State of Florida

# Public Service Commission

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RECORDS AND REPORTING

**DATE:** SEPTEMBER 14, 2000

**TO:** DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYÓ)

**FROM:** DIVISION OF COMPETITIVE SERVICES (MCKEE, MAKIN, BULECZA-BANKS)
DIVISION OF ECONOMIC REGULATION (C. ROMIG, L. ROMIG, LESTER)
DIVISION OF LEGAL SERVICES (HART)

**RE:** DOCKET NO. 000922-GU - JOINT PETITION FOR APPROVAL OF GAS TRANSPORTATION AGREEMENT, REQUEST FOR AUTHORITY TO ACCRUE ALLOWANCE FOR FUNDS USED DURING CONSTRUCTION (AFUDC), AND REQUEST FOR EXPEDITED TREATMENT, BY FLORIDA PUBLIC UTILITIES COMPANY AND LAKE WORTH GENERATION, LLC.

**AGENDA:** SEPTEMBER 26, 2000 - REGULAR AGENDA - INTERESTED PERSONS MAY PARTICIPATE

**CRITICAL DATES:** NONE

**SPECIAL INSTRUCTIONS:** NONE

**FILE NAME AND LOCATION:** S:\PSC\CMP\WP\000922.RCM

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## DISCUSSION OF ISSUES

**ISSUE 1:** Should the Commission approve the Gas Transportation Agreement between Florida Public Utilities Company (FPUC or Company) and Lake Worth Generation, LLC (LWG)?

**RECOMMENDATION:** Yes. The Commission should approve the Gas Transportation Agreement between FPUC and LWG, effective the date of the Commission vote. (MCKEE, MAKIN, BULECZA-BANKS)

**STAFF ANALYSIS:** On July 24, 2000, FPUC and LWG filed a joint petition for approval of a Gas Transportation Agreement as a special contract under Rule 25-9.034(1), Florida Administrative

DOCUMENT NUMBER-DATE
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FPSC-RECORDS/REPORTING

Code. Jurisdiction over this matter is vested in the Commission by several provisions of Chapter 366, Florida Statutes, including Sections 366.04, 366.05, 366.06, Florida Statutes.

FPUC has entered into a 30-year Gas Transportation Agreement contract with LWG for services that are not specifically covered by its tariff. LWG intends to operate a gas-fired power generation facility that will add approximately 200 MW to the existing Lake Worth municipal utility currently being served by FPUC. The special contract will replace the transportation service currently provided to Lake Worth's existing power plants. Service to LWG's Power Generation Facility is expected to begin by midyear 2002.

Under this Agreement, FPUC will provide dedicated transportation of natural gas to LWG's Power Generation Facility by constructing a gate station for interconnection with Florida Gas Transmission's (FGT) system and constructing a lateral distribution main for transporting gas from the gate station to the Power Generation Facility. This Agreement requires FPUC to contract with FGT to build FGT's portion of the gate station and for FPUC to construct, own, and operate its own portion of the gate station and construct, own, and operate approximately six miles of a lateral main located between the gate station and the site of the Power Generation Facility. The construction cost for the gate station and the lateral main is approximately $5.5 million.

LWG will pay FGT for the transportation of gas from the gate station to the Delivery Point at FPUC's dedicated lateral main. FPUC is responsible for the transportation of natural gas on the dedicated lateral main and for the delivery of gas to LWG's Power Generation Facility. The sole purpose of constructing the gate station and the lateral main is to serve one customer, LWG's Power Generation Facility.

Under the terms of the Agreement, a volumetric transportation rate per therm will not be applied. Instead, LWG will be responsible for the cost of service through a transportation charge. The transportation charge is intended to recover FPUC's costs of providing dedicated transportation services to LWG along with FPUC's investment in the construction of dedicated facilities (net depreciated plant).

FPUC conducted a cost of service study to estimate the investment necessary to construct, own, and operate the lateral main, as well as FPUC's portion of the gate station. The estimated cost of service will recover FPUC's investment made to construct the lateral main and gate station, provide a 11.17% rate of return

on that investment, and recover the costs of operating and maintaining the dedicated facility.

FPUC's investment in construction of the dedicated facilities will be added to its rate base after construction is completed. The estimated investment is based on the preliminary construction costs of $5,452,549 and represents approximately 16% of FPUC's rate base.

The estimated preliminary construction costs of $5,452,549 include the following:

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| $4,108,767 | construction cost of the lateral main based on the lowest contractor's bid; |
| $ 699,582 | construction of the gate station based on FGT's estimate; |
| $ 250,000 | FPUC's cost of financing through debt/equity for the gate station; and |
| $ 394,200 | FPUC's preliminary construction, inspection and permits. |

The transportation charges are subject to change based on adjustment factors to the cost of service. The charges may be adjusted after the construction costs become final. The final construction costs are capped at plus or minus 10% of the preliminary construction costs. FGT's estimated construction cost for the gate station will not be subject to the 10% cap and will be adjusted for its actual construction cost. The operations and maintenance charge includes an additional 25% of the estimated costs for operation and maintenance in the event of contingencies. If no contingencies occur, the operations and maintenance costs may be reduced by as much as 25%. The operations and maintenance charge also allows recovery of incremental expenses. Specifically if hours of operation increase, additional rights-of-way costs are incurred, and/or odorant expense exceeds base amounts, the operations and maintenance charge may increase.

In addition, FPUC will incur "up-front expenses" for permit, design, and other associated expenses before construction begins. LWG will reimburse FPUC an amount not to exceed $55,500 to recover the "up-front expenses." The reimbursement will be treated as Contribution In Aid of Construction (CIAC) and will be capitalized after construction is completed. The $55,500 in "up-front expenses" are in addition to the preliminary construction costs of $394,200, associated with preliminary construction, inspection and permits.

In the event that LWG terminates the Agreement before, during, or after the construction of the dedicated facilities, terms within the Agreement provide protection to FPUC's current body of ratepayers from any business risk associated with FPUC's net investment in the LWG dedicated facilities, as well as, related operations and maintenance expenses. LWG shall provide FPUC an irrevocable letter of credit to secure FPUC's recovery of its investment in the net depreciated plant, less any CIAC, plus $37,900 compounded annually by a factor of 3% throughout the 30-year term of the Agreement. The amount of $37,900 is based on one-half of the estimated operations and maintenance annual expense. In addition, LWG will reimburse FPUC the "up-front expenses" should the agreement terminate before construction begins.

Through this Agreement, FPUC is expected to increase its current rate base by an estimated 16%, shield its current body of ratepayers from business risk associated with the investment, and realize a favorable overall rate of return on the investment that will benefit current ratepayers by offsetting future costs.

**ISSUE 2:** Should the Company's request to accrue AFUDC on the FPUC/LWG project be approved?

**RECOMMENDATION**: No. The interest the Company is authorized to capitalize should be limited to the interest calculated using the method prescribed by Section 263(A), Internal Revenue Code (IRC), as agreed to by the Company. (L. ROMIG, C. ROMIG)

**STAFF ANALYSIS**: Rule 25-7.0141, Florida Administrative Code, states that "A utility shall not accrue allowance for funds used during construction without prior Commission approval." Accordingly, by this Petition, the Company requested permission to capitalize interest and financing costs on the construction of the project facilities.

In the Company's Petition, it estimated that the project would cost in excess of $5 million or approximately 16% of its distribution plant in service as of March 31, 2000. The estimated cost included all construction expenditures and estimated interest and finance costs. Based on additional information provided by the Company, approximately $316,000 of the $5 million total construction costs represent interest and finance costs, using the calculated Allowance for Funds Used During Construction (AFUDC) rate. The Company calculated the AFUDC rate to be 11.17%, the requested overall rate of return on this project (14.40% ROE and 9.93% debt cost). Staff discusses the overall rate of return and ROE in more detail in Issue 3. For tax purposes, the Company proposed to capitalize interest on the project in accordance with Section 263(A), IRC.

It is staff's belief that the use of 11.17%, which includes a 14.40% ROE, is excessive given that the Company's currently authorized ROE is 11.40%. Staff is also concerned that the use of a 14.40% ROE could be precedent-setting even if this is a unique contractual agreement and as such should be viewed as a unique situation.

Consequently, following several discussions between Staff and the Company, whereby Staff expressed its concern in using the 11.17% AFUDC rate, the Company agreed to use the IRC method to capitalize the project interest for book and regulatory purposes, instead of the 11.17% AFUDC rate originally requested in its petition. The Company estimates the interest rate using the IRC method to be 8.50%. Corresponding book, tax and regulatory treatment of the capitalized interest would avoid the necessity of accounting for book/tax timing differences that occur when different AFUDC or capitalized interest rates are used.

**ISSUE 3:** Should the Commission authorize FPUC to charge an overall rate of return of 11.17% on its net investment in dedicated facilities serving LWG?

**RECOMMENDATION:** Yes. The Commission should approve the Gas Transportation Agreement providing the negotiated return by FPUC and LWG. Approval of the Agreement will not change the authorized return on equity for FPUC as a whole. (LESTER)

**STAFF ANALYSIS:** For this Agreement, FPUC negotiated a return on its net investment of 11.17%, which is a weighted average cost of capital, based, in part, on a 14.40% return on common equity. The Commission set FPUC's current authorized return on equity at 11.40% by Order No. PSC-95-0518-FOR-GU, issued April 26, 1995. The Company states that the 14.40% return is based on its assessment of its required return on alternative investments. The Joint Petition states that, if the Commission does not approve the 11.17% return, then FPUC is entitled to void the transaction.

Though the Agreement has a built-in return on equity that is higher than the return authorized by the Commission, staff believes the higher return on equity should not stop the Commission from approving the Agreement. The Agreement is the product of a negotiation between LWG as the willing buyer and FPUC as the willing seller.

FPUC submits that approval of this Agreement will not put its customers at risk. FPUC notes that the 14.40% return on equity is recovered only from LWG. Moreover, if the Commission does not approve the Agreement, FPUC may lose LWG as a customer. In addition, if LWG defaults under the Agreement at any time, the general body of customers is protected in that recovery of FPUC's sunk investment and related expense is covered by an irrevocable letter of credit.

In rate cases and earnings surveillance matters, different customer classes contribute in varying amounts to the utility's return on equity. The Commission looks at the aggregate effect in that it sets the utility's return on equity for the company as a whole. FPUC will include the earnings and net investment from this Agreement in its earnings surveillance report. Therefore, the Commission's authorized return of 11.40% will continue to govern and FPUC's shareholders will not be allowed to earn an excessive return.

By approving this Agreement, the Commission is accepting an agreement between two consenting parties. It is not approving the 14.40% return as a reasonable return for the company as a whole.

**ISSUE 4:** Should this docket be closed?

**RECOMMENDATION:** Yes. If no protest is filed by a person whose substantial interests are affected within 21 days of the issuance of the Order, this docket should be closed upon the issuance of a Consummating Order. (HART)

**STAFF ANALYSIS:** If a protest is filed by a person whose substantial interests are affected within 21 days of the Consummating Order approving this gas agreement, the agreement should remain in effect pending resolution of the protest. If no protest is filed, this docket should be closed upon the issuance of a Consummating Order.