State of Florida

Public Service Commission

CAPITAL CIRCLE OFFICE CENTER ● 2540 SHUMARD OAK BOULEVARD
TALLAHASSEE, FLORIDA 32399-0850

-M-E-M-O-R-A-N-D-U-M-

DATE: FEBRUARY 6, 2003

TO: DIRECTOR, DIVISION OF THE COMMISSION CLERK & ADMINISTRATIVE SERVICES (BAYÓ)

FROM: DIVISION OF ECONOMIC REGULATION (GARDNER, P. LEE, KENNY)
DIVISION OF AUDITING & SAFETY (MILLS)
OFFICE OF THE GENERAL COUNSEL (VINING)

RE: DOCKET NO. 020304-GU - 2002 DEPRECIATION FILING BY FLORIDA DIVISION OF CHESAPEAKE UTILITIES CORPORATION.

AGENDA: 02/18/03 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\ECR\WP\020304.RCM

CASE BACKGROUND

Rule 25-7.045, Florida Administrative Code (F.A.C.), requires natural gas utilities to file comprehensive depreciation studies once every five years. On May 8, 2002, the Florida Division of Chesapeake Utilities Corporation (Chesapeake or company) filed its depreciation study in accordance with this rule. Chesapeake's last comprehensive depreciation study was filed on April 4, 1997.

Staff has completed its review of Chesapeake's depreciation study and presents its recommendation herein. The Commission has jurisdiction in this matter pursuant to Sections 366.04, 366.05, and 366.06, Florida Statutes.

DISCUSSION OF ISSUES

ISSUE 1: Should the currently prescribed depreciation rates of the Florida Division of Chesapeake Utilities Corporation be changed?

RECOMMENDATION: Yes. A comprehensive review of Chesapeake's planning and activity since its prior depreciation filing indicates a need for a revision to the currently prescribed depreciation rates. (GARDNER, P. LEE)

STAFF ANALYSIS: The current depreciation rates for Chesapeake are those provided by Order No. PSC-98-0379-FOF-GU, issued March 9, 1998. The current study is in keeping with Rule 25-7.045, F.A.C., which requires gas utilities to file a comprehensive depreciation study at least once every five years from the submission date of the previously filed study.

The company has increased its average number of customers by about four percent over the past five years and expects this growth to continue into the future. A review of the company's activity data indicates the need to revise depreciation rates.

ISSUE 2: What should be the implementation date for new depreciation rates?

RECOMMENDATION: Staff recommends approval of the company's requested January 1, 2003, implementation date for new depreciation rates. (GARDNER, P. LEE)

STAFF ANALYSIS: Chesapeake has proposed January 1, 2003, as the implementation date for new depreciation rates. All the supporting data and calculations have been submitted abutting this date. Staff recommends approval of this date as being the earliest practicable date for utilizing the revised depreciation rates.

ISSUE 3: What are the appropriate depreciation rates?

RECOMMENDATION: Staff's recommended lives, net salvages, reserves, and resultant depreciation rates are shown on Attachment A. Attachment B shows the estimated annual expenses of about $1.5 million, based on January 1, 2003, investments and reserves. This represents a decrease in annual expenses of about $158,000. (GARDNER, P. LEE)

STAFF ANALYSIS: Staff's recommendations are the result of a comprehensive review of Chesapeake's depreciation study. Attachment A shows a comparison of the currently approved, company proposed, and staff recommended rate parameters. Attachment B shows a comparison of resultant expenses, based on January 1, 2003, investments.

Chesapeake's authorized return on equity (ROE) is 11.5% with a floor of 10.5%. The impact of the decrease in estimated annual expenses will increase the company's return on equity (ROE) by 93 basis points. Based on the September 2002 surveillance report, Chesapeake's achieved ROE was 9.85%. All things remaining equal, a decrease in depreciation expenses will increase the company's ROE slightly above the floor.

This filing was essentially a staff-assisted study. The company provided aged retirement data for the 1998-2001 period and forecasted 2002 data. The company also provided the average age distributions of the surviving investments for each account. Staff then worked with the company in developing appropriate life and salvage values. As a result of the review and analytical process, staff and the company agree on lives, net salvages, and resultant depreciation rates for all accounts.

The recommended changes in the distribution and general plant depreciation rates can be attributed mainly to: (1) updated account ages to reflect activity since the last represcription, and (2) changes in the associated reserve positions. The accounts with a substantial change are discussed below.

Mains and Services (Accounts 376 and 380)

Mains and services comprise about 78 percent of the investment in the distribution plant function and about 73 percent of the company's total depreciable investment. When a main or service is

retired, it is generally abandoned in place rather than physically removed. Cost of removal is associated with activities incurred with the abandonment process. This involves labor and material costs associated with a crew to travel to the site, digging down to the pipe, cutting and capping the pipe, refilling the hole, and restoring the roadway. Restoring the roadway becomes significant if the main or service is located under pavement. Surface restoration normally occurs at two locations for each service line retired; one at the point of the service riser, and the other at the property line or at the connection to the main. The galvanic action of dissimilar metals such as a galvanized steel service line running off a cast iron main requires that the line be cut at the main rather than the property line. Under these circumstances, paving restoration is required.

The recommended remaining lives for these accounts simply reflect an update of each account's age. New mains and services are generally plastic rather than steel. In fact, only $7,000 of steel services have been added since 1997 compared to over $2 million of plastic services.

The recommended net salvage values are generally in line with each account's expectations. The retirement rate for steel services during the 1997-2002 period has averaged almost two percent with cost of removal averaging over 100 percent. An increase in the cost of removal is recommended for steel services in recognition of consistent activity based on substantive retirements.

Meters and Regulators (Accounts 381 and 383)

Meters are used to measure gas consumption at the customer's premise; regulators are used to regulate the gas pressure at the customer's premise. Under Rule 25-7.0461(6), F.A.C., the accounting treatment for this equipment is cradle-to-grave. At the time a meter or regulator is purchased, the cost is capitalized. A retirement does not occur until final disposition. All costs associated with change-outs and refurbishment are expensed. The recommended remaining lives simply reflect account activity since the last depreciation review.

Meter and Regulator Installations (Accounts 382 and 384)

When a meter or regulator is placed in a location which has never before had service, or when an additional meter or regulator is added to an old location (increasing the number at the location), the installation costs are capitalized. Generally, meter and regulator installations are retired only when the meter or regulator is removed from the location, and no new one is installed, or when service through the meter or regulator is cut. In other words, the life of these installations should be very similar to the life of services. The recommended remaining lives are in line with this practice. The recommended negative 20 percent net salvage is more reflective of expected removal costs than the current negative five percent.

Other Equipment (Account 387)

This account has experienced a substantial increase in investment over the past five years with a growth rate of over 84 percent and no retirements. The company has stated that the growth is directly related to the growth of the company's customer base. A review of the data indicates that this investment is experiencing a longer life indication than first perceived. Recognizing the current age of the surviving investment is 7.8 years, and the fact that there are no near-term plans for retiring any of this equipment, staff recommends use of a 15-year average service life with a S4 mortality dispersion. A 7.2-year remaining life results.

VAX Equipment (Account 391.4)

This subaccount is not used by the other gas distribution companies in Florida, so direct comparison is not available; however, the associated equipment is basically computer equipment, and so this account should be treated like the computer equipment accounts of other Florida companies. According to Chesapeake, this equipment was initially purchased for use with its financial system. The company states that the equipment is virtually obsolete now. The fact that the equipment is tied to the corporate headquarters imposes additional factors to be considered.

Since the last represcription, almost 30 percent of the account's investment has been either retired or transferred to the corporate office. Three printers have been retired, while one printer and its associated power equipment was transferred. The remaining investment is comprised of printers and cables with a

5.2-year average age. The recommended average remaining life reflects the account's age and a 7-year average service life.

The current reserve position reflects the near full recovery of the embedded investment. Additionally, the company does not anticipate purchasing additional VAX equipment. Nevertheless, in the event new equipment is added, staff recommends use of a 14.2 percent whole life depreciation rate, comprised of a 7-year average service life and zero net salvage.

Transp. Equipment-Autos/Light Trucks (Account 392.1)

This transportation account has experienced several changes since the last depreciation study. In 2001, three vehicles were transferred from the regulated to the non-regulated company. At that time, the related investments were transferred with no commensurate transfers of reserve. The company made correcting journal entries in 2002. However, upon staff's review, it was discovered that additional adjustments are needed to reflect an overstatement of investment transferred and an understatement of reserve transferred. According to the company, correcting journal entries will be made during the first quarter of 2003. The investment and reserve positions for this account as shown on Attachment B reflect these corrections.

Transportation Equipment-Other (Account 392.3)

The investment in this account consists of four trailers. Recognizing the average age of 10.1 years, minimal salvage is expected to be realized at the time of retirement. With this in mind, staff recommends zero salvage for this account.

Tools and Work Equipment (Account 394)

The investment in this account has increased almost 150 percent during the past five years since the last represcription. The majority of the growth is due to a transfer associated with a 1986 compressed natural gas station from Account 392.3, Transportation - Other. A recommended 7.6 year average remaining life reflects the age impact of this transfer.

Power Operated Equipment (Account 396)

This account contains special equipment such as trenchers, forklifts, and backhoes. The investment has experienced an 88 percent growth rate during the 1997-2002 period, while at the same time experiencing no retirements. A recommended 8-year average remaining life and zero net salvage simply reflect an update of activity.

ISSUE 4: Should the current amortization of investment tax credits (ITCs) and the flowback of excess deferred income taxes be revised to reflect the approved depreciation rates and recovery schedules?

RECOMMENDATION: Yes. The current amortization of ITCs and the flowback of excess deferred income taxes (EDIT) should be revised to match the actual recovery periods for the related property. The utility should file detailed calculations of the revised ITC amortization and flowback of EDIT at the same time it files its surveillance report covering the period ending December 31, 2003. (KENNY)

STAFF ANALYSIS: In earlier issues, staff recommends revisions to the company's remaining lives, to be effective January 1, 2003. Revising a utility's book depreciation lives generally results in a change in its rate of ITC amortization and flowback of EDIT, in order to comply with the normalization requirements of the Internal Revenue Code (IRC) and underlying Regulations (REGs) found in Sections 46, 167, and 168, and 1.46, 1.67, and 1.68, respectively.

Section 46(f)(6), IRC, states that the amortization of ITCs should be determined by the period of time actually used in computing depreciation expense for ratemaking purposes and on the regulated books of the utility. Since staff is recommending a change in remaining lives, it is also important to change the amortization of ITCs to avoid violation of the provisions of sections 46 and 1.46, IRC and REGs, respectively.

Section 203(3) of the Tax Reform Act of 1986 (the Act) prohibits rapid flowback of depreciation related (protected) EDIT. Further, Rule 25-14.013, Accounting for Deferred Income Taxes Under SFAS 109, F.A.C., generally prohibits EDIT from being written off any faster than allowed under the Act. The Act, SFAS 109, and Rule 25-14.013, F.A.C., regulate the flowback of EDIT. Therefore, staff recommends that the flowback of EDIT be adjusted to comply with the Act, SFAS 109, and Rule 25-14.013, F.A.C.

Staff, the Internal Revenue Service, and independent outside auditors look at a company's books and records and at the orders and rules of the jurisdictional regulatory authorities to determine if the books and records are maintained in the appropriate manner and to determine the intent of the regulatory bodies in regard to normalization. Therefore, staff recommends that the current amortization of ITCs and the flowback of EDIT be revised to reflect the approved remaining lives. In order for there to be a clear audit trail, a prudent utility should revise ITCs and EDIT amortization and produce work papers to show how the revisions were made.

ISSUE 5: Should this docket be closed?

RECOMMENDATION: Yes. If no person whose substantial interests are affected by the proposed agency action files a protest within 21 days of the issuance of the order, this docket should be closed upon the issuance of a consummating order. (Vining)

STAFF ANALYSIS: At the conclusion of the protest period, if no person whose substantial interests are affected by the proposed agency action files a protest within 21 days of the issuance of the order, this docket should be closed upon the issuance of a consummating order.

CHESAPEAKE UTILITIES CORPORATION
DOCKET NO. 020304 - GU
2002 DEPRECIATION STUDY

COMPARISON OF RATES AND COMPONENTS

ATTACHMENT A

ACCOUNT	CURRENT AVERAGE REMAINING LIFE (YRS.)	CURRENT NET SALVAGE (%)	CURRENT REMAINING LIFE RATE (%)	COMPANY/STAFF RECOMMENDED AVERAGE REMAINING LIFE (YRS.)	COMPANY/STAFF RECOMMENDED NET SALVAGE (%)	COMPANY/STAFF RECOMMENDED 1/1/03 RESERVE (%)	COMPANY/STAFF RECOMMENDED REMAINING LIFE RATE (%)
DISTRIBUTION PLANT							
375.0 - Structures & Improvements	34.0	(15.0)	3.0	32.0	(15.0)	26.26	2.8
376.1 - Mains - Steel	29.0	(30.0)	3.2	27.0	(30.0)	40.26	3.3
376.2 - Mains - Plastic	33.0	(30.0)	3.5	36.0	(30.0)	12.99	3.3
378.0 - Measuring and Regulating Eqpt. - General	26.0	(5.0)	3.6	23.0	(5.0)	24.08	3.5
379.0 - Measuring and Regulating Eqpt.- City Gate	25.0	(5.0)	3.5	24.0	(5.0)	17.68	3.6
380.1 - Services -Steel	21.0	(52.0)	5.1	18.1	(80 0)	48.91	7.2
380.2 - Services - Plastic	21.0	(25.0)	5.5	30.0	(25.0)	17.96	3.6
381.0 - Meters	13.9	0.0	4.5	14.9	0.0	41.99	3.9
382.0 - Meters and Regulators Installations	25.0	(5.0)	3.5	26.0	(20.0)	22.03	3.8
383.0 - House Regulators	21.0	0.0	3.6	21.0	0.0	32.52	3.2
385.0 - Measuring & Regulating Eqpt. -Industrial	23.0	(5.0)	4.0	22.0	(5 0)	11.13	4.3
387.0 - Other Equipment	5.0	(5.0)	16.8	9.5	0.0	78.60	2.3
GENERAL PLANT							
390.0 - Structures & Improvements	32.0	5.0	2.3	29.0	5.0	28.90	2.3
391.1 - Data Processing Equipment	2.9	0.0	14.3	3.2	0.0	67.23	10.2
391.2 - Office Furniture	10.5	3.0	5.8	9.5	3.0	50.34	4.9
391.3 - Office Equipment	7.7	0.0	9.4	7.9	0.0	42.41	7.3
391.4 - VAX System Equipment	2.1	0.0	16.7	1.8	0.0	89.98	5.6
392. 1 Transp. Equip.- Auto/ Large Trucks	3.1	15.0	14.2	2.9	15.0	51.32	11.6
392.3 - Transp. Equip. - Other	3.5	10.0	2.9	5.0	0.0	43.38	11.3
394.0 - Tools, Shop, & Garage Equipment	12.8	0.0	5.3	7.6	0.0	73.36	3.5
396.0 - Power Operated Equipment	8.1	0.0	7.8	8.0	0.0	51.86	6.0
397.0 - Communication Equipment	9.3	0.0	6.8	10.5	0.0	19.81	7.6
398.0 - Miscellaneous Equipment	11.8	0.0	7.4	8.6	0.0	42.66	6.7

CHESAPEAKE UTILITIES CORPORATION
DOCKET NO. 020304-GU
2002 DEPRECIATION STUDY

COMPARISON OF EXPENSES

ATTACHMENT B

ACCOUNT	1/1/03 INVESTMENT	1/1/03 RESERVE	CURRENT RATE	CURRENT EXPENSES	COMPANY/STAFF RECOMMENDED RATE	COMPANY/STAFF RECOMMENDED EXPENSES	CHANGE IN EXPENSES
DISTRIBUTION PLANT	($)	($)	(%)	($)	(%)	($)	($)
375.0 - Structures & Improvements	251,426	66,017	3.0	7,543	2.8	7,040	(503)
376.1 - Mains -Steel	12,538,186	5,047,453	3.2	401,222	3.3	413,760	12,538
376.2 - Mains -Plastic	10,625,272	1,380,244	3.5	371,885	3.3	350,634	(21,251)
378.0 - Measuring and Regulating Eqpt - General	638,680	153,813	3.6	22,992	3.5	22,354	(638)
379.0 - Measuring and Regulating Eqpt.-City Gate	1,974,412	349,078	3.5	69,104	3.6	71,079	1,975
380.1 - Services - Steel	893,734	437,126	5.1	45,580	7.2	64,349	18,769
380.2 - Services - Plastic	3,498,952	628,558	5.5	192,442	3.6	125,962	(66,480)
381.0 - Meters	1,395,412	585,907	4.5	62,794	3.9	54,421	(8,373)
382.0 - Meters and Regulators Installation	952,552	209,800	3.5	33,339	3.8	36,197	2,858
383.0 - House Regulators	867,815	282,184	3.6	31,241	3.2	27,770	(3,471)
385.0 - Measuring & Regulating Eqpt. -Industrial	1,274,080	141,810	4.0	50,963	4.3	54,785	3,822
387.0 - Other Equipment	332,311	261,197	16.8	55,828	2.3	7,643	(48,185)
TOTAL DISTRIBUTION PLANT	35,242,832	9,543,186		1,344,933		1,235,994	(108,939)
GENERAL PLANT							
390.0 - Structures & Improvements	378,254	109,317	2.3	8,700	2.3	8,700	0
391.1 - Data Processing Equipment	165,639	111,360	14.3	23,686	10.2	16,895	(6,791)
391.2 - Office Furniture	97,943	49,305	5.8	5,681	4.9	4,799	(882)
391.3 - Office Equipment	98,846	41,916	9.4	9,292	7.3	7,216	(2,076)
391.4 - VAX System Equipment	36,282	32,646	16.7	6,059	5.6	2,032	(4,027)
392.1 - Transp. Equip. - Autos/ Large Trucks	1,027,098	527,138	14.2	145,848	11.6	119,143	(26,705)
392.3 - Transp. Equip. - Other	12,690	5,505	2.9	368	11.3	1,434	1,066
394.0 - Tools, Shop, & Garage Equipment	169,669	124,461	5.3	8,992	3.5	5,938	(3,054)
396.0 - Power Operated Equipment	451,004	233,876	7.8	35,178	6.0	27,060	(8,118)
397.0 - Communication Equipment	254,066	50,327	6.8	17,276	7.6	19,309	2,033
398.0 - Miscellaneous Equipment	57,174	24,392	7.4	4,231	6.7	3,831	(400)
TOTAL GENERAL PROPERTY	2,748,664	1,310,243		265,311		216,357	(48,954)
TOTAL PLANT	37,991,496	10,853,431		1,610,244		1,452,351	(157,893)