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: September 17, 2008

TO: Office of Commission Clerk (Cole)

FROM: Division of Economic Regulation (Slemkewicz, Bulecza-Banks, Kyle, Livingston, Maurey, Springer)
Office of the General Counsel (Klancke)

RE: Docket No. 080514-GU – Investigation into 2006 earnings of the gas division of Florida Public Utilities Company.

AGENDA: 09/29/08 – Regular Agenda – Proposed Agency Action – Interested Persons May Participate

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Administrative

CRITICAL DATES: None

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\080514.RCM.DOC

Case Background

Through the Commission's continuing earnings surveillance program, staff noted that the Gas Division of Florida Public Utilities Company (FPUC or Company) had reported an achieved return on equity (ROE) of 12.31 percent on its December 2006 Earnings Surveillance Report (ESR). This reported ROE exceeded the 12.25 percent maximum ROE authorized in Docket No. 040216-GU.[1] Staff subsequently contacted FPUC concerning the reported overearnings for calendar year 2006. On April 16, 2007, FPUC submitted a letter[2] to staff in which it agreed to

[1] Order No. PSC-04-1110-PAA-GU, issued November 8, 2004, in Docket No. 040216-GU, In re: Application for Rate Increase by Florida Public utilities Company.
[2] Document No. 06552-08 in Docket No. 080514-GU.

cap the earnings of the Gas Division at a 12.25 percent ROE for the calendar year 2006. In the letter, FPUC proposed applying any overearnings to the storm reserve as an alternative to a direct cash refund. Staff requested an audit of FPUC's December 2006 ESR to verify the amount of any overearnings.

On June 10, 2008, FPUC notified the Commission of its intent to file for a general rate increase for its Gas Division on December 23, 2008. Docket No. 080366-GU has been opened to process the forthcoming rate case. The Gas Division of FPUC is engaged in business as a natural gas utility company providing distribution and gas transportation service to over 51,000 customers located in Broward, Martin, Palm Beach, Seminole and Volusia Counties. FPUC is also engaged in a separately regulated business as an electric utility providing service in Fernandina Beach and Marianna.

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

Discussion of Issues

Issue 1: What is the appropriate amount of rate base for the Gas Division of Florida Public Utilities Company for determining the amount of excess earnings for 2006?

Recommendation: The appropriate amount of rate base for the Gas Division of Florida Public Utilities Company for determining the amount of excess earnings for 2006 is $57,640,036. (Slemkewicz)

Staff Analysis: Per the December 2006 ESR, the Company reported a total "FPSC Adjusted" rate base of $58,029,461. Based on the adjustment discussed below, staff recommends that the appropriate rate base for 2006 is $57,640,036. (Attachment A)

Non-Utility Plant (Audit Finding No. 1): During the audit, it was discovered that the Company had incorrectly calculated the 13-month average adjustments to remove non-utility operations from the rate base. In the ESR, FPUC had reduced plant by $820,604 and accumulated depreciation by $254,284. The appropriate adjustment amounts for plant and accumulated depreciation were $1,362,760 and $407,015, respectively. In order to correct the miscalculations, plant should be reduced by an additional $542,156 and accumulated depreciation should be reduced by an additional $152,731. The net effect is a $389,425 reduction to rate base. The Company agrees with this adjustment.

Issue 2: What is the appropriate overall rate of return for the Gas Division of Florida Public Utilities Company for determining the amount of excess earnings for 2006?

Recommendation: The appropriate overall rate of return for the Gas Division of Florida Public Utilities Company for determining the amount of excess earnings for 2006 is 8.29 percent. (Livingston)

Staff Analysis: Based on the proper components, amounts, and cost rates associated with the capital structure for the period ended December 31, 2006, staff recommends a weighted average cost of capital of 8.29 percent for purposes of determining the amount of excess earnings for 2006. Attachment B details staff's determination of its recommended overall rate of return.

Staff began with the 13-month average capital structure from the Company's ESR for the period ended December 31, 2006. In its ESR, the Company removed its investment in Flo-Gas[3] entirely from common equity in a manner consistent with previous cases. In addition, the Company specifically identified the balances of deferred taxes, investment tax credits, and customer deposits.

As discussed in Issue 1, rate base was reduced by $389,425 to correct an error in the calculation of the 13-month average adjustment to remove non-utility operations from rate base. Consistent with previous cases, non-utility investments should be removed from common equity. Therefore, staff made a specific adjustment to remove the $389,425 from common equity.

Staff also made another specific adjustment in the amount of $79,973, representing staff's calculation of the 13-month average balance of excess earnings for 2006. This amount was included as a separate line item in the capital structure and was assigned an effective cost rate of 5.26 percent. The cost rate for the excess earnings is derived by dividing the 12-month total of the 2006 commercial paper rate interest by the 2006 average excess earnings balance. ($4,208/$79,973) The 30-day commercial paper rate is applied pursuant to Rule 25-6.109, Florida Administrative Code. This adjustment recognizes that the excess earnings are a source of capital to the Company. The treatment of excess earnings as a separate line item in the capital structure is consistent with the treatment of excess earnings in the 2002[4] and 2005[5] earnings review of the Gas Division. Staff further reconciled the $79,973 excess earnings on a pro rata basis as a reduction to investor-supplied sources of capital. Attachment C details staff's calculation of the amount of excess earnings for 2006.

The Commission established the return on common equity (ROE) for the Gas Division of 11.25 percent, with a range from 10.25 percent to 12.25 percent, in Order No. PSC-04-1110-PAA-GU.[6] Based upon the proper components, amounts, and cost rates associated with the

[3] Flo-Gas is an unregulated wholly owned subsidiary that sells propane gas.
[4] Order No. PSC-05-0769-PAA-GU, issued July 25, 2005, in Docket No. 050224-GU, In Re: Investigation into 2002 Earnings of the Gas Division of Florida Public Utilities Company.
[5] Order No. PSC-07-0671-PAA-GU, issued August 21, 2007, in Docket No. 070107-GU, In Re: Investigation into 2005 Earnings of the Gas Division of Florida Public Utilities Company.
[6] Order No. PSC-04-1110-PAA-GU, issued November 8, 2004, in Docket No. 040216-GU, In Re: Application for Rate Increase by Florida Public Utilities Company.

capital structure for the period ended December 31, 2006, discussed above, and using the top of the authorized ROE range of 12.25 percent, the appropriate weighted average cost of capital for purposes of determining the amount of excess earnings for 2006 is 8.29 percent.

Issue 3: What is the appropriate net operating income for the Gas Division of Florida Public Utilities Company for determining the amount of excess earnings for 2006?

Recommendation: The appropriate net operating income for the Gas Division of Florida Public Utilities Company for determining the amount of excess earnings for 2006 is $4,876,605. (Slemkewicz)

Staff Analysis: Per the December 2006 ESR, the Company reported an "FPSC Adjusted" net operating income of $4,833,890. Based on the adjustments discussed below, staff recommends that the appropriate net operating income for 2006 is $4,876,605. (Attachment A)

Payroll Overhead (Audit Finding No. 4): In the conservation audit for 2006, the payroll overhead rates were reviewed and traced to a detailed Company schedule. The audit disclosed that certain employee-related costs were not allocated to conservation expenses due to a computer programming error. As a result, the O&M expenses included in the 2006 ESR were overstated by $67,968. As a result, O&M expenses should be reduced by $67,968 to correct the computer programming error. The Company agrees with this adjustment.

Interest Synchronization: As a result of the adjustments to the amounts for long-term debt, short-term debt and the 2006 excess earnings components in the capital structure, interest expense increased by $860. Since interest expense is a deduction in the calculation of income taxes for net operating income purposes, the increased interest expense results in a lower income tax expense. Utilizing a 37.60 percent income tax rate, the decrease in income tax expense for 2006 is $324.

Income Taxes: This is a fallout calculation based on the above adjustments to net operating income. As a result, total income taxes should be increased by $25,576. This amount does not include the specific $324 income tax adjustment related to interest synchronization.

Issue 4: What is the appropriate amount of excess earnings for the Gas Division of Florida Public Utilities Company for 2006?

Recommendation: The appropriate amount of excess earnings for the Gas Division of Florida Public Utilities Company for 2006 is $176,144, including interest of $16,199 through August 31, 2008. Interest should continue to accrue until a final disposition of the excess earnings is made. (Slemkewicz)

Staff Analysis: Based on the recommendations discussed in the previous issues, staff has determined that the excess earnings for 2006 are $159,945, plus interest of $16,199, calculated through August 31, 2008. As of August 31, 2008, the total amount of excess earnings is $176,144, including interest (Attachments C and D). With the excess earnings of $159,945 included, FPUC had a 2006 achieved ROE of 12.74 percent, which exceeds the maximum authorized ROE of 12.25 percent. Interest should continue to be accrued until a final disposition of the excess earnings is made.

Issue 5: What is the appropriate disposition of the 2006 excess earnings for the Gas Division of Florida Public Utilities Company?

Recommendation: The 2006 excess earnings of $176,144, including interest, should be applied to the storm reserve to cover future storm-related costs. (Slemkewicz)

Staff Analysis: In its letter, dated April 16, 2007,[7] the Company requested that the Commission consider other alternatives to a direct credit on the customers' bills, such as additional contributions to the storm reserve.

A credit of the excess earnings, based on actual 2007 therm sales, would equate to .290 cents/therm ($176,144/60,735,210 therms). Therefore, a residential customer using 20 therms would be entitled to a one-time credit of approximately 5.8 cents. There could be some administrative costs, such as computer programming, associated with implementing the refund as a credit on the customers' bills. An alternative to a direct credit would be to reduce the Company's Purchased Gas Adjustment by the excess earnings. This would eliminate the need to incur any additional administrative costs.

In lieu of a credit, the excess earnings could be used to increase the storm reserve. During 2004, Hurricanes Charley, Frances, and Jeanne struck FPUC's service territory. In Docket No. 041441-GU,[8] it was determined that the Company had incurred $543,602 in storm-related damages that could be charged against the storm reserve. At December 31, 2004, FPUC's storm reserve balance was $59,070, leaving an unrecovered balance of $484,532. As a result, FPUC was authorized to implement a surcharge to collect the $484,532 unrecovered balance over a 30-month period through May 2008. Based on the amount of the surcharge recovered and the application of prior overearnings, the Company was able to end the surcharge in October 2007 instead of May 2008.

Due to the damages caused by the 2004 storms, the storm reserve was depleted and had a zero balance. Because the Company is not authorized to make any accruals to the storm reserve, the balance remained at zero until September 2007. At that time, prior overearnings[9] were credited to the storm reserve. As of July 31, 2008, the balance in FPUC's storm reserve was $612,774. The balance in the storm reserve will not increase until such time as FPUC is authorized to begin making accruals to the storm reserve.

Based on prior actual experience, it is apparent that the Company's facilities can be significantly impacted by the effects of storms. Therefore, an adequate storm reserve balance should be maintained to cover the damages caused by future storms. Without an adequate balance, there is a possibility that a surcharge could be required to recover additional storm-related damages. Although it may not be possible to predict when and where future storms may occur, past events have demonstrated that such events do impact the Company's service territory.

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[7] Document No. 06552-08 in Docket No. 080514-GU.

[8] Order No. PSC-05-1040-PAA-GU, issued October 25, 2005, in Docket No. 041441-GU, In re: Petition for Approval of Storm Cost Recovery Clause to Recover Storm Damage Costs in Excess of Existing Storm Damage Reserve, by Florida Public Utilities Company.

[9] Order No. PSC-07-0671-PAA-GU, issued August 21, 2007, in Docket No. 070107-GU, In Re: Investigation into 2005 Earnings of the Gas Division of Florida Public Utilities Company.

After considering the alternatives for the disposition of the 2006 excess earnings, staff recommends that the excess earnings of $176,144 be applied to increase the storm reserve balance. Whether any annual storm reserve accrual should be implemented may be an issue in the Company's forthcoming rate case in Docket No. 080366-GU. It should also be noted that FPUC's 2007 actual achieved ROE declined to 7.16 percent which is below the minimum authorized ROE of 10.25 percent.

Issue 6: Should this docket be closed?

Recommendation: 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. (Klancke)

Staff Analysis: At the conclusion of the protest period, if no protest is filed this docket should be closed upon the issuance of a consummating order.

FLORIDA PUBLIC UTILITIES COMPANY — ATTACHMENT A
CONSOLIDATED GAS DIVISION
DOCKET NO. 080514-GU
REVIEW OF 2006 EARNINGS

	As Filed FPSC Adjusted Basis	Audit Finding No. 1 Non-Utility Plant	Audit Finding No. 4 Payroll Overhead			Interest Synch	Total Adjustments	Total Adjusted Rate Base
RATE BASE								
Plant in Service	92,517,838	(542,156)					(542,156)	91,975,682
Accumulated Depreciation	(32,664,340)	152,731					152,731	(32,511,609)
Net Plant in Service	59,853,498	(389,425)	0	0	0	0	(389,425)	59,464,073
Property Held for Future Use	0						0	0
Construction Work in Progress	2,527,690						0	2,527,690
Net Utility Plant	62,381,188	(389,425)	0	0	0	0	(389,425)	61,991,763
Working Capital	(4,351,727)						0	(4,351,727)
Total Rate Base	58,029,461	(389,425)	0	0	0	0	(389,425)	57,640,036
INCOME STATEMENT								
Operating Revenues	30,254,407						0	30,254,407
Operating Expenses:								
Operation & Maintenance - Fuel	0						0	0
Operation & Maintenance - Other	14,223,519		(67,968)				(67,968)	14,155,551
Depreciation & Amortization	4,215,619						0	4,215,619
Taxes Other Than Income	5,501,540						0	5,501,540
Income Taxes - Current	3,519,739		25,576			(324)	25,253	3,544,992
Deferred Income Taxes (Net)	(1,997,258)						0	(1,997,258)
Investment Tax Credit (Net)	(42,642)						0	(42,642)
(Gain)/Loss on Disposition	0						0	0
Total Operating Expenses	25,420,517	0	(42,392)	0	0	(324)	(42,715)	25,377,802
Net Operating Income	4,833,890	0	42,392	0	0	324	42,715	4,876,605
OVERALL RATE OF RETURN	8.33%						0.13%	8.46%
RETURN ON EQUITY	12.31%						0.43%	12.74%

FLORIDA PUBLIC UTILITIES COMPANY
CONSOLIDATED GAS DIVISION
DOCKET NO. 080514-GU
REVIEW OF 2006 EARNINGS

ATTACHMENT B

CAPITAL STRUCTURE

AS FILED - FPSC ADJUSTED	Amount	Ratio	Cost Rate	Weighted Cost
Long Term Debt	$23,185,262	39.95%	8.02%	3.20%
Short Term Debt	1,519,522	2.62%	3.28%	0.09%
Preferred Stock	273,788	0.47%	4.75%	0.02%
Customer Deposits	5,277,158	9.09%	6.61%	0.60%
Common Equity	20,652,725	35.59%	12.25%	4.36%
Deferred Revenues	0	0.00%	0.00%	0.00%
Deferred Income Taxes	6,889,503	11.87%	0.00%	0.00%
Tax Credits - Zero Cost	0	0.00%	0.00%	0.00%
Tax Credits - Weighted Cost	231,503	0.40%	9.75%	0.04%
Total	$58,029,461	100.00%		8.31%

ADJUSTED	Amount	Adjustments Specific	Adjustments Pro Rata	Adjusted Total	Ratio	Cost Rate	Weighted Cost
Long Term Debt	$23,185,262		($40,634)	$23,144,628	40.15%	8.02%	3.22%
Short Term Debt	1,519,522		(2,663)	1,516,859	2.63%	3.28%	0.09%
Preferred Stock	273,788		(480)	273,308	0.47%	4.75%	0.02%
Customer Deposits	5,277,158			5,277,158	9.16%	6.61%	0.61%
Common Equity	20,652,725	(389,425)	(36,196)	20,227,104	35.09%	12.25%	4.30%
2006 Excess Earnings	0	79,973		79,973	0.14%	5.26%	0.01%
Deferred Income Taxes	6,889,503			6,889,503	11.95%	0.00%	0.00%
Tax Credits - Zero Cost	0			0	0.00%	0.00%	0.00%
Tax Credits - Weighted Cost	231,503			231,503	0.40%	9.74%	0.04%
Total	$58,029,461	($309,452)	($79,973)	$57,640,036	100.00%		8.29%

INTEREST SYNCHRONIZATION

	Adjustments	Cost Rate	Effect on Interest Exp.	Tax Rate	Effect on Income Taxes
Long Term Debt	($40,634)	8.02%	($3,259)	37.630%	$1,226
Short Term Debt	(2,663)	3.28%	(87)	37.630%	33
2006 Excess Earnings	79,973	5.26%	4,207	37.630%	(1,583)
Customer Deposits	0	6.61%	0	37.630%	0
Total	$36,676		$860		($324)

CHANGE IN COST RATE

Cost Rate as Filed	Revised Cost Rate	Difference	$ Amount	Effect on Interest Exp.	Tax Rate	Effect on Income Taxes
		0.00%		0	37.63%	0

TOTAL EFFECT ON INCOME TAXES

Interest Synchronization	($324)
Change in Cost Rate	0
Total	($324)

ATTACHMENT C

FLORIDA PUBLIC UTILITIES COMPANY
CONSOLIDATED GAS DIVISION
DOCKET NO. 080514-GU
REVIEW OF 2006 EARNINGS

Adjusted Rate Base		$57,640,036
Adjusted Required Rate of Return	x	8.29%
Required Net Operating Income		$4,778,359
Adjusted Achieved Net Operating Income	-	4,876,605
Excess Net Operating Income		98,246
Revenue Expansion Factor	x	1.628002
Excess Revenues		$159,945
Excess Earnings - 13 Month Average		$79,973

FLORIDA PUBLIC UTILITIES COMPANY
CONSOLIDATED GAS DIVISION
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REVIEW OF 2006 EARNINGS

ATTACHMENT D

	2006											2005
	January	February	March	April	May	June	July	August	September	October	November	December
Beginning Balance	0	13,351	26,755	40,214	53,733	67,313	80,959	94,676	108,454	122,288	136,182	150,137
Additions	13,329	13,329	13,329	13,329	13,329	13,329	13,329	13,329	13,329	13,329	13,329	13,329
Ending Balance	13,329	26,680	40,084	53,543	67,062	80,641	94,288	108,005	121,783	135,617	149,511	163,466
Average Balance	6,664	20,016	33,420	46,878	60,397	73,977	87,623	101,341	115,118	128,952	142,847	156,802
Average Interest Rate	4.050%	4.520%	4.655%	4.870%	4.985%	5.150%	5.325%	5.315%	5.265%	5.265%	5.260%	5.260%
Interest	22	75	130	190	251	317	389	449	505	566	626	687
Ending Bal. w/ Interest	13,351	26,755	40,214	53,733	67,313	80,959	94,676	108,454	122,288	136,182	150,137	164,154

	2007											2006
	January	February	March	April	May	June	July	August	September	October	November	December
Beginning Balance	164,154	164,874	165,596	166,322	167,051	167,784	168,520	169,259	170,025	170,781	171,476	172,153
Additions	0	0	0	0	0	0	0	0	0	0	0	0
Ending Balance	164,154	164,874	165,596	166,322	167,051	167,784	168,520	169,259	170,025	170,781	171,476	172,153
Average Balance	164,154	164,874	165,596	166,322	167,051	167,784	168,520	169,259	170,025	170,781	171,476	172,153
Average Interest Rate	5.265%	5.260%	5.260%	5.260%	5.260%	5.270%	5.260%	5.430%	5.335%	4.885%	4.735%	4.865%
Interest	720	723	726	729	732	737	739	766	756	695	677	698
Ending Bal. w/ Interest	164,874	165,596	166,322	167,051	167,784	168,520	169,259	170,025	170,781	171,476	172,153	172,851

	2008											2007
	January	February	March	April	May	June	July	August	September	October	November	December
Beginning Balance	172,851	173,431	173,877	174,291	174,689	175,072	175,428	175,786	176,144			
Additions	0	0	0	0	0	0	0	0	0	0	0	0
Ending Balance	172,851	173,431	173,877	174,291	174,689	175,072	175,428	175,786	176,144	0	0	0
Average Balance	172,851	173,431	173,877	174,291	174,689	175,072	175,428	175,786	176,144	0	0	0
Average Interest Rate	4.030%	3.085%	2.860%	2.735%	2.635%	2.440%	2.445%	2.445%				
Interest	580	446	414	397	384	356	357	358				
Ending Bal. w/ Interest	173,431	173,877	174,291	174,689	175,072	175,428	175,786	176,144				

Total Interest
01/01/06 - 07/31/08 0