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: July 18, 2013

TO: Office of Commission Clerk (Cole)

FROM: Division of Economics (King, Ollila, Draper)
Division of Accounting and Finance (Maurey)
Office of the General Counsel (Brownless)

RE: Docket No. 130130-GU – Petition for approval of special contract with the Florida Department of Corrections - DeSoto Correctional Institution, by Sebring Gas System, Inc.

AGENDA: 07/30/13 – Regular Agenda – Proposed Agency Action – Interested Persons May Participate

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Administrative

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: Please place this item immediately after Docket No. 130079-GU.

FILE NAME AND LOCATION: S:\PSC\ECO\WP\130130.RCM.DOC

Case Background

On May 1, 2013, Sebring Gas System, Inc. (Sebring or the Company) filed a petition for approval of a Special Contract (contract) with the Florida Department of Corrections (DOC) for transportation of natural gas to the DeSoto Correctional Institution (DCI or the Facility) located in DeSoto County, Florida. The Company also filed for approval of a Special Contract with the DOC for the Hardee Correctional Institution (see Docket No. 130079-GU). The contract terms and condition are substantially similar; however, the costs to serve differ. Sebring provides firm transportation service and does not engage in the sale of natural gas. As of December 31, 2012, Sebring had 397 customers with annual revenues of $685,538.

DCI currently uses propane to provide heat, hot water, cooking, and laundry services but would like to convert to natural gas. There is no existing natural gas service within the vicinity of the Facility which is located in a rural, sparsely populated area in the northern part of the county. Subject to the terms of the contract, Sebring will transport natural gas on DOC's account from a delivery point on the Florida Gas Transmission (FGT) pipeline through Sebring's distribution system and redeliver the natural gas at the Facility. The contract has an initial term of fifteen years, and may be extended for additional periods of five years each.

Rule 25-9.034(1), Florida Administrative Code (F.A.C.), requires that whenever a special contract is entered into by a utility for the sale of its product or services in a manner or subject to the provisions not specifically covered by its filed regulations and standard approved rate schedules, such contract must be approved by the Commission prior to its execution. The Commission has jurisdiction over this matter pursuant to Chapter 366, Florida Statutes.

Discussion of Issues

Issue 1: Should the Commission approve the contract between Sebring and the DOC?

Recommendation: Yes, the Commission should approve the contract between Sebring and the DOC. (King, Maurey)

Staff Analysis: As required by Rule 25-9.034(1), F.A.C., and its tariff, Sebring filed for Commission approval of its proposed contract with the DOC for transportation of natural gas to the DCI. The rule also requires each contract be accompanied by a justification for the deviation from the utility's filed regulations and standard approved rate schedules. The Company concluded a special contract was needed after determining the cost to install facilities to serve DCI and comparing the cost to the expected revenues under Sebring's applicable rate schedule. Based upon DCI's projected annual usage of 170,000 therms and applying rate schedule TS-5, the annual revenues would be approximately $70,831. Sebring's investment to serve DCI is $809,000, and includes a city gate station, distribution mains, and meters, as well as the cost to convert existing propane equipment to natural gas.[1] The estimated annual cost associated with that investment is $119,277 and includes a return on investment, operations and maintenance expense, depreciation, and taxes.[2]

Sebring's tariff addresses main extensions such as the one required for DCI. Specifically, the tariff states that the maximum cost to be incurred for an extension of facilities is defined as the maximum allowable construction costs (MACC), which is equal to four times the estimated annual revenue. Any cost above the MACC must be paid by the customer up front. DCI's MACC is $283,325, which is below Sebring's investment of $809,000 to serve DCI. Sebring noted that the DOC was not willing to pay any amount up front, so any contribution-in-aid-of-construction was not an option. After completing its cost analysis and negotiations with the DOC, the Company determined that it had no available tariff options other than a contract.

To provide natural gas transportation service to DCI, Sebring will interconnect with FGT and install the necessary facilities up to the delivery point between it and the Facility. The interconnection with FGT will be on the State's property thus no easement or permits will be required. The DOC does have the ability to bypass Sebring and directly interconnect with FGT. However, this option would have resulted in substantial up front costs to the DOC that it was unwilling to pay (FGT tap, gate station, etc.). Also, the DOC would have then been responsible for ownership of the distribution system and the ongoing operating and maintenance costs of the system. To the Company's knowledge, the DOC does not own natural gas distribution assets and does not have the resources to operate and maintain any such system.

To overcome the apparent inability of the DOC to provide any upfront payment toward the interconnection, the project will be financed through a new debt issuance obtained from Sebring's financial institution. As reflected in the cost analysis provided, the interest rate on the

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[1] Exhibit C of the Special Contract identifies the equipment to be converted.

[2] In the cost analysis the Company used its Commission-approved depreciation rates. See Order No. PSC-12-0043-PAA-GU, issued January 26, 2012, in Docket No. 110233-GU, In re: Petition for approval of 2011 Depreciation Study by Sebring Gas Systems, Inc.

long term debt (fifteen years) is 6.25 percent. During the initial term, the DOC will pay approximately $11,667 per month, escalated by 1.5 percent per year, beginning July 2015. The monthly rate of $11,667 would initially generate annual transportation revenues of $140,004, which will cover the estimated annual operating costs of $119,277. In addition, Sebring noted that since the contract rate ($11,667 per month) will generate more revenues than the standard tariff rate ($5,903 per month), there would be no revenue shortfall to recover from the general body of ratepayers.

As noted above, the initial investment to serve DCI will be financed entirely by long-term debt incurred by Sebring. Combined with the investment contemplated in Docket No. 130079-GU to serve the Hardee Correctional Institution (HCI), this debt issuance will significantly alter the current capitalization of the Company.[3] As of year-end December 31, 2012, Sebring's capitalization was approximately 63 percent equity and 37 percent debt as a percentage of investor capital. Based upon the amount of debt contemplated to fund the new investment, Sebring's capitalization would be approximately 33 percent equity and 67 percent debt. In response to staff's second data request, the Company provided its projections for revenue, expense, and capitalization over the term of the proposed contracts. Based upon its forecasts, the Company projects to return to an equity ratio of 40 percent by 2014 and to an equity ratio of 50 percent by 2023. Staff has reviewed Sebring's projections and they appear reasonable. Thus, while the change in Sebring's capitalization as a result of incurring the debt associated with making the investment to serve HCI and DCI is significant, it appears the Company's relative level of capitalization will return to a financially strong position within a reasonable timeframe assuming the net margins associated with the contracts are achieved as represented and both facilities continuously take service over the stated term of the respective contracts.

Staff notes that the contract includes a provision that the DOC's obligation to pay for services is contingent upon an annual appropriation by the Legislature. Staff believes that this provision is standard in contracts with the State of Florida and has been approved by this Commission in the past.[4] Sebring believes that the likelihood of non-appropriation or insufficient appropriations is remote given that DCI is a high security facility. The Company noted, in response to staff's data request, that if this scenario were to occur it would attempt to recover any remaining investment from its ratepayers through a general rate increase filing. The Company acknowledges that it would have the burden of demonstrating why any remaining investment should be recoverable through rates from its remaining ratepayers.

Given that the contract will generate annual revenues of approximately $140,004 which exceeds the annual cost ($119,277) to serve by $20,727, and that the Commission would have the opportunity to approve or disallow any request to recover costs associated with default by the DOC, staff recommends the Commission should approve the contract between Sebring and the DOC.

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[3] The total investment to serve both facilities is approximately $1,554,300.

[4] See Order No. PSC-05-0784-PAA-GU, issued July 27, 2005, in Docket No. 050327-GU, In re: Petition by Florida Division of Chesapeake Utilities Corporation for approval of special contract with Department of Management Services, Agency of the State of Florida.

Issue 2: 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. (Brownless)

Staff Analysis: 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.