reports consistent with Commission adjustments in its last rate case, further adjustments are necessary to accurately measure earnings. For example, a Company's last rate case is usually based on a projected test year, but the subsequent surveillance reports are always historical. Also, a rate case may contain amortization of an item that is appropriately expensed entirely during the historical surveillance period.

Staff believes the intercompany payable should be included in the capital structure as short-term debt for the following reasons. First, during 1996, the intercompany payable existed as an interest-bearing amount. That is a historical fact. Unlike the rate case in Docket No. 891353-GU, it is not a balancing entry for projection purposes. Second, the intercompany payable is tied to a specific interest expense. By including the intercompany payable as short-term debt in the capital structure, the Commission will allow the Company to recover its appropriate interest expense. If the intercompany payable is prorated over all sources of capital, it will earn the overall rate of return, which is higher than its interest rate. Finally, Staff notes that the payable was interest bearing. In this respect, it is like any other debt instrument in the Company's capital structure. The intercompany payable supplied funds to the Company that otherwise would be supplied by investors. Therefore, Staff recommends that the Commission include the intercompany payable as short-term debt in the capital structure.

On Schedule 2, Staff included $7,724,000, the amount of the intercompany payable, as a specific increase to short-term debt. Staff calculated the 6% interest rate by dividing interest expense for the year by the amount of the payable.

In order to reflect Staff's adjustment expensing environmental costs, Staff reduced common equity and deferred taxes by $754,000 and $455,000, respectively. The Commission set the Company's return on equity at 11.25%, with a range of plus or minus 100 basis points. (See Order No. PSC-93-1773-FOF-GU, issued December 10, 1993, in Docket No. 931101-GU.) Using the top of the range, 12.25%, for measuring excess earnings, Staff has calculated the weighted average cost of capital at 9.26%.

ISSUE 3: What is the appropriate net operating income for 1996?

RECOMMENDATION: The appropriate net operating income is $23,125,999 for 1996. (Schedule 1) (L. ROMIG, C. ROMIG)

STAFF ANALYSIS: Per the December 1996 Earnings Surveillance Report, the Company reported a "FPSC Adjusted" net operating income of $24,051,000. Based on the adjustments discussed below, the appropriate net operating income is $23,125,999 for 1996.

Adjustment 4: Overaccrual - IBM Studies - In May 1996, the Company accrued $250,000 to expenses for a study being performed by IBM. According to the Company, the actual cost of the study was $188,600. In March 1997, the Company credited expenses $61,400 to reflect the actual cost. Therefore, it would be appropriate to reduce 1996 expenses by $61,400. (Audit Disclosure No. 3) Peoples Gas agrees with the adjustment.

Adjustment 5: Director Fees - Two of the Company's directors, who are also employees of the Company, were paid $2,000 each in 1996 for director fees. Expenses should be reduced by $4,000.

The Commission, in Order No. PSC-95-0964-FOF-GU, issued August 8, 1995, and in Order No. PSC-96-1188-FOF-GU, issued September 23, 1996, denied West Florida Natural Gas and St. Joe Natural Gas, respectively, the allowance of directors' fees for those directors who were already compensated through the payment of salaries. The Commission found it appropriate to reduce expenses for director fees in each of these overearnings dockets. Similar adjustments were not made in prior rate cases or other earnings dockets for these companies.

The Company believes that no adjustment should be made based on the disclosure for the following reasons: 1) the expenses are paid to the employees in recognition of the services performed as directors in addition to their regular duties, and 2) no adjustment was made for these expenses in the Company's last rate case.

Staff believes that it is appropriate to distinguish between an earnings review and a rate case. Although the companies must file their earnings surveillance reports consistent with Commission adjustments made in their last rate case, further adjustments may be appropriate to accurately measure earnings and also reflect current Commission policy. For example, a Company's last rate case is usually based on a projected test year, but the earnings reports are based on historical data. Staff, therefore, recommends that expenses be reduced by $4,000.

Adjustment 6: **Charitable Contributions and Chamber of Commerce Dues** - During the audit of the 1996 surveillance report, a sample of the transactions recorded in the managers' working funds was reviewed for the proper treatment of employee activities or civic/social club dues. Based on this review, it was determined that expenses included \$18,767 and \$6,040 for charitable contributions and chamber of commerce dues, respectively. Since similar adjustments were made in the Company's last case, it would be appropriate to reduce expenses by the above amounts. (Audit Disclosure No.6) The Company accepted the disclosure in its response to the audit report.

Adjustment 7: **Environmental Costs** - By Order No. PSC-92-0924-FOF-GU, in Docket No. 911150-GU, the Company's last rate case, the Commission authorized the Company to amortize \$1,248,000 in environmental costs annually based on a 5 year amortization period beginning on November 1, 1990. The Commission then opened Docket No. 931101-GU to investigate the appropriate equity return for Peoples Gas. In Order No. PSC-93-1773-FOF-GU, issued December 10, 1993, the Commission reduced the Company's ROE from 12.00% to 11.25%, plus or minus 100 basis points, beginning January 1, 1994. In the same Order, the Commission ordered Peoples Gas to fully amortize \$2,496,000 in environmental clean-up costs by September 30, 1994. Since then, the Company has been deferring all environmental costs incurred. Staff believes that the Company should be expensing these costs as incurred because the Company did not have explicit Commission authorization to defer the costs.

Peoples Gas submitted the following position on this adjustment.

> Peoples has been properly authorized by the Commission to utilize deferral accounting treatment. The Commission first authorized Peoples to utilize deferral accounting for environmental costs in its 1985 rate case (Docket No. 850811-GU). The Company's position supporting deferral accounting was then and remains today, that environmental costs are outside the Company's control in either magnitude or timing, and are so unpredictable and erratic from year to year that deferral accounting is the only appropriate accounting method with which to account for them. The Commission agreed with the Company's position in its 1985 decision

> and has consistently reaffirmed its decision in subsequent rate cases (Docket 891353-GU and 911150-GU). In November 1993, Peoples entered into an agreement in which the Company agreed, among other things, to accelerate the amortization of previously incurred environmental costs. That agreement did not change the Commission's authorization for Peoples to use deferral accounting for environmental costs.

As stated above, the Company has been deferring all environmental costs since September 30, 1994, instead of expensing them. Staff believes that the Company should be expensing these costs because it was allowed $1,248,000 in expenses in its last rate case and does not have the specific authority to defer these costs without Commission approval. Staff reviewed prior orders addressing environmental costs and did not find Commission authorization for Peoples to utilize deferral accounting.

Based on the above, Staff recommends that the deferred balance at the end of 1995 should have been expensed in 1995, and current expenses should be increased by $1,629,373 for environmental costs incurred during 1996. In addition, working capital should be reduced by $949,297 for the $452,352 incurred prior to 1996 and the 13 month average of the costs incurred in 1996. If, during any year in the future, the Company incurs environmental expenses of such magnitude as to distort earnings, or for any other reason, then the Company should file a petition requesting Commission approval to utilize deferral accounting or reserve accounting.

<u>Adjustment 8:</u> Taxes Other Than Income - Staff auditors reviewed the tax returns and property tax assessments paid by the Company and determined that Taxes Other Than Income is understated by $11,784. This amount is based on two adjustments. First, property taxes should be increased by $8,893 to the amount that was paid in 1996. (The resultant amount recommended is net of maximum discounts available.) Second, Regulatory Assessment Fees should be increased by $2,891 for a credit adjustment relating to November 1995 taxes that was not booked until January 1996. Because the adjustment was not booked until 1996, the Regulatory Assessment Fees reflected in the general ledger and in the ESR were understated for the calendar year 1996. In its response to the Audit Report, the Company agrees with these adjustments.

<u>Adjustment 9:</u> **Tax Effect of Net Operating Income Adjustments** - Because of the adjustments made to net operating income, it is appropriate to reduce income taxes by $598,279.

<u>Adjustment 10:</u> **Interest Reconciliation** - The Company made an adjustment of $43,000 to reduce income taxes. This adjustment reconciles the interest used in the calculation of the income tax expense to that interest which is inherent in the reconciled capital structure. Based on Staff's recommended adjustments to rate base, income taxes should be reduced an additional $27,670.

ISSUE 4: What is the amount of excess earnings for 1996?

RECOMMENDATION: The amount of excess earnings for 1996 is $107,181, plus interest of $9,321, for a total of $116,502. (Schedule 1) (L. ROMIG)

STAFF ANALYSIS: Based on its recommendations in the above issues, Staff has determined that the excess earnings for 1996 are $107,181, plus interest of $9,321 calculated through December 31, 1997, for a total amount of $116,502.

ISSUE 5: What is the appropriate disposition of the 1996 excess earnings?

RECOMMENDATION: Staff recommends that the $116,502 excess earnings be refunded through the PGA Clause effective January 1, 1998. (MAKIN)

STAFF ANALYSIS: Staff has reviewed the Company's balance sheet and is not aware of any large regulatory assets that the overearnings could be applied to other than the Deferred Environmental Cost previously addressed under Issue 3, Adjustment 7. For this reason, Staff recommends that the $116,502 be refunded through the PGA Clause by crediting fuel expense for the month of January, 1998.

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.

PEOPLES GAS SYSTEM, INC
Docket No. 971310-GU

Schedule 1
23-Oct-97

CALCULATION OF 1996 EXCESS REVENUE

Adj. No.			
	NET OPERATING INCOME PER ESR		$24,051,000
	Staff Adjustments:		
4	Overaccrual - IBM studies	61,400	
5	Director Fees	4,000	
6	Charitable Contributions	18,767	
6	Chamber of Commerce	6,040	
7	Environmental Costs	(1,629,373)	
8	Taxes Other - Understated	($11,784)	
9	Income Taxes	598,279	
10	Interest Reconciliation	27,670	
	Total Adjustments		(925,001)
	Adjusted NOI		$23,125,999
	RATE BASE PER ESR		$253,138,000
	Staff Adjustments:		
1	Unamortized Environmental Costs Correct Errors	($260,000)	
2	Deferred Environmental Costs	(949,297)	
3	Conservation Overrecovery	(1,935,000)	
3	Gas Overrecovery	(960,000)	
	Total Adjustments		(4,104,297)
	Adjusted Rate Base		$249,033,703
	ROR @ 12.25% ROE		x 9.26%
	Maximum allowed NOI		23,060,521
	Achieved NOI		23,125,999
	Excess NOI		65,478
	NOI Multiplier		x 1.6369
	1996 Excess Revenue		107,181
	Interest		9,321
	TOTAL 1996 EXCESS REVENUE		$116,502

DOCKET NO. 971310-GU
DATE: October 23, 1997

PEOPLES GAS SYSTEM
DOCKET NO 971310-GU

Schedule 2
23-Oct-97

1998 CAPITAL STRUCTURE

		COMPANY ADJUSTMENTS			STAFF ADJUSTMENTS						
	PER BOOKS	SPECIFIC	PRORATA	TOTAL COMPANY	REVERSE COMPANY PRO RATA	SPECIFIC	PRO RATA	ADJUSTED	RATIO (%)	COST RATE (%)	WEIGHTED COST (%)
LONG TERM DEBT	82,338,000	(929,000)	3,502,000	84,911,000	(3,502,000)	0	(64,000)	81,345,000	32.66%	8.97%	2.93%
SHORT TERM DEBT	0	0	0	0	0	7,724,000	(6,000)	7,718,000	3.10%	6.00%	0.19%
COMMERCIAL DEPOSITS	19,912,000	0	857,000	20,769,000	(857,000)	0	(3,000)	19,909,000	7.99%	7.00%	0.56%
RESIDENTIAL DEPOSITS	4,010,000	0	172,000	4,182,000	(172,000)	0	(16,000)	3,994,000	1.60%	6.00%	0.10%
INACTIVE DEPOSITS	35,000	0	2,000	37,000	(2,000)	0	0	35,000	0.01%	0.00%	0.00%
COMMON EQUITY	118,336,000	(5,848,000)	4,838,000	117,326,000	(4,838,000)	(754,000)	(88,000)	111,645,000	44.83%	12.25%	5.49%
DEFERRED INCOME TAXES	21,958,000	0	945,000	22,903,000	(945,000)	(455,000)	0	21,503,000	8.63%	0.00%	0.00%
TAX CREDITS-ZERO COST	0	2,887,000	124,000	3,011,000	(124,000)	0	0	2,887,000	1.16%	0.00%	0.00%
TAX CREDITS-WEIGHTED COST	0	0		0	0		0	0	0.00%	0.00%	0.00%
TOTAL	248,580,000	(3,891,000)	10,441,000	253,130,000	(10,441,000)	6,515,000	(177,000)	249,033,703	100.00%		9.28%

SCHEDULE 2
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