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STATE OF FLORIDA
OFFICE OF THE PUBLIC COUNSEL

c/o The Florida Legislature
111 West Madison St.
Room 812
Tallahassee, Florida 32399-1400
850-488-9330

JACK SHREVE
PUBLIC COUNSEL

October 12, 1998

Ms. Blanca S. Bayó, Director
Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0870

RE: Docket No. 950379-EI

Dear Ms. Bayó:

Enclosed is an original and fifteen copies of the Direct Testimony of Hugh Larkin, Jr., on behalf of the Office of Public Counsel for filing in the above referenced file.

Please indicate receipt of filing by date-stamping the attached copy of this letter and returning it to this office. Thank you for your assistance in this matter.

Sincerely,

John Roger Howe
Deputy Public Counsel

JRH/dsb
Enclosures

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

Investigation into Earnings for 1995 and 1996 of Tampa Electric Company	)))	DOCKET NO. 950379-EI FILED: October 12, 1998

DIRECT TESTIMONY OF HUGH LARKIN, JR.

Respectfully submitted,

Jack Shreve
Public Counsel

Office of the Public Counsel
c/o The Florida Legislature
111 West Madison Street
Room 812
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(850) 488-9330

Attorney for the Citizens
of the State of Florida

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

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Attorney for the Citizens
of the State of Florida

TABLE OF CONTENTS

DIRECT TESTIMONY

OF

HUGH LARKIN, JR.

ON BEHALF OF THE CITIZENS OF FLORIDA

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

REGARDING INTEREST ON DEFERRED REVENUES

<u>INTRODUCTION</u>

Q. PLEASE STATE YOUR NAME, OCCUPATION, AND BUSINESS ADDRESS.

A. My name is Hugh Larkin, Jr. I am a Certified Public Accountant licensed in the states of Florida and Michigan and the senior partner in the firm of Larkin & Associates, Certified Public Accountants, with offices at 15728 Farmington Road, Livonia, Michigan 48154.

Q. WOULD YOU PLEASE STATE YOUR QUALIFICATIONS?

A. I have been a practicing CPA for approximately 36 years. I have worked in the field of regulatory consulting for approximately 28 years of the 35 years I have been in public accounting. I have testified in numerous jurisdictions throughout the United States and Canada. I have filed testimony in over 300 cases over that period of time. I have testified before the Florida Public Service Commission on numerous occasions and my qualifications, including a detailed list of cases I have testified in, have been filed before this Commission in previous dockets.

Q. ON WHOSE BEHALF ARE YOU APPEARING?

A. Larkin & Associates was employed by the Florida Office of Public Counsel ("OPC") to evaluate and provide testimony regarding the treatment of deferred revenues in Tampa Electric Company's capital structure for 1995 and 1996 and how that treatment affects the interest required to be paid on deferred revenues.

Q. HOW WILL YOUR TESTIMONY BE ORGANIZED?

A. My testimony will be organized in the following manner:

1. Requirements of the *stipulations*;
2. The effect of including deferred revenues in the capital structure with a cost rate;
3. Method of calculating over-earnings is flawed;
4. Consistent with Florida Public Utility Company - Fernandina Beach Division case; and
5. Commission's past treatments of interest costs in the fuel adjustment clause.

Requirements of the Stipulations

Q. HAVE YOU REVIEWED THE STIPULATIONS WITH TAMPA ELECTRIC COMPANY WHICH REQUIRE THE RECORDING OF DEFERRED REVENUES?

A. Yes, I have.

Q. ARE THERE REQUIREMENTS IN THOSE STIPULATIONS RELATED TO THE PAYMENT OF INTEREST?

A. Yes, there are. The original stipulation, at page 14, contains the following language:

> "General Provisions. The revenues held subject to refund and the deferred revenues provided for herein shall accrue interest at the thirty-day commercial paper rate as specified in Rule 25-6.109, Florida Administrative Code. These revenues shall be treated as if collected evenly throughout the year."

In a subsequent stipulation involving Tampa Electric Company related to the Polk Unit, the following language is included on page 8:

> "General Provisions. The revenues held subject to refund shall accrue interest calculated at the thirty day commercial paper rate as specified in Rule 25-6.109, Florida Administrative Code. For purpose of this calculation, these revenues shall be treated as if collected evenly throughout the year."

Q. WHAT IS YOUR UNDERSTANDING OF THESE PROVISIONS IN THE STIPULATIONS?

A. It has been my experience, and it is my interpretation of these provisions in both stipulations, that the Company is required to pay interest to the customers on the use of funds which have been set aside as deferred revenues.

The payment of interest on the use of these funds would mean that, in the calculation of over-earnings, and in the calculation of the actual return, any interest which might accrue on these funds should not impact the amount of the deferral or the over-earnings of the Company.

Q. WHY WOULD IT BE INAPPROPRIATE FOR THE REQUIREMENT TO PAY INTEREST TO AFFECT EITHER THE AMOUNT OF THE DEFERRAL OR THE OVER-EARNINGS OF THE COMPANY?

A. Clearly, the intent of the agreement was to charge the Company for the use of these funds, which are, in effect, provided by the ratepayers. If the calculation of interest due on these funds either affects the size of the deferral and/or the over-earnings of the Company, then the impact is to negate the provisions in each stipulation to pay interest at the 30-day commercial paper rate. If, in effect, the interest expense associated with the deferral is included as an offsetting expense to the Company's over-earnings, the ratepayers are paying their own interest costs, and the provisions of the stipulations are violated. This is true because the deferral is dependent on the amount of over-earnings, and if the interest expense required to be paid on the deferral is used as a deduction in determining the total amount of the over-earnings, in effect, ratepayers are paying the interest on the deferral. The deferral is reduced by the amount of the interest required and, therefore, violates the provisions of the settlement which requires interest to be paid, and causes less to be deferred than if there had been zero interest.

Effect of Including Deferred Revenues in the Capital Structure with a Cost Rate

Q. WOULD YOU PLEASE DEMONSTRATE HOW THE INCLUSION OF THE DEFERRED REVENUES IN THE CAPITAL STRUCTURE WITH A COST RATE IN EFFECT REDUCES THE DEFERRED REVENUES, CAUSING RATEPAYERS TO PAY THE INTEREST REQUIRED BY THE STIPULATION?

A. I have included as schedules to this testimony Attachments B and F of the Staff memorandum, dated March 26, 1998, regarding the investigation into earnings for 1995 and 1996 of Tampa Electric Company. Attachment B is included as Schedule 1 and Attachment F is included as Schedule 2 to this testimony. Schedule 1 shows the Staff's calculations of the overall rate of return after adjustments and inclusion of deferred revenue with a cost rate of 5.46%. The overall rate of return under Staff's calculation is 8.10%. This is carried forward to Attachment F, which is my Schedule 2. The required rate of return of 8.10% is deducted from the Company's achieved rate of return, and the calculation flows through to show a net deferred revenue of $23,345,525 for 1996.

Returning to Schedule 1, which is the Staff's Attachment B, I have recalculated the overall rate of return including deferred revenue at zero cost. This reduces the overall rate of return requirement from 8.10% to 7.87%. Again, referring to Schedule 2, I have carried the 7.87% rate of return forward and substituted in hand written amounts the lower rates of return. I have recalculated the net 1996 deferred revenue based on the inclusion of the deferral in the capital structure at zero cost. This shows that the deferred revenue for 1996 should have been $27,455,685. As can be seen, the inclusion of deferred revenue in the capital structure at a cost rate has the effect of reducing the 1996 deferred revenue by $4,110,160. ($27,455,685 - $23,345,525 = $4,110,160).

This is approximately the same amount one would get by multiplying the deferred revenue included in the capital structure of $77,670,075 by the cost rate of 5.46%, which would equal $4,240,786.

It is clear that the result of including the deferred revenue in the capital structure with a cost rate has the effect of decreasing the deferred revenue, and in effect, placing the burden of the interest cost on the ratepayers and not the stockholders. This results in the circumvention of the requirement of the stipulations and allows the Company the use of these funds interest free.

Q. IN THE COMMISSION'S PROPOSED AGENCY ACTION, DATED JUNE 9, 1998, THE COMMISSION DID NOT AGREE WITH INCLUDING DEFERRED REVENUES IN THE CAPITAL STRUCTURE AT ZERO COST. WOULD YOU PLEASE COMMENT?

A. Yes. On page 7 of the proposed agency action, the Commission discusses OPC's and FIPUG's contention that the deferred revenue should be included in the capital structure at zero cost. It states:

"We disagree with this proposal. But for the availability of the deferred revenue, TECO would have to find another source of funds, which would likely be at a cost rate equal to or greater than the 30-day commercial paper rate."

If this statement is true and the deferred revenues were not available, they still would not be available because rates would have been decreased and the deferred revenue would not have arisen. Rather, they would have flowed back to the ratepayers. The ratepayers would have had those funds available to invest or to pay off indebtedness at their cost of capital. Thus, the ratepayers would have earned or avoided capital costs at or above the 30-day commercial paper rate. Under the Commission's theory for not including the deferred revenue in the capital structure at zero cost, ratepayers are charged the cost rate that the Company would have incurred had it not had rates which were excessive. It is not appropriate to collect from the ratepayers funds which they could use or invest on their own, and then place those funds in the capital structure and charge the ratepayers a cost rate. The availability of the funds to TECO results from an over-earnings, which, if treated in the alternative, could have been flowed back to the ratepayers through lower rates starting in 1995. However, the stipulations allowed the Company to defer these over-earnings and use the funds while paying the ratepayer a carrying cost on such funds. The circular reasoning that had the ratepayers not provided these funds to the Company, the Company would have borrowed funds, and therefore, the ratepayer ought to pay the cost associated with their own provision of funds is not equitable.

Method of Calculating Over-Earnings is Flawed

Q. IS IT YOUR OPINION THAT THE METHOD USED BY TAMPA ELECTRIC TO CALCULATE THE OVER-EARNINGS RESULTS IN A FLAWED DETERMINATION OF THE REFUND AMOUNT?

A. Yes, it does. By estimating the over-earnings on a monthly basis and accruing these over-earnings, plus interest, Tampa Electric's deferred revenue balance reflects both the principle and interest at the end of December 1996. This balance is then included in the capital structure with a cost rate. The cost rate then is weighted in the capital structure and the over-earnings for 1996 are reduced by the amount of interest. Thus, the accrual of interest on a monthly basis and the accrual of the over-earnings itself, serves as a method of reducing the overall over-earnings which might be, eventually, refunded to ratepayers. The calculation, in effect, counts interest twice, once in the monthly accrual that is reflected in the deferred revenue balance and again in the weighted cost rate. By accruing the deferred revenue and interest on the deferred revenue, the Company overstates the balance included in the capital structure, which is then weighted again by the cost rate. The amount subsequently deferred is reduced by the double counting of interest in the calculation.

Q. CAN YOU GIVE A SIMPLE EXAMPLE OF THIS OVERSTATEMENT?

A. Assume that Tampa Electric projects a $1,200 over-earnings for the year. They accrue $100 a month plus interest. Assuming a 12% return, the Company would accrue principal and interest of approximately $1,281. The capital structure would include an average balance of this amount or approximately $641 ($1,281 / 2). This amount would be included in the capital structure at a cost rate of 12%. The effect of including it in the capital structure at a 12% cost rate reduces the over-earnings by the carrying charge on the average balance or $76.92 ($641 x 12%= $76.92). Thus, the balance carried forward as an over-earning into the next period would not be the $1,281 accrual at the end of the year, but the amount of the over-earning less the interest which was reflected in the rate of return calculation. Thus, assuming the $1,200 over-collection was correct, instead of ratepayers receiving $1,200 plus interest of $81, they would receive $1,200 less the negative interest of $76.92, or $1,123.08.

The effect of accruing the over-earnings during the year and interest on those over-earning, and then including it the capital structure at a cost rate, effectively circumvents the stipulation which requires the over-earnings to be calculated after the fact and carry an interest rate as if that amount was collected rateably over the entire year. I do not believe that this was the intent of the stipulation. A clear understanding of how refunds work would conclude that this is an unfair basis for determining the amount of over-earnings and interest to be carried forward.

Q. IN YOUR OPINION, DOES IT MAKE ANY SENSE TO ATTEMPT TO

DETERMINE OVER-EARNINGS AS TAMPA ELECTRIC COMPANY HAS BEEN ALLOWED TO DO IN THIS DOCKET?

A. No, it does not. It seems to me that over-earnings result from an after-the-fact calculation, one in which all the legitimate expenses are determined prior to the calculation of the over-earnings. Interest, if required on the over-earnings, should not be considered as an expense in determining the amount of the over-earnings. Otherwise, it make no sense to include in a stipulation that interest should be paid on an over-earnings amount because the methodology would allow the deduction of the interest prior to the determination of the over-earnings. The theory of allowing interest to ratepayers on over-earnings is that they have given up that source of capital for their own use. The Commission, in effect, is saying that the Company has independently raised these funds for the benefit of the ratepayer, and therefore, the ratepayer should pay the carrying costs associated with them. Clearly, this is not the case. These are ratepayer funds collected with zero cost to the Company. The interest arises as a result of the stipulation, which as a requirement for allowing the Company to hold the funds to a future point in time, requires an interest payment.

Q. TAMPA ELECTRIC'S WITNESS, IN THIS CASE, STATES THAT THE INCLUSION OF AN INTEREST EXPENSE ASSOCIATED WITH DEFERRED REVENUE IS NO DIFFERENT THAN INCLUDING INTEREST COSTS ON CUSTOMER DEPOSITS IN THE COST OF SERVICE. WOULD YOU PLEASE COMMENT?

A. Customer deposits are a requirement for certain customers to receive service. The customer cannot qualify for service unless he provides a security deposit. This is a condition of service which he must meet in order to become an electric customer. He must make the deposit and is entitled to its return, plus interest, after a year of acceptable bill payments. In the instance of a refund of over-earnings, the ratepayer is entitled to those funds at the point the over-earnings occurs. The customer does not have to make the payment as a condition of service, he is making the over-earnings payment as a result of the stipulation which allowed Tampa Electric to keep the over-earnings. The customer who gives a deposit eventually receives back the deposit plus interest. The Company's approach, however, would reduce the customers deposit by interest owed.

Consistent with Florida Public Utility Company - Fernandina Beach Division Case

Q. ONE OF THE CASES SIGHTED BY TECO'S WITNESS AND IN THE COMMISSION'S ORDER IS THE FLORIDA PUBLIC UTILITIES COMPANY -FERNANDINA BEACH DIVISION CASE, ORDER NO. 97-0135-FOF-EI (DOCKET NO. 961542-EI). BOTH THE COMMISSION ORDER IN THIS DOCKET AND THE COMPANY CITE THIS CASE AS BEING CONSISTENT WITH THE TAMPA ELECTRIC COMPANY METHODOLOGY, DO YOU AGREE?

A. No, I do not. In the Florida Public Utility Company (FPUC) case the Commission found that the excess earnings were $61,651, to which the Commission calculated and added interest of $1,855 for a total excess earnings plus interest of $63,506, which was added to the Company's storm damage reserve. A copy of the FPUC order is appended to this testimony. The storm damage reserve would be the equivalent of deferred over-earnings in the instance of Tampa Electric. Reviewing the methodology used by the Commission in the FPUC case clearly shows that it is distinctly different from Tampa Electric's approach in this case. First of all, the Commission in the FPUC case calculated a rate base by removing the deferred excess earnings from the calculation of working capital, which increased the rate base. This is shown in Attachment 1 to the FPUC order, the column labeled AD-1. The amount is $2,308, which is the 13-month average of the over-collection FPUC used to reduce working capital, but is added back by the adjustment. In the income statement, the Commission added back the accrual of $30,000. The effect of these two adjustments was to remove the accrual and its effect on the income statement and rate base from consideration. Next, on Attachment 2 to the FPUC Order, FPUC's capital structure was adjusted in the column labeled "Adjustments:Specific" to reflect the refund amount adjusted for deferred taxes as short-term debt. The Commission also adjusted other capital components, reducing both long-term debt and equity when reflecting the over-earnings in the capital structure. The effect of these adjustments is to increase the over-earnings since it decreases the overall cost of capital.

The point that should be focused on is that the Commission did not increase the capital structure for the over-earnings in the FPUC case. Instead, it reduced other capital components to reflect the amount of the over-earnings in the capital structure. After calculating the over-earnings reflected on Attachment 3 to the FPUC order, the Commission calculated interest and added the interest to the over-earnings.

If the Commission would focus on Attachment 2 to the FPUC order, it is easily proven that the inclusion of over-earnings in the capital structure, as done in that case, in effect increases the amount of the refund rather than decrease it. FPUC's capital structure is shown in the top portion of Attachment 2 and is labeled "Capital Structure as Filed." If one adjusts FPUC's filed capital structure for the same rate of return on equity used in the Commission's capital structure of 12.60%, an overall cost of capital would be calculated on the same basis as the Commission's of 9.22% (the weighted cost on tax credits would change because of the change in equity cost).

Starting with the same dollar amounts as the Commission did on Attachment 2 to the FPUC order, under the heading of "Adjustments:Amount" and making only those adjustments in the "Adjustments:Specific" column, which reflects the over-collection, I have recalculated the total overall rate of return. Based on that recalculation, my cost of capital would be 9.20%, a reduction from FPUC's restated on the same basis as the Commission's of two basis points. Clearly, this shows the methodology used in the FPUC case reduces the overall cost of capital when the over-earnings are included in the capital structure. The effect of the Commission's approach in the FPUC case is to increase the over-collection, not decrease it, as is the effect in Tampa

Electric's approach.

In the Tampa Electric case the Company is adding in, as a separate capital component, the over-earnings; it is not adjusting the capital structure components downward to reflect the over-earnings. In addition, it is not calculating interest separately and adding it to the over-earnings as was done in the FPUC case.

The FPUC case is not consistent with what Tampa Electric is doing, which penalizes the ratepayer for interest being required by the stipulation.

Commission's Past Treatment of Interest Cost in the Fuel Adjustment Clause

Q. HOW HAS THE COMMISSION TREATED INTEREST COSTS AND INTEREST PAYMENTS RELATED TO THE FUEL ADJUSTMENT CLAUSE IN ESTABLISHING BASE RATES?

A. The Commission was cognizant that, in establishing base rates for an electric utility, the accrual of interest and refunds associated with the fuel adjustment clause had to be treated in a manner which insured that base rates did not reflect the impact of the fuel adjustment clause. The Commission understood that to do otherwise would shift the impact of the fuel adjustment clause into base rates.

Q. WOULD YOU PLEASE EXPLAIN HOW THE COMMISSION DEALS WITH REFUNDS OR PAYMENTS AND THE ASSOCIATED INTEREST WHEN

ESTABLISHING BASE RATES?

A. In establishing base rates, an electric utility will either have an asset associated with an under-collection due from the ratepayers and associated interest, or the utility will have a liability which reflects an over-collection and the associated interest due to the ratepayers. In the determination of working capital, if there is a debit balance or an amount due the Company and accrued interest, the Commission excludes that balance from the determination of working capital since to include it would require a return to be paid on that balance and the accrued interest in rate base. This would be inappropriate since the fuel adjustment clause itself acts to determine the amount of under-collection and accrued interest on it. Thus, to include it as a current asset in working capital would be charging the ratepayers for the carrying cost on the under-collection and the accrued interest twice, once through the fuel adjustment clause and a second time through base rate.

Alternatively, if there is an over-collection, that balance is included as a current liability in calculating working capital because the Company has those funds in its possession. To not deduct them from current assets in the working capital calculation will allow the Company the use of the funds cost free.

Thus, the Commission clearly understands that, in the determination of working capital, an adjustment must be made for over and under-collections to insure that the effect of the over and under-collection and accrued interest does not impact base rates. The same is also true as it pertains to deferred revenue. If the Commission includes the deferred revenue in the capital structure with a cost rate, it in effect reduces the deferred revenue which flows to ratepayers and requires the ratepayers to forego the interest which is required by the stipulation. Clearly, that was not the intent of the stipulation.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

CERTIFICATE OF SERVICE
DOCKET NO. 950379-EI

I HEREBY CERTIFY that a true and correct copy of the foregoing DIRECT TESTIMONY OF HUGH LARKIN, JR., has been furnished by U. S. Mail or *Hand-delivery to the following parties on this 12th day of October, 1998.

Robert V. Elias, Esquire*
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2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

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Deputy Public Counsel

ATTACHMENT B

DOCKET NO. 950379-EI
TAMPA ELECTRIC COMPANY
STAFF ADJUSTED EARNINGS SURVEILLANCE REPORT
YEAR ENDING DECEMBER 31, 1996

AVERAGE TEST YEAR

		ADJUSTMENTS									
	RETAIL PER BOOKS	COMPANY SPECIFIC	COMPANY PRO RATA	COMPANY ADJUSTED	Deferred Revenue Adjustment	STAFF SPECIFIC	STAFF PRO RATA	STAFF ADJUSTED	WEIGHT	COST RATE	WEIGHTED COST
LONG TERM DEBT	$562,708,744	($7,886,641)	($95,979,404)	$478,842,699	($20,233,055)	$29,200,000	($2,372,724)	$485,436,920	26.53%	6.74%	1.79%
SHORT TERM DEBT	130,437,308	(380)	(21,779,362)	108,657,566	($4,590,301)		($506,187)	$103,561,078	5.66%	5.47%	0.31%
PREFERRED STOCK	30,728,000	(416,176)	(5,061,237)	25,250,587	($1,064,080)		($117,644)	$24,068,863	1.32%	5.75%	0.08%
CUSTOMER DEPOSITS	52,390,453	0	(8,747,758)	43,642,695	($1,640,781)		($203,326)	$41,598,588	2.27%	5.65%	0.13%
COMMON EQUITY	1,085,501,475	(4,306,847)	(180,529,621)	900,665,007	($38,058,337)	(29,200,000)	($4,053,721)	$829,352,950	45.33%	11.75%	5.33%
DEFERRED REVENUE	0	0		0	77,670,075			77,670,075	4.25%	~~5.46%~~ 0	~~0.23%~~ 0
DEFERRED TAXES	279,332,463	1,830,118	(46,946,380)	234,216,201	($9,910,702)		($1,091,030)	223,214,469	12.20%	0.00%	0.00%
FAS 109 DEFERRED TAXES	0	0	0	0	0		0	0	0.00%	0.00%	0.00%
TAX CREDITS - ZERO COST	38,290	0	(6,393)	31,897	0		($155)	$31,741	0.00%	0.00%	0.00%
TAX CREDITS - WEIGHTED COST	56,126,574	(13,922)	(9,369,262)	46,743,390	($1,972,820)		($217,766)	$44,552,804	2.44%	9.82%	0.24%
	$2,217,263,307	($10,793,848)	($368,419,417)	$1,838,050,042	($0)	$0	($8,562,553)	$1,829,487,489	100.00%		~~8.10%~~ 7.87
			EQUITY RATIO	59.51%			EQUITY RATIO	57.50%			

Docket No. 950379-EI
Exhibit ____ (HL-1)
Schedule 1
Witness Hugh Larkin, Jr.

ATTACHMENT F

TAMPA ELECTRIC COMPANY
DOCKET NO. 950379-EI
REVIEW OF 1996 EARNINGS

Adjusted Rate Base			$1,829,487,489
Adjusted Achieved Rate of Ret	9.91%		
Beginning Sharing Point at 11.75% ROE	7.87 ~~8.10%~~		
Excess Rate of Return		x	2.04 ~~1.81%~~
Excess Net Operating Income			37321,545 33,113,724
Revenue Expansion Factor		x	1.62800
Gross Excess Revenues			60,759,475 53,909,208
Less Refund			(15,000,000)
Gross Excess Revenues Less Refund			45,759,475 38,909,208
60% Deferred Per Stipulation		x	60.00%
Net 1996 Deferred Revenues			27,455,685 $23,345,525

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Investigation of 1995 earnings of Florida Public Utilities Company - Fernandina Beach Electric Division.	DOCKET NO. 961542-EI ORDER NO. PSC-97-0135-FOF-EI ISSUED: February 10, 1997

The following Commissioners participated in the disposition of this matter:

JULIA L. JOHNSON, Chairman
SUSAN F. CLARK
J. TERRY DEASON
JOE GARCIA
DIANE K. KIESLING

NOTICE OF PROPOSED AGENCY ACTION
ORDER DISPOSING OF 1995 OVEREARNINGS

BY THE COMMISSION:

NOTICE IS HEREBY GIVEN by the Florida Public Service Commission that the action discussed herein is preliminary in nature and will become final unless a person whose interests are substantially affected files a petition for a formal proceeding, pursuant to Rule 25-22.029, Florida Administrative Code.

CASE BACKGROUND

Pursuant to the Commission's continuing earnings surveillance program, it was noted that the earnings of the Fernandina Beach Electric Division of Florida Public Utilities Company (FPUC-FB or Company) were in excess of the maximum authorized return on equity (ROE) of 12.60%. After discussions with our staff, by letter dated June 19, 1995, the Company agreed to cap its 1995 earnings at a 12.60% ROE. The disposition of any excess earnings was left to the discretion of the Commission. The Company, however, reserved the right to request alternative dispositions such as additional contributions to its storm damage reserve or the reduction of any depreciation reserve deficiencies. An Audit Report was issued on July 17, 1996. The Company's response to the audit report was received on August 12, 1996.

Based upon our review of the audit report, the Company's response and the Company's December, 1995 Earnings Surveillance Report, we have determined that for 1995, the Company has excess earnings of $61,651, plus interest of $1,855. (Attachment 3) This represents an earned ROE of 13.35%, which exceeds the maximum authorized ROE of 12.60% Our findings and calculation of excess earnings are shown below.

We find that the appropriate amount of rate base for determining the amount of excess earnings for 1995 is $14,928,526. (Attachment 1) We determined this amount by making the following adjustments to the total "FPSC Adjusted" rate base of $15,072,505 reported in the Company's December 1995 Earnings Surveillance Report:

(1) Common Plant Allocations: The Company used incorrect amounts in determining the amount of common plant to be allocated between the electric and water divisions at Fernandina Beach. Based on a recalculation using the proper amounts, we reduced the electric division's plant in service and accumulated depreciation by $96,524 and $5,758, respectively.

(2) Working Capital: The Company did not follow our normal procedure of reducing working capital by any net overrecovery of fuel or conservation cost recovery revenues. In this case, the Company had a net overrecovery of $57,326. Therefore, we reduced working capital by this amount.

(3) Capital Item Erroneously Expensed: The Company expensed the cost of replacing a failed Large Feeder Cable. Under normal accounting procedures, the cost of the new cable should have been capitalized and the cost of the old cable should have been retired. On a 13-month average basis, we increased plant in service by a net amount of $628 and reduced accumulated depreciation by a net amount of $1,177. There are also income statement effects which are discussed later in this Order.

(4) Refund Provision: The Company booked a $30,000 Provision for Rate Refund in December 1995. On a 13-month average basis, this decreased working capital by $2,308. We reversed this amount to determine the total amount of the excess earnings for 1995. The income statement effects are discussed later in this Order.

We find that the appropriate overall rate of return for determining the amount of excess earnings for 1995 is 9.19% based on a 12.60% ROE and a 13-month average capital structure for the period ending December 31, 1995. Using the 13-month average capital structure from the Company's December, 1995 Earnings Surveillance Report, we made several adjustments. We reconciled our adjustments to rate base on a pro rata basis over investor-supplied sources of capital, except for the deferred income taxes related to the $30,000 refund provision. These taxes were reconciled specifically to cost free deferred taxes in the capital structure. In addition, the average amount of excess earnings for 1995 was specifically included as short-term debt, with an effective interest rate of 5.97%. We reduced the other sources of investor-supplied capital on a pro rata basis to reconcile the additional short-term debt. Based on these adjustments which are shown on Attachment 2, we determined that the appropriate overall rate of return for evaluating excess earnings is 9.19%.

We find that the appropriate net operating income for determining the amount of excess earnings for 1995 is $1,409,717. (Attachment 1) This amount was calculated by making adjustments to the "FPSC Adjusted" net operating income of $1,386,035 reported in the Company's December, 1995 Earnings Surveillance Report. Our adjustments are as follows:

(1) Capital Item Erroneously Expensed: The Company expensed the cost of replacing a failed Large Feeder Cable rather than capitalizing it. To correct this error, we reduced O&M expenses by $7,834 and increased depreciation expense by $21.

(2) Prior Audit Expense Adjustments: The Company used amounts determined in its last rate case to allocate certain costs between the electric and water divisions, however, these amounts should have been updated to reflect the current amounts as of December 31, 1995. Based on a recalculation using the updated amounts, we reduced O&M expense by $2,742; Taxes Other Than Income by $338; and depreciation expense by $1,482.

(C) Interest Income on Cash in Working Capital: The Company included interest earning cash in working capital but did not include the related interest income in revenues. In the Company's MMFR review in Docket No. 930720-EI, we determined that the interest income should be included in revenues if the interest bearing cash is included in working capital. Therefore, we increased operating revenues by $2,257 to reflect inclusion of interest income in revenues.

(D) Refund Provision: The Company booked $30,000 as a Provision for Rate Refund in December, 1995 which reduced the operating revenues reported for 1995. We reversed this amount to determine the total amount of the excess earnings for 1995.

(E) Stone & Webster Payments: The Company allocated $56,173 to the Fernandina Beach electric division for services performed by Stone & Webster. In a subsequent reconciliation of the account, it was discovered that $58,482 should have been allocated. Therefore, we increased O&M expenses by the $2,309 difference.

(F) Interest Synchronization: This is a fallout adjustment based on the reconciliation of the rate base and the capital structure due to our adjustments to the rate base. In this instance, income taxes were increased by $2,754.

We find that the total amount of 1995 excess earnings of $63,506, including interest, shall be contributed to Fernandina Beach's Storm Damage Reserve. The booking of this amount should be considered to be effective as of January 1, 1996, for ratemaking, earnings surveillance, and overearnings review purposes.

By letter dated December 20, 1996, the Company requested that the $63,506 of excess earnings be contributed to the Storm Damage Reserve for Fernandina Beach because of the current disparity of the reserve and accrual levels between its Marianna and Fernandina Beach electric divisions. There appears to be a deficiency in the Storm Damage Reserve for Fernandina Beach and the current annual accrual is inadequate for the building of a sufficient reserve in the short-term. Therefore, we agree that the $63,506 of excess earnings should be included in the Storm Damage Reserve.

Since the excess earnings occurred during 1995 and interest has only been calculated for that year, the increase in the reserve shall be effective as of January 1, 1996, for all regulatory purposes. This will eliminate the need for calculating any additional amounts of interest and provides for the inclusion of the increased reserve in the determination of earnings for 1996.

Based on the foregoing, it is

ORDERED by the Florida Public Service Commission that the Fernandina Beach Electric Division of Florida Public Utilities Company's total amount of 1995 excess earnings of $63,506, including interest, shall be contributed to Fernandina Beach's Storm Damage Reserve. The booking of this amount shall be effective as of January 1, 1996, for ratemaking, earnings surveillance, and overearnings review purposes. It is further

ORDERED that the provisions of this Order, issued as proposed agency action, shall become final and effective unless an appropriate petition, in the form provided by Rule 25-22.036, Florida Administrative Code, is received by the Director, Division of Records and Reporting, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, by the close of business on the date set forth in the "Notice of Further Proceedings or Judicial Review" attached hereto. It is further

ORDERED that in the event this Order becomes final, this Docket shall be closed.

By ORDER of the Florida Public Service Commission, this 10th day of February, 1997.

/s/ Blanca S. Bayó

BLANCA S. BAYÓ, Director
Division of Records and Reporting

This is a facsimile copy. A signed copy of the order may be obtained by calling 1-904-413-6770.

(S E A L)

VDJ

NOTICE OF FURTHER PROCEEDINGS OR JUDICIAL REVIEW

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.

The action proposed herein is preliminary in nature and will not become effective or final, except as provided by Rule 25-22.029, Florida Administrative Code. Any person whose substantial interests are affected by the action proposed by this order may file a petition for a formal proceeding, as provided by Rule 25-22.029(4), Florida Administrative Code, in the form provided by Rule 25-22.036(7)(a) and (f), Florida Administrative Code. This petition must be received by the Director, Division of Records and Reporting, 2540 Shumard Oak Boulevard, Tallahassee, Florida 32399-0850, by the close of business on March 3, 1997.

In the absence of such a petition, this order shall become effective on the day subsequent to the above date as provided by Rule 25-22.029(6), Florida Administrative Code.

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.

If this order becomes final and effective on the date described above, any party substantially affected may request judicial review by the Florida Supreme Court in the case of an electric, gas or telephone utility or by the First District Court of Appeal in the case of a water or wastewater utility by filing a notice of appeal with the Director, Division of Records and Reporting and filing a copy of the notice of appeal and the filing fee with the appropriate court. This filing must be completed within thirty (30) days of the effective date of this order, pursuant to Rule 9.110, Florida Rules of Appellate Procedure. The notice of appeal must be in the form specified in Rule 9.900(a), Florida Rules of Appellate Procedure.

ATTACHMENT 1

FLORIDA PUBLIC UTILITIES COMPANY
FERNANDINA BEACH ELECTRIC DIVISION
DOCKET NO. 961542-EI
REVIEW OF 1995 EARNINGS

	As Filed FPSC Adjusted Basis	Deferred Excess Earnings Booked [AD-1]	Common Plant Allocations [AE-1&4]	Over/Under Recoveries [AE-2]	Capitalize Erroneously Expensed Item [AE-3]	Interest Income on Cash in Work. Cap. [AE-5]	Stone & Webster Payments [AD-4]	Interest Synch	Total Adjustments	Total Adjusted Rate Base
RATE BASE										
Plant in Service	$22,688,821		($96,524)		$628				($95,896)	$22,592,925
Accumulated Depreciation	(7,847,127)		5,758		1,177				6,935	(7,840,192)
Net Plant in Service	14,841,694	0	(90,766)	0	1,805	0	0	0	(88,961)	14,752,733
Property Held for Future Use	0								0	0
Construction Work in Progress	212,757								0	212,757
Net Utility Plant	15,054,451	0	(90,766)	0	1,805	0	0	0	(88,961)	14,965,490
Working Capital	18,054	2,308		(57,326)					(55,018)	(36,964)
Total Rate Base	$15,072,505	$2,308	($90,766)	($57,326)	$1,805	$0	$0	$0	($143,979)	$14,928,526
INCOME STATEMENT										
Operating Revenues	$4,804,881	$30,000				$2,257			$32,257	$4,837,138
Operating Expenses:										
Operation & Maintenance - Fuel	0								0	0
Operation & Maintenance - Other	1,671,696		(2,742)		(7,834)		2,309		(8,267)	1,663,429
Depreciation & Amortization	772,724		(1,482)		21				(1,461)	771,263
Taxes Other Than Income	582,848		(338)						(338)	582,510
Income Taxes - *Current*	235,996		1,159		2,948	849	(869)	2,754	6,841	242,837
Deferred Income Taxes (Net)	181,566	11,250	558		(8)				11,800	193,366
Investment Tax Credit (Net)	(25,984)								0	(25,984)
(Gain)/Loss on Disposition	0								0	0
Total Operating Expenses	3,418,846	11,250	(2,845)	0	(4,873)	849	1,440	2,754	8,575	3,427,421
Net Operating Income	$1,386,035	$18,750	$2,845	$0	$4,873	$1,408	($1,440)	($2,754)	$23,682	$1,409,717

OVERALL RATE OF RETURN	9.20%	0.25%	9.44%
RETURN ON EQUITY	12.60%	0.75%	13.35%

ATTACHMENT 2

FLORIDA PUBLIC UTILITIES COMPANY
FERNANDINA BEACH ELECTRIC DIVISION
DOCKET NO. 961542-EI
REVIEW OF 1995 EARNINGS

CAPITAL STRUCTURE

AS FILED - FPSC ADJUSTED	Amount	Ratio	Cost Rate	Weighted Cost
Long Term Debt	$5,708,690	37.87%	10.05%	3.81%
Short Term Debt	1,061,239	7.04%	6.56%	0.46%
Preferred Stock	148,670	0.99%	4.75%	0.05%
Customer Deposits	624,991	4.15%	6.57%	0.27%
Common Equity	5,168,400	34.29%	11.60%	3.98%
Deferred Income Taxes	1,933,138	12.83%	0.00%	0.00%
Tax Credits - Zero Cost	1,097	0.01%	0.00%	0.00%
Tax Credits - Weighted Cost	426,280	2.83%	10.35%	0.29%
Total	$15,072,505	100.00%		8.86%

		Adjustments					
ADJUSTED	Amount	Specific	Pro Rata	Adjusted Total	Ratio	Cost Rate	Weighted Cost
Long Term Debt	$5,708,690	(15,247)	($68,227)	$5,625,216	37.68%	10.05%	3.79%
Short Term Debt	1,061,239	29,448	(13,070)	1,077,617	7.22%	6.54%	0.47%
Preferred Stock	148,670	(397)	(1,777)	146,496	0.98%	4.75%	0.05%
Customer Deposits	624,991			624,991	4.19%	6.57%	0.28%
Common Equity	5,168,400	(13,804)	(61,770)	5,092,826	34.11%	12.60%	4.30%
Deferred Income Taxes	1,933,138	865		1,934,003	12.96%	0.00%	0.00%
Tax Credits - Zero Cost	1,097			1,097	0.01%	0.00%	0.00%
Tax Credits - Weighted Cost	426,280			426,280	2.86%	10.77%	0.31%
Total	$15,072,505	$865	($144,844)	$14,928,526	100.00%		9.19%

INTEREST SYNCHRONIZATION

	Adjustments	Cost Rate	Effect on Interest Exp.	Tax Rate	Effect on Income Taxes
Long Term Debt	($83,474)	10.05%	($8,389)	37.63%	$3,157
Short Term Debt	16,378	6.54%	1,071	37.63%	(403)

Customer Deposits	0	6.57%	0	37.63%	0
Total	($67,096)		($7,318)		$2,754

ATTACHMENT 3

FLORIDA PUBLIC UTILITIES COMPANY
FERNANDINA BEACH ELECTRIC DIVISION
DOCKET NO. 961542-EI
REVIEW OF 1995 EARNINGS

Adjusted Rate Base			$14,928,526
Achieved Rate of Return	9.44%		
Maximum Rate of Return	9.19%		
Excess Rate of Return		x	0.26%
Excess Net Operating Income			38,293
Revenue Expansion Factor		x	1.61000
Excess Revenues			$61,651