State of Florida

Public Service Commission

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TALLAHASSEE, FLORIDA 32399-0850

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

DATE: October 11, 2007

TO: Office of Commission Clerk (Cole)

FROM: Division of Economic Regulation (Marsh, Bulecza-Banks, Kyle, Lee, Maurey, Slemkewicz)
Office of the General Counsel (Jaeger)
Division of Regulatory Compliance & Consumer Assistance (Hicks)

RE: Docket No. 060657-GU – Petition for approval of acquisition adjustment and recognition of regulatory asset to reflect purchase of Florida City Gas by AGL Resources, Inc.

AGENDA: 10/23/07 – Regular Agenda – Proposed Agency Action - Interested Persons May Participate

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: McMurrian

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\060657.RCM.DOC
Attachment A - not available on-line

Case Background

Florida City Gas (FCG or Company), formerly City Gas Co. of Florida (City Gas), sells and transports natural gas in Dade, Broward, Brevard, Indian River, Palm Beach and St. Lucie Counties. It is the second largest investor-owned natural gas utility in Florida, serving approximately 104,000 customers. FCG was incorporated in 1949 as a propane dealer, and in the late 1950's it began acquiring liquid propane (LP) companies in South Florida. In 1960, FCG gained access to the Florida Gas Transmission Company's pipeline and converted its existing underground pipeline systems to natural gas. Upon doing so, FCG became regulated by the Florida Public Service Commission.

In 1988, NUI Corporation (NUI) acquired all outstanding shares of City Gas' common stock. City Gas was subsequently merged into Elizabethtown Gas Company, the principal operating subsidiary of NUI Utilities, operating as a separate division of the subsidiary corporation. On November 30, 2004, AGL Resources Inc. (AGLR) acquired all of the outstanding common stock of NUI Corporation. On December 6, 2004, the name of City Gas was changed to Florida City Gas. AGLR has gas operations in Florida, Georgia, Maryland, New Jersey, Tennessee, and Virginia.

On October 3, 2006, FCG filed its petition requesting that the Commission approve a positive acquisition adjustment to be amortized over a period of 30 years. In addition, FCG also requested regulatory asset treatment for the outstanding amount of the former NUI pension plan allocated to FCG.

On May 4, 2007, FCG provided updated figures, revising the purchase price premium to \$21,656,835. The revised transaction and transition costs are \$1,615,149 and \$1,991,998 respectively. The revised pension costs are \$1,365,897, net of deferred taxes. On October 1, 2007, the Company filed a proposal refining certain points of its initial filing and reflecting the figures in its May 4, 2007, update.

An acquisition adjustment is the difference between the purchase price of a utility and an original cost calculation. Such an adjustment provides an incentive for stronger companies to purchase weak or troubled companies. Acquisition adjustments have been allowed in extraordinary circumstances if a company could demonstrate that customers will derive certain benefits attributable to the acquisition. Historically, this Commission has generally considered five factors when determining whether the recognition of an acquisition adjustment is appropriate for a natural gas utility. Those factors are:

1. Increased quality of service;
2. Lower operating costs;
3. Increased ability to attract capital for improvements;
4. Lower overall cost of capital; and
5. More professional and experienced managerial, financial, technical and operational resources.[1]

Although the utility is not requesting a rate increase at this time, it provided testimony and exhibits in conjunction with its petition to provide additional support and information for its request.

The Commission has jurisdiction in this matter pursuant to Sections 366.06 and 366.076, Florida Statutes (F.S.).

[1] Order No. 23376, issued August 21, 1990, in Docket No. 891309-WS, In re: Investigation of Acquisition Adjustment Policy; Order No. 23858, issued December 11, 1990, in Docket No. 891353-GU, In re: Application of Peoples Gas Systems, Inc. for a rate increase; and Order No. PSC-04-1110-PAA-GU, issued November 8, 2004, in Docket No. 040216-GU, In re: Application for a rate increase by Florida Public Utilities Company.

Discussion of Issues

Issue 1: Should the Commission accept Florida City Gas' proposal to amortize a $21,656,835 positive acquisition adjustment over a 30-year period, beginning November 2004?

Recommendation: Yes. Florida City Gas should be allowed to record the $21,656,835 purchase price premium as a positive acquisition adjustment to be amortized over a 30-year period beginning November 2004. The amortization should be recorded in Account 406, Amortization of Gas Plant Acquisition Adjustments. The permanence of the cost savings supporting FCG's request should be subject to continuing review. The Company should file its earnings surveillance reports with and without the effect of the acquisition adjustment. In the Company's next rate proceeding, if it is determined that the cost savings no longer exist, the acquisition adjustment may be partially or totally removed as deemed appropriate by the Commission. (Marsh, Hicks, Lee, Kyle, Maurey)

Staff Analysis: On October 1, 2007, FCG filed a proposal "[i]n consideration of the Company's desire to reach a favorable resolution by the Commission in this matter…." (Proposal, p. 2) The proposal is shown in Attachment A to this recommendation. In the proposal, FCG reflected the amounts from schedules that it revised on May 4, 2007, in response to questions from staff. The dollar figures differed from those in the original petition due to the removal of a small LP gas company, a change in the tax rate, and the use of actual 2006 expenses instead of projected expenses. Using the revised figures, the acquisition of FCG by AGLR resulted in a purchase price premium of $117,127,285 in excess of the book value of the original assets, of which $21,656,835 was allocated to FCG. The transaction and transition costs are $1,615,149 and $1,991,998, respectively. The Pension Regulatory Asset is $1,365,897, net of deferred tax, for a total of $26,629,879. Transaction and transition costs are addressed in Issue 2. The Pension Regulatory Asset is addressed in Issue 3.

FCG asks that the acquisition adjustment and the associated annual amortization be included in rate base and cost of service, respectively. The Company believes that this regulatory treatment will more accurately portray the Company's actual investment and earnings level. FCG is not requesting a rate adjustment associated with the acquisition adjustment at this time. Rather, FCG proposes a 3 to 5 year base rate stay-out period, which is addressed in Issue 4.

The Company recognizes that, in the past, the Commission has generally considered five factors when determining whether recognition of such an adjustment is appropriate for a natural gas utility. Those factors are increased quality of service; lower operating costs; increased ability to attract capital for improvements; lower overall cost of capital; and more professional and experienced managerial, financial, technical and operational resources.[2]

To determine whether the Company has adequately demonstrated the potential or actual qualitative and quantitative benefits to FCG's customers as a result of the acquisition by AGLR, staff has analyzed each of the five factors as follows:

[2] See Orders Nos. 23376, 23858, and PSC-04-1110-PAA-GU.

Increased quality of service

FCG explains that it has improved customer service by centralizing the call center function in Atlanta, offering third-party payment locations for customers to pay their bills in person, and instituting monthly meter reading using automated meter reading devices, along with other such technological improvements. The Company provided data showing a reduction in call volume as well as a decline in both volume and percentage of abandoned calls. Although AGLR eliminated customer payment locations previously provided by FCG, it replaced them with four free payment locations as well as accepting payments at 109 Western Union locations for a one dollar fee. The Company also increased its number of meter readers to ensure more timely reading of meters.

Staff notes that Commission complaint activity for FCG has remained consistent following its acquisition by AGLR. Prior to its acquisition by AGLR, the Commission logged 144 and 134 consumer complaints against FCG in 2003 and 2004, respectively. Since acquisition by AGLR, in 2005, FCG received 134 consumer complaints, followed by 136 consumer complaints received in 2006. As of October 8, 2007, FCG received 118 complaints for the year. Thus, it appears that the complaints received by the Commission have remained relatively steady. Staff also learned that on March 19, 2007, the Company moved its call center function to India. Staff believes the level of customer complaints shows neither an improvement nor a decline in quality of service.

2. Lower operating costs

FCG made a number of improvements to reduce operating costs. AGLR centralized its facilities and implemented an inventory management system that it believes is more efficient. By increasing controls over material purchasing and ordering, stock inventory has been reduced. As a result, the Company was able to close one warehouse that it was leasing, thereby reducing related operations and maintenance expense.

The Automated Dispatch (AD) system, known as Field Force Automation (FFA), was implemented in all Florida locations in 2005. The purpose of FFA is to maximize electronic orders and minimize paper orders to increase efficiency and performance. FFA allows for more efficient assignment of work orders and enhances FCG's ability to respond more quickly to emergency situations. The Company advises that the use of the automated dispatch system has resulted in an increase in the number of work orders completed per field technician from 12 to 16 per day, and allowed the reduction of 18 field distribution employees.

FCG has put a greater emphasis on reducing its response time to reports of natural gas leaks. It has employed Geographic Information System (GIS) mapping and mobility tracking, which is a technology that allows dispatchers to locate the leak and assign the work order to the closest available field technician. Mobility tracking allows dispatchers to electronically assign the work order directly to the selected field technician. The Company shows a decrease in average leak response time from 39.1 minutes in May, 2005, to 29.3 minutes in April, 2006.

The Company also believes the relationships between AGLR and its multiple contractors has opened FCG's contracted services to more competition. FCG points out that most of the new growth is in Brevard, Indian River, and St. Lucie counties. The contract services for this area were bid out in early 2005 with a resulting 20 percent reduction in pricing. The Company advises that simplification of the blanket contract pricing structure has reduced engineering labor costs for design and estimating. Conversion to AGLR's work management system has reduced engineering administration labor. These cost reductions have afforded FCG the ability to provide new service to more customers in the area by eliminating or significantly reducing the need for customer contributions.

The Company states that AGLR ownership has resulted in an annual reduction in gas capacity cost of $.5 million. This reduced gas cost represents a reduction in the gas reservation charge payments made by FCG to Florida Gas Transmission Company (FGT). FCG states that AGLR personnel, using their forecasting and modeling tools, determined that a portion of the capacity under the FGT contract could be released without affecting customer deliverability or reliability.

The Company's revised schedules also show annualized savings of $1,305,000, which takes into consideration the federal tax rate of 34 percent rather than 35 percent (excluding the impact of state taxes), as originally filed. However, the schedules do not include amortization of the Pension Regulatory Asset, nor do they reflect the accelerated amortization of the transaction and transition costs proposed by the Company. When adjustments are made for these items, a cost savings is still apparent. Staff's review of FCG's quarterly surveillance reports also show evidence of a reduction in costs.

3. <u>Increased ability to attract capital for improvements</u>

FCG is a division of Pivotal Utility Holdings, Inc., which became a wholly-owned subsidiary of AGLR when AGLR merged with NUI Corporation (NUI) on November 30, 2004. AGLR has an equity market capitalization of approximately $3.0 billion as of August 2007, is traded on the New York Stock Exchange, and has an investment grade credit rating. With natural gas operations in Florida, Georgia, Maryland, New Jersey, Tennessee, and Virginia, AGLR has become the largest natural gas distribution company along the East Coast of the United States in terms of number of customers. As a result, FCG is now able to benefit from AGLR's ability to attract capital for improvements.

Moody's Investors Service (Moody's) had assigned NUI and NUI Utilities non-investment grade (speculative) credit ratings of Caa1 and B1, respectively. For comparison, AGLR is assigned investment grade credit ratings of Baa1 and A- from Moody's and Standard & Poors' (S&P), respectively. This improved ability to attract capital is demonstrated by AGLR's ability to refinance NUI's short-term debt, which carried an interest rate of London Interbank Offered Rate (LIBOR) plus 4.83 percent (10.15 percent at the time of acquisition), into fixed rate long-term debt with an interest rate of 5.50 percent. Additionally, AGLR was able to refinance two series of long-term debt held by NUI at fixed interest rates of 6.35 percent and 6.40 percent, respectively, into long-term debt with variable interest rates of 3.63 percent and 3.82 percent, respectively, as of June 30, 2006. Prior to the acquisition, FCG had been overly reliant on short-term debt due to NUI's inability to obtain new long-term financing under reasonable terms. FCG is now able to obtain both short-term and long-term financing as needed through AGLR.

Another example of FCG's improved ability to attract capital is demonstrated by the performance of AGLR's stock. NUI's stock price had been in a state of decline, falling from

$26.78 per share on July 1, 2002, to $13.30 on July 15, 2004 (the date of the announcement of the acquisition). In contrast, AGLR's stock price had risen from $18.95 on July 1, 2002, to $25.99 on July 15, 2004. As of October 5, 2007, AGLR's stock closed at $40.68.

For the reasons discussed above, FCG is now better positioned to attract the debt and equity capital needed to support its operations as a result of AGLR's acquisition of NUI.

4. Lower overall cost of capital

As noted earlier, FCG's ability to attract capital under reasonable terms was in a state of decline prior to the acquisition by AGLR. Due to NUI's deteriorating financial condition, it was required to pre-pay for its gas supply, including the gas supply for FCG. As a result of the acquisition by AGLR, FCG was able to resume the practice of post-paying for its gas supply. Post paying for its gas supply allowed FCG to decrease its amount of working capital which resulted in a one-time reduction in financing costs of approximately $375,000. Additionally, due to its poor credit rating, NUI was borrowing at short-term rates of LIBOR plus 4.83 percent. In contrast, as a result of the acquisition, FCG is now able to borrow at short-term rates of LIBOR plus 0.05 percent.

In addition to the reduction in borrowing costs discussed above, AGLR used three methods to compare the overall cost of capital under NUI ownership versus the cost of capital under AGLR. Each of the three methods showed a decrease in the overall cost of capital under AGLR ownership compared to NUI ownership. Two of the three cost of capital calculation methods showed a decrease in the revenue requirement while one of the methods showed an increase in revenue requirement. Staff's own comparison of the overall cost of capital under NUI and AGLR as of June 30, 2006, showed a decrease in both the overall cost of capital and the revenue requirement.

Even though two of the three methods used by AGLR showed a decrease in the revenue requirement and support the Company's position that FCG has a lower cost of capital under AGLR ownership, the Company did not include an amount associated with the reduction in the cost of capital in the calculation of the savings resulting from the acquisition. The Company stated that it excluded the impact on cost of capital due to the conflicting results and to present a conservative estimate of the savings. Based on its own analysis, staff believes FCG has a lower cost of capital as a result of AGLR's acquisition of NUI.

5. More professional and experienced managerial, financial, technical and operational resources

AGLR is among the largest gas distributors in the country, the single largest operator of liquefied natural gas (LNG) peaking facilities, and states it is consistently one of the top quartile operators according to industry metrics. It serves 2.2 million natural gas customers, owns more than 35,000 miles of natural gas pipelines and five LNG facilities. Further, AGLR advises that it was named the 2003 Gas Company of the year by Platt's Global Energy Awards, and was a finalist for that award in 2004. In 2006, AGLR was ranked as the 10th Best Managed Utility Company in the United States by Forbes.

AGLR contends that this experience in operating a natural gas utility benefits FCG's customers and allows AGLR to develop a number of best practices and metric measurements with regard to operations, inventory management, productivity improvements, safety and reliability. AGLR also states that FCG has been able to tap into the expertise and employ these techniques and processes to enhance the operation of the FCG system and it has been able to take advantage of the synergies to reduce costs and deploy advanced technologies which allow additional efficiency gains for work processes in the field. Staff has no evidence to the contrary.

Savings

Staff has provided a table below to show the savings reported by the Company and the impact of the amortization resulting from the acquisition. Column 1 shows the revised amounts as filed by the Company as of 2004, adjusted by staff to reflect the transaction and transition costs and the amortization of the Pension Regulatory Asset discussed in later issues. Column 2 shows the impact of accumulated amortization on rate base through December 2006. Staff notes that although the Company filed 2006 savings information, no adjustment for accumulated amortization was made to show the effect of the amortization on rate base.

By November 2009, the transaction and transition costs will be fully amortized if the 5-year amortization proposed by FCG is approved. The pension costs will also be fully amortized over a shorter timeframe than the acquisition adjustment. As the acquisition adjustment and regulatory assets are amortized, if approved, the impact will be to increase the net savings, assuming savings in O&M expenses remain unchanged.

Net Savings to Florida City Gas as a Result of the AGL Resources Inc. Acquisition

	(1) Company Proposed 2004	(2) EOY 2006 Balances
Operation and Maintenance Expense Savings	$4,170,000	$4,170,000
Reduction in Gas Cost--Financing	415,000	415,000
Reduction in Gas Cost--Release of Excess Capacity	495,000	495,000
Total Savings Due to Acquisition	$5,080,000	$5,080,000
Acquisition Adjustment Allocated to Florida City Gas		
Purchase Premium	$21,656,835	$20,092,730
Transaction and Transition Costs	3,607,147	2,044,050
Pension	1,365,897	1,143,939
Total	$26,629,879	$23,281,000
Multiplied by Wtd. Ave. Cost of Capital (After-tax)	7.11%	7.11%
Return on Rate Base - Operating Income Requirement	$1,893,384	$1,655,259
Gross-Up Factor	1.6329	1.6329
Revenue Requirement	$3,091,707	$2,702,873
Annual Amortization*	1,546,023	1,545,766
Total Revenue Requirement	$4,637,730	$4,248,639
Annualized Savings as a Result of the Acquisition	$442,270	$ 831,361

*Amortization includes the Acquisition Adjustment, Transaction and Transition Costs, and Pension Costs

Provisional Treatment

Staff believes the Company has demonstrated that the acquisition of FCG by AGLR has resulted in a benefit to FCG's customers. AGLR brings substantial expertise in the business to bear, and has made considerable effort to improve the operations of the Company. What remains to be seen is whether these benefits will continue in the future. Further, the approval of the acquisition in this case would represent the first time such approval by this Commission has occurred outside of a rate proceeding. Given that, staff believes it may be appropriate to revisit the effects of the adjustment in the future. There is Commission precedent for the approval of acquisition adjustments on a provisional basis.

In Order No. 18716, issued January 26, 1988,[3] a $200,000 acquisition adjustment for Central Florida Gas Company (Central Florida) was approved based on projected savings due to the acquisition of Central Florida Gas Company by Chesapeake Utilities Corporation in 1985. The acquisition adjustment was approved with the caveat that the projected savings would be analyzed in future rate cases to determine if the projected savings actually occurred or had eroded. However, it was later found that Central Florida had experienced a total increase in its revenue requirements after its acquisition by Chesapeake. As a result, the acquisition adjustment of $200,000 was removed from Central Florida's rate base.[4]

A positive acquisition was approved for Peoples Gas System (Peoples) when it demonstrated extraordinary circumstances to justify a positive acquisition adjustment resulting from its purchase of Southern Natural Gas.[5] The Commission determined that the adjustment "should be amortized over 30 years and all funds . . . held subject to refund with interest at the short-term average commercial paper rate (as reported in the Wall Street Journal) pending review of the anticipated savings, in the Company's next rate case."[6] In Peoples' next rate case, the Commission found that no portion of the revenues held subject to refund as a result of the approved acquisition should be refunded.[7] Staff notes that FCG is not requesting an increase in rates. Thus, unlike Peoples Gas System, there is no rate increase to hold subject to refund.

Per the Uniform System of Accounts, acquisition adjustments are to be recorded in Account 114, Gas Plant Acquisition Adjustments. The related acquisition adjustment amortization is to be recorded in Account 425, Miscellaneous Amortization, unless the Commission authorizes the use of another account. Account 425 is a below-the-line expense account that is not included for ratemaking or earnings surveillance purposes. However, the Commission can authorize the use of Account 406, Amortization of Gas Plant Acquisition Adjustments, as an above-the-line expense account. The amortization amounts recorded in Account 406 would be included for ratemaking and earnings surveillance purposes. As discussed previously, staff believes that customers have derived benefits from the acquisition. Therefore, the Commission should authorize FCG to amortize the acquisition adjustment to Account 406 for ratemaking and earnings surveillance purposes.

Staff believes FCG should file its quarterly earnings surveillance reports (ESR) showing the effects of the acquisition adjustment, and showing the earnings if the acquisition adjustment is not included. The effect of not including the acquisition adjustment should be shown in the appropriate "Pro Forma Adjustment" sections of the ESR. This will allow staff to monitor the impact until the next rate proceeding.

Staff recommends that Florida City Gas should be allowed to record the $21,656,835 purchase price premium as a positive acquisition adjustment to be amortized over a 30-year period beginning November 2004. The amortization should be recorded in Account 406, Amortization of Gas Plant Acquisition Adjustments. The permanence of the cost savings

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[3] In Docket No. 870118-GU, In re: Petition of Central Florida Gas Company to increase its rates and charges.
[4] Order No. 23166, issued July 10, 1990, in Docket No. 891179-GU, In re: Petition of Central Florida Gas Co. and Plant City Natural Gas Co, Divisions of Chesapeake Utilities Corp. for a rate increase, pp. 3-4.
[5] Order No. 23858, issued December 11, 1990, in Docket No. 891353-GU, In re: Application of Peoples Gas Systems, Inc. for a rate increase.
[6] Id. at 6.
[7] Order No. PSC-92-0924-FOF-GU, issued September 3, 1992, in Docket No. 911150-GU, In re: Application for a rate increase by Peoples Gas System, Inc., p. 4.

supporting FCG's request should be reviewed in the Company's next rate proceeding. The Company should file its earnings surveillance reports with and without the effect of the acquisition adjustment. If it is determined that the cost savings no longer exist, the acquisition adjustment may be partially or totally removed as deemed appropriate by the Commission.

<u>Issue 2</u>: Should the Commission accept Florida City Gas' proposal to include $1,615,149 in transaction costs and $1,991,998 in transition costs to be amortized over five years, beginning November 2004?

<u>Recommendation</u>: Yes. Transaction and transition costs should be recorded as a regulatory asset and amortized over five years beginning November 2004. The amounts should be $1,615,149 and $1,991,998, respectively. The Commission should find that the approval to record the regulatory asset for accounting purposes does not limit the Commission's ability to review the amounts for reasonableness in future rate proceedings. (Marsh)

<u>Staff Analysis</u>: In addition to the purchase premium, AGLR incurred transaction costs and transition costs as a result of the acquisition, which were allocated in part to FCG. The numbers reflect the use of a 34 percent federal tax rate instead of the 35 percent rate used by the Company (excluding the state tax impact), as discussed in Issue 1.

<u>Transaction Costs</u>

Transaction costs are those costs necessary to effect the acquisition of FCG by AGLR. FCG stated that AGLR incurred $8,735,259 in transaction costs, of which $1,615,149 or 18.49 percent was allocated to FCG. Approximately two thirds of the total costs were incurred for the investment banker ($3,081,847) and legal fees ($2,774,279). Other costs include such items as consultants and Federal Trade Commission filing fees.

<u>Transition Costs</u>

Transition costs are costs incurred after the acquisition. The total transition costs were $165,399,973. Of that amount, $5,383,831 or 18.49 percent was allocated to FCG. The Company decreased the amount by $2,025,936, for deferred taxes, resulting in net transition costs of 3,357,895. Those costs were further reduced by the regulatory asset for pensions of $1,365,897, net of deferred tax. The details of these costs are discussed below. The regulatory asset is discussed in Issue 3.

1. <u>Employee Severance Payments</u>: The Company explained that it operates under a business model to lower costs through increased efficiencies. One of the areas where the Company achieved lower costs was improved employee productivity, which resulted in a reduced number of employees. According to FCG, the reduced number of employees performed the same amount of work without sacrificing the level of service. This increased productivity enabled the Company to reduce the number of FCG employees by 34 since the acquisition. The result was a reduction to payroll and employee benefits of approximately $1.3 million and $.4 million, respectively, for the twelve-month period ended September 2004. The total severance payments were $2,180,930.

2. <u>Information System Write-Offs</u>: Another part of AGLR's business model was the consolidation of its subsidiaries' technology systems into a single system, to the extent possible. These systems included, but were not limited to, financial, general networks and programs, and customer management. The consolidation rendered existing systems obsolete, requiring the write-off of NUI's financial and general information systems. The cost of the write-offs was $926,670.

3. Change of Control Payments: These payments were the result of agreements between NUI and certain NUI executives that were made prior to the acquisition by AGLR. Under the agreements, the executives were to be compensated if they were terminated within a three-year period if there was a change in control, which in this case was an acquisition. The payments totaled $871,726.

4. Retention Compensation: Retention compensation was paid to certain FCG and NUI employees prior to and during the transition period after AGLR's acquisition. Total payments of $435,033 were made to mitigate the financial and operational impact of the acquisition.

5. Directors' and Officers' Insurance: AGLR agreed to provide liability insurance for the former directors and officers of NUI. FCG states that this coverage was a necessary part of the transition of ownership and was one of the terms of the acquisition agreement. The cost was $647,519.

6. Transition Costs Not Allocated to FCG: AGLR incurred $75,230,524 of transition costs that were not allocated to FCG. These costs were related to other companies acquired from NUI, non-jurisdictional operations, or the impairment of non-FCG assets.

7. Pensions and Post-retirement Benefits Other Than Pensions: First, as a result of the acquisition, Generally Accepted Accounting Principals (GAAP) require the recognition of accelerated pension costs. Statement of Financial Accounting Standards No. 87, Employers Accounting for Pensions (FAS 87), requires the acquiring company to recognize the full projected benefit obligation in excess of plan assets at the time of the acquisition. The projected benefit obligation included deferred investment plan asset gains and losses and prior service costs. These costs are typically amortized over the average remaining service period of active employees expected to receive the benefits. The effect of the FAS 87 requirement is to accelerate these costs at the time of the acquisition. The $2,189,990 in accelerated pension costs recognition was assigned to FCG based on an actuarial study. The Company is requesting regulatory asset treatment of this as addressed in Issue 3.

Second, this item includes a $321,953 reduction to the acquisition adjustment to reflect the appropriate level of pension assets for FCG. As of this acquisition date, FCG had a liability recorded on its books, but the records should have reflected an asset. An adjustment was made to correct the books for this item.

8. Deferred Tax Adjustment: This item reflects the effect on accumulated deferred income taxes for each component of the transition costs. The $1,201,843 in deferred taxes (net of deferred taxes on the Pension Regulatory Asset) was calculated by applying the 37.63 percent combined federal and state tax rate to each of the transition items.

Analysis

The FERC Uniform System of Accounts adopted by the Commission prescribes the accounts to be used by regulated natural gas utilities. Account 114, Gas Plant Acquisition Adjustments, is the appropriate account for use in recording acquisition adjustments. This account states in part that "[t]his account shall include the difference between (a) the cost to the accounting utility of gas plant acquired as an operating unit or system by purchase, merger, consolidation, liquidation, or otherwise, and (b) the original cost, estimated, if not known, of such property. . . ."

In staff's opinion, the transaction and transition costs do not fit the description of plant costs to be included in Account 114. These costs are more appropriately recorded as a regulatory asset to be amortized over five years. A regulatory asset is a cost that is capitalized and recovered over a future period, rather than charged to expense when incurred. This approach has been used by this Commission for recording of gains and losses for plant sales. Normally, gains are amortized back to customers over an appropriate period as decided by the Commission, usually five years. For instance, Southern States Utilities, Inc. was required to amortize gains on the sale of facilities and land over a period of five years.[8] The Commission found that "[when] a utility sells property that was formerly used and useful or included in uniform rates, the ratepayers should receive the benefit of the gain on sale of such utility property."[9] Similarly, in an FPL rate proceeding,[10] the Commission stated:

> We have addressed the issue of the actual sale of Utility property in FPL's last full rate case and in a number of other rate cases. In those cases, we determined that gains or losses on disposition of property devoted to, or formerly devoted to, public service should be recognized above the line and that those gains or losses, if prudent, should be amortized over a five-year period. We reaffirm our existing policy on this issue.

More recently, the Commission approved petitions by Florida Public Utilities Company's gas division to amortize gains on the sale of property above the line.[11]

Staff recommends that transaction and transition costs of $1,615,149 and $1,991,998, respectively should be recorded as a regulatory asset and amortized over five years beginning November 2004. Staff also recommends that the Commission should find that the approval to record the regulatory asset for accounting purposes does not limit the Commission's ability to review the amounts for reasonableness in future rate proceedings.

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[8] Order No. PSC-96-1320-FOF-WS, issued October 30, 1996, in Docket No. 950495-WS, In re: Application for rate increase and increase in service availability charges by Southern States Utilities, Inc. for Orange-Osceola Utilities, Inc. in Osceola County, and in Bradford, Brevard, Charlotte, Citrus, Clay, Collier, Duval, Highlands, Lake, Lee, Marion, Martin, Nassau, Orange, Osceola, Pasco, Putnam, Seminole, St. Johns, St. Lucie, Volusia, and Washington Counties.

[9] Id. at 202.

[10] Order No. 13537, issued July 24, 1984, in Docket No. 830465-EI, In re: Petition of Florida Power and Light Company for an increase in its rates and charges, pp. 17-18.

[11] Order No. PSC-02-1159-PAA-GU, issued August 23, 2002, in Docket No. 020521-GU, In re: Petition for approval to amortize gain on sale of property over five-year period by Florida Public Utilities Company; and Order No. PSC-02-1727-PAA-GU, issued December 9, 2002, in Docket No. 021014-GU, In re: Petition for approval to amortize gain on sale of property by Florida Public Utilities Company.

Issue 3: Should the Commission accept Florida City Gas' proposal to recognize a net regulatory asset for pensions of $1,365,897 ($2,189,990 (gross) less $824,093 (accumulated deferred income taxes)), to be amortized over 13.3 years, beginning November 2004?

Recommendation: Yes. The Commission should authorize FCG to use deferral accounting to create a regulatory asset to recognize and offset the accelerated treatment for pension costs the company must record in accordance with Statement of Financial Accounting Standards (FAS) 87. The amount of the net regulatory asset should be $1,365,897 ($2,189,990 gross, less $824,093 accumulated deferred income taxes). This amount should be amortized over a period of 13.3 years, beginning November 2004. Finally, the Commission should find that the approval to record the regulatory asset or liability for accounting purposes does not limit the Commission's ability to review the amounts for reasonableness in future rate proceedings. (Kyle)

Staff Analysis: FCG and AGLR account for pension costs in accordance with FAS 87. The Commission has recognized FAS 87 for ratemaking purposes. Essentially, this means that utilities must account for benefit plan costs using accrual accounting, as opposed to "pay-as-you-go" methods which were prevalent prior to the promulgation of the above standard. FAS 87 requires that the acquiring company in a merger recognize the full projected benefit obligation in excess of plan assets at the time of acquisition. For a pension plan, the projected benefit obligation is the actuarial present value of all benefits attributed by the pension benefit formula to employee service rendered prior to that date.

According to FCG, an amount of $2,189,990 in accelerated pension cost recognition was assigned to FCG based on an actuarial study. FCG is requesting the creation of a regulatory asset for this amount, net of the associated deferred income taxes. The Company states that the amount of the deferred taxes is $824,093. The Company also states that the appropriate period for amortization of the regulatory asset is 13.3 years, which is the approximate remaining service period of FCG employees expected to receive benefits from the pension plan. In its petition, the Company notes that prior to the acquisition, FCG had recovered pension costs in its base rates. Further, FCG states that establishing the regulatory asset and amortizing it over 13.3 years will result in recognition of the accelerated items over a period which approximates the normal pension expense recognition under FAS 87.

FAS 71 allows regulated companies to defer costs and create regulatory assets, provided that it is probable that future revenue in an amount at least equal to the capitalized cost will result from inclusion of that cost in allowable costs for rate-making purposes. To create a regulatory asset or liability, a regulated company must have the approval of its regulator. This concept of deferral accounting allows companies to defer costs due to events beyond their control and seek recovery through rates at a later time. The alternative would be for the Company to seek a rate case each time it experiences an exogenous event.

Staff believes FCG's request to create a regulatory asset to record charges that would otherwise have been recorded in equity under the provisions of FAS 87 meets the requirements of FAS 71 and should be approved. The amount of the regulatory asset should be $1,365,897 ($2,189,990 gross, less $824,093 accumulated deferred taxes) and this amount should be amortized over 13.3 years, beginning November 2004. Staff also recommends that the Commission find that the approval to record the regulatory asset for accounting purposes does not limit the Commission’s ability to review the amounts for reasonableness in future rate proceedings.

Issue 4: Should the Commission accept FCG's proposal for a base rate stay-out period?

Recommendation: Yes. A five-year base rate stay-out period should be accepted, subject to approval of the acquisition adjustment. The stay-out period should not include annual cost recovery proceedings, and should begin on the date of the Commission vote, if there is no protest. Exceptions to the base rate stay-out should include items such as unforeseen acts, force majeure, acts of God, and terror-related events. (Marsh)

Staff Analysis: In its October 1, 2007, proposal, FCG indicated a willingness to agree to a 3 to 5 year stay-out period, beginning with the date of a favorable vote on its proposal. The Company advises that the stay-out period would not include the annual cost recovery proceedings such as the Purchased Gas Adjustment (PGA). It also would be subject to certain exceptions, such as unforeseen acts, force majeure, Acts of God, and/or terror-related events.

Staff believes that a five-year base rate stay-out period is in the best interests of the customers. Under such a provision, base rates will not be increased for five-years from the date of the vote on this recommendation. Staff believes the exceptions proposed by the Company are reasonable. However, it should be specified that unforeseen acts should be items beyond the control of the Company.

The base rate stay-out provision does not preclude the Commission from initiating proceedings, such as, but not limited to, overearnings proceedings. The Commission may also reevaluate the reasonableness of the acquisition adjustment at any time during the stay-out period.

Accordingly, staff recommends that FCG's proposal for a five-year base rate stay-out period should be accepted, subject to approval of the acquisition adjustment. The stay-out period should not include annual cost recovery proceedings, and should begin on the date of the Commission vote, if there is no protest. Exceptions to the base rate stay-out should include items such as unforeseen acts, force majeure, acts of God, and terror-related events.

Issue 5: Should this docket be closed?

Recommendation: Yes. If no person whose substantial interests are affected by this Proposed Agency Action files a protest within 21 days of the Order, a Consummating Order will be issued and the docket will be closed. (Jaeger)

Staff Analysis: If no person whose substantial interests are affected by this Proposed Agency Action files a protest within 21 days of the Order, a Consummating Order will be issued and the docket will be closed.