

State of Florida



Public Service Commission

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

DATE: March 26, 2009

TO: Office of Commission Clerk (Cole)

FROM: Division of Economic Regulation (Lee, Ollila)
Office of the General Counsel (Jaeger)

RE: Docket No. 080548-GU – 2008 depreciation study by Florida Public Utilities Company.

AGENDA: 04/07/09 – Regular Agenda – Proposed Agency Action - Interested Persons May Participate

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Argenziano

CRITICAL DATES: Revenue Requirement Agenda for Docket No. 080366-GU – Petition for rate increase by Florida Public Utilities Company: Staff Recommendation Due 04/23/09 for 05/05/09 Agenda Conference.

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\080548.RCM.DOC

Case Background

Rule 25-7.0145, Florida Administrative Code (F.A.C.), requires natural gas utilities to file comprehensive depreciation studies at least once every five years from the submission date of the previous study unless otherwise required by the Commission. On December 10, 2008, Florida Public Utilities Company (FPUC or Company) filed its regular depreciation study in accordance with this rule. FPUC's last depreciation study was filed on April 20, 2004.

Staff has completed its review of the depreciation study and presents its recommendations herein. The Commission has jurisdiction in this matter pursuant to Sections 366.04, 366.05, and 366.06, Florida Statutes (F.S.)

Discussion of Issues

Issue 1: Should currently prescribed depreciation rates and recovery schedules of Florida Public Utilities Company be revised?

Recommendation: Yes. A review of the Company's current capital recovery position indicates the need to revise depreciation rates. (P. Lee, Ollila)

Staff Analysis: FPUC's last comprehensive depreciation study was filed on April 20, 2004, with an effective date for new depreciation rates of January 1, 2005. The current study is in accord with the five-year depreciation review cycle for gas companies required by Rule 25-7.045, F.A.C. A review of the Company's activity since the last study indicates the need to revise depreciation rates and the need for recovery schedules.

Issue 2: What should be the implementation date for new depreciation rates and recovery schedules?

Recommendation: Staff recommends approval of the Company's requested July 1, 2009, implementation date for new depreciation rates and recovery schedules. (P. Lee, Ollila)

Staff Analysis: FPUC requests that its new depreciation rates be implemented coincident with new base rates approved in its current rate proceeding, in Docket No. 080366-GU. The original depreciation filing was based on data supporting a January 1, 2009, implementation date.

To properly express capital recovery requirements, a reserve-sensitive formula, such as remaining life, should utilize components reflecting the recovery position at the point of implementation of revised depreciation rates. Subsequent to the original depreciation filing, FPUC updated all supporting depreciation data and calculations to match a July 1, 2009, date, the estimated date new base rates will be effective. Accordingly, staff recommends approval of this date to more closely match the increase in depreciation rates to new base rates.

Issue 3: What are the appropriate depreciation rates and recovery schedules?

Recommendation: The staff-recommended lives, net salvages, reserves, and resultant depreciation rates are shown on Attachment A. The result is an increase in annual depreciation expense of approximately \$200,000, based on the estimated June 30, 2009, investments shown on Attachment B. (P. Lee, Ollila)

Staff Analysis: Staff's recommendations are the result of a comprehensive review of FPUC's depreciation study. Attachment A shows a comparison of the currently-approved, company-proposed, and staff-recommended depreciation rate parameters. Attachment B shows a comparison of resultant expenses based on estimated June 30, 2009, investments.

The purpose of depreciation is to recover a company's prudently invested capital over the period of time the assets representing that capital are providing service. Depreciation is not intended to fund the replacement of plant. However, it does create internally generated funds that the Company can use for anything within legal constraints, including purchasing new plant.

A depreciation study provides an opportunity to review a company's present recovery position (depreciation reserve) and determine whether any changes should be made to the existing pattern of recovery (depreciation rates). A prime concern of the depreciation study is life and salvage. As part of the review process, the prudence of company planning (including additions and retirements), technological impacts, retirement and salvage practices, and other related activities are reviewed. The average service life for each account refers to the average expected period the equipment under discussion is expected to provide service to the public. This recognizes that some equipment may live much longer or much shorter than the average life. The average service life is projected based on experience or estimates. The average remaining life is the remaining period of service which can be expected, on the average, from the equipment under study. This period is measured from the time of implementation of the depreciation rates being designed to the expected ultimate retirement of the embedded investment associated with the given equipment. Average remaining lives are derived through planning for retirement or derived as a function of the age of the equipment, its expected average service life, and the expected future retirement pattern (mortality curve shape).

FPUC provided aged retirement data and average age distributions of the surviving investments for each account. Investments, reserves, and activity were estimated through June 30, 2009. For the most part, the underlying average service life and mortality dispersion for each account continue to be appropriate and reasonable. Based on the information FPUC provided, staff has determined the appropriate average remaining lives, net salvage values, and resultant depreciation rates for all accounts. Differences between the positions of staff and the Company are mainly due to: (1) average age calculations, (2) rounding, and (3) use of mortality tables in determining the average remaining lives. In some accounts, FPUC inadvertently assigned an age to plant estimated to be added during the first half of 2009 that reflected older investment rather than new. With rounding, staff continues the practice of rounding remaining lives less than 20 years to one decimal point and to the nearest year thereafter.

The staff recommended changes to depreciation rates can be attributed mainly to two factors: (1) updated account ages to reflect activity since the last represervation, such as new investment, and (2) changes in the associated reserve position. The accounts with substantial changes are discussed below.

Distribution Plant

Land Rights (Account 374.1)

This account contains the cost of easements. It currently has a negative reserve balance of \$7,053 due to the retirement of an easement associated with a project cancelled by the city of Winter Springs. The negative reserve translates into a positive rate base component on which the Company earns a return. Additionally, the negative reserve represents an unrecovered amount of investment that no longer exists. Logic dictates that nonlife related deficiencies, such as this, be recovered as fast as economically practicable. Considering the amount, staff recommends that the negative reserve be separately recovered over a five-year period. A whole life rate based on a 30-year average service life and zero net salvage is recommended for the remaining account investment.

Mains (Account 376) and Services (Account 380)

Mains and services comprise about 84 percent of FPUC's investment in the distribution plant function and about 72 percent of the Company's total depreciable investment. During the 2004-2008 period, the Company's retirement rate for steel and plastic mains averaged less than one percent, making reliance on industry averages for life and salvage necessary. Although there has been minimal retirement activity, the 70 percent growth in the investment in plastic mains is indicative that plastic is the technology of choice. For steel mains (Account 376.02), scant retirement activity indicates that the Company has no wholesale replacement strategy in place but rather is replacing older mains that are experiencing maintenance problems. FPUC has proposed retaining the currently-prescribed 45-year average service life for both the steel and the plastic mains accounts. Staff believes a 45-year average service life remains reasonable, and the recommended remaining lives are the product of applying each account's average age with the underlying mortality dispersions.

Service lines connect the main to the meter on the customer's premises. The retirement rate for plastic service lines has averaged less than one percent since the last study. The retirement rate for steel services has averaged about 1.5 percent. The steel services account investment has decreased about 10 percent since the last review, with retirements averaging nearly 16 times the amount of additions. This activity is indicative of an obsolete technology being phased out and replaced with more efficient technology. As new services are generally plastic, only \$14,000 has been added to the steel services account since 2004, compared to over \$7 million for plastic services.

In FPUC's last base rate proceeding in 2004 (Docket No. 040216-GU), the Commission approved a 50-year recovery for expenditures to replace aging bare steel mains and services (the Bare Steel Replacement Program). As staff understands it, the Company is receiving additional annual revenues of \$566,000 in exchange for the commitment to spend at least that much in

installing replacement pipe. The mains and services subject to retirement and replacement in any given year are based on age or maintenance history. The recovery mechanism essentially funds the replacement with new plastic pipe. The additional revenues are treated as a contribution towards the cost of installing the new pipe. For example, if the Company installs \$700,000 in replacement plastic services, this cost would be offset by the contribution of \$566,000, resulting in a net amount of \$134,000 being recorded as an addition subject to depreciation.

The Company's Bare Steel Replacement Program does not address the retirement or cost of removal of the bare steel pipe being retired and replaced. Eventually, the Company plans to replace all of its embedded bare steel mains and services with plastic pipe, as the bare steel facilities encounter maintenance problems. FPUC asserts it has no specific plans for retiring its remaining steel mains and services, other than a commitment that it will spend at least \$566,000 each year in connection with installing plastic pipe in the Bare Steel Replacement Program. To the extent the Company develops plans for the retirement of the remaining steel mains and services investments, the associated net investments, as well as the cost of removal, can be withdrawn from the account and recovered through a capital recovery schedule or be used in developing an average remaining life. In this manner, the unrecovered net investments subject to retirement can be amortized over the associated planned period of service remaining.

At this time, staff's life recommendations for steel services consider that: (1) the replacement program is a 50-year program, (2) the Company has no plans for retiring the remaining steel services, and (3) the current average age of the surviving investment is about 32 years. These considerations lead staff to conclude that the age of the embedded bare steel service lines can reasonably be expected to exceed 36 years of age at retirement. FPUC proposes to maintain the currently prescribed average service life of 36 years, resulting in an average remaining life of 7.9 years. Based on the information provided, staff believes it is reasonable to expect that steel services will experience a longer average service life. Staff recommends an average service life of 38 years with an average remaining life of 12.3 years.

The main question with the services and mains accounts is the cost of removal portion of the net salvage component. Net salvage consists of gross salvage less cost of removal. Gross salvage is the amount realized for the property retired due to the sale, reimbursement, or reuse. Cost of removal relates to costs incurred in connection with the retirement from service and the disposition of the related assets. When a main or service line is retired, it is generally abandoned in place rather than physically removed. Abandoning the line typically involves labor and material costs associated with a crew traveling to the site, digging down to the pipe, cutting and capping the pipe, refilling the hole, and restoring the roadway. Restoring the roadway can be 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 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 at the property line. Net salvage for retiring mains and services usually consists of no gross salvage but significant removal costs.

Since the last review, the cost of removal has averaged over 50 percent for retiring plastic services, and over 200 percent for retiring steel mains and services. The Company acknowledges the minimal retirement activity for steel mains and has proposed a slight decrease, from negative 15 percent net salvage to negative 20 percent. For steel services, the Company proposes a decrease in net salvage from negative 71 percent to negative 125 percent. For plastic services, the Company proposes a decrease in net salvage from negative 15 percent to negative 25 percent. Staff does not question the amounts that FPUC booked for the retirement and cost of removal activity in the 2004-2008 period, nor the relative consistency of that activity (considering inflation) with previous experience. However, staff is concerned about the use of a 125 percent cost of removal figure for steel services in arriving at depreciation expenses for the future of the account. Further, staff is concerned with the underlying assumption that the minimal sample of 2004-2008 activity is representative of the universe of the entire account, and that past inflation is indicative of the future. The dilemma is whether it should be assumed that the historic inflation pattern will continue and therefore be provided recovery.

If a 125 percent cost of removal component is used in the design of the depreciation rate for steel services, a remaining life rate of 11.1 percent results. The life component of this rate is 4.9 percent with a cost of removal component of 6.2 percent. If this rate had been in effect for each of the years 2005-2008, the annual provision, through depreciation expense, for cost of removal would have averaged about \$136,000, while the annual realized cost of removal averaged about \$152,000. The argument can be made that presuming continued inflation, a 125 percent cost of removal component is not adequate. It can also be argued that depreciation is being used to provide future costs of removal of plant now serving the public. Recognizing the state of the economy, staff believes the current rate of inflation will continue, at least in the short term. Staff thus recommends approval of FPUC's proposed negative net salvage component of 125 percent for this review. Staff will monitor future costs and recommend adjustments as needed.

A somewhat different situation exists for plastic services if a 25 percent cost of removal component is used in the design of its depreciation rate. The resulting remaining life rate is 3.8 percent, with a life component of 3.0 percent and a cost of removal component of 0.8 percent. If this remaining life rate had been in effect for each of the years 2005-2008, the annual provision, through depreciation expense, for cost of removal would have averaged about \$159,000, while the annual realized cost of removal averaged about \$70,000. In this situation, depreciation expense associated with future costs of removal would have been more than twice the actual removal costs booked. The excess depreciation expense over realized cost of removal is likely due to the presumption of continued inflation, and that tomorrow's inflated cost of removal is being provided at today's dollars. It can also be argued that the higher depreciation rate would have the effect of decreasing rate base, a desirable side effect.

If the currently prescribed 15 percent cost of removal component is maintained, the remaining life rate is 3.4 percent with a life component of 2.9 percent and a cost of removal component of 0.5 percent. Going through the same exercise as before, the annual provision, through depreciation expense, for cost of removal would have averaged about \$99,000, while the annual realized cost of removal averaged about \$70,000. While depreciation expense would still be in excess of realized removal costs, staff believes this considers adequate inflation. Staff thus

recommends retaining the currently prescribed net salvage component of negative 15 percent for the plastic services account.

Measuring and Regulating Equipment (Accounts 378 and 379)

These accounts contain equipment used to maintain the correct operating pressure throughout the distribution system. The Company has proposed reducing the currently prescribed average service lives for these accounts from 31 years and 30 years, respectively, to 27 years for each account. Retirement activity for each of these accounts has historically been sporadic and minimal. This data does not lend support to a reduction in average service life as the Company reasons. Staff's recommended average remaining lives are based on maintaining the current underlying average service lives for each account.

The Company's proposed reduction in net salvage from zero to negative 10 percent for Account 378 is based primarily on removal costs incurred in 2006 for the retirement of System Control and Data Acquisition (SCADA) equipment. Recognizing the minimal activity experienced in this account while also recognizing some removal costs are likely at retirement, staff recommends a negative five percent net salvage.

Because both Account 378 and Account 379 contain similar equipment, staff believes the two accounts are likely to experience similar life and salvage patterns. For this reason, staff recommends a negative five percent net salvage for Account 379 as well.

Other Equipment (Account 387)

The Company proposes a decrease in average service life from 30 years to 25 years to recognize historical retirement activity and the account's average age. While the reasons for the Company's proposal may be disputed, staff nevertheless believes a 25-year average service life is reasonable based on the industry expectations for this account. The staff-recommended average remaining life of 17.6 years is reflective of the staff's recalculated age.

General Plant

For many general plant accounts, the differences between the staff and Company positions are due to staff's recalculated average ages of the surviving investment. For two accounts, staff is recommending a longer average service life that better reflects future expectations.

Passenger Cars (Account 392.1)

The age of the passenger cars that retired during the 2004-2008 period averaged over 9 years, indicating an average service life longer than the currently prescribed 8 years. The staff recommendations (10-year average service life, 4.2-year average remaining life, and 10 percent net salvage) are more reflective of the account's activity and life expectations.

Light Trucks & Vans (Account 392.2)

This account is experiencing the most significant change in expense in the General Plant function. The staff recommended average remaining life was determined using mortality life tables and is reflective of the account's activity since the last study.

Heavy Trucks (Account 392.3)

While FPUC currently does not own any heavy trucks, it expects to purchase some in the future. The Company has requested approval of a remaining life rate to apply to investment added to this account. For new investment, a whole life rate is the appropriate rate design given that there is no reserve associated with new investment. Staff recommends an 11-year average service life and a 10 percent net salvage based on gas industry averages in the State. At the next depreciation review, the recovery of this account will be reviewed and analyzed for any needed revisions and possible move to a remaining life rate design.

Communication Equipment (Account 397)

The communication equipment account is comprised of telecommunications equipment, including 2-way radio equipment, and GPS tracking and directional units. Telecommunications equipment is subject to technological changes that can impact life expectations. FPUC proposes decreasing the average service life for this account from 14 years to 13 years based on increased retirement activity since the last depreciation study review. The 2004-2008 activity period includes a 2005 retirement representing about 70 percent of the retirements booked during the period and about 52 percent of the total retirements booked in the last 14 years. Nearly 85 percent of the total 2005 retirement was related to the replacement of the Company's telecommunications system.

Staff believes the Company's proposed decrease in average service life is more in line with the expected life of the related equipment. The recommended average remaining life reflects a corrected average age of 4.7 years.

Miscellaneous Equipment (Account 398)

This account has experienced significant growth since the last review. Nearly 87 percent of the account's investment has been added since 2006. Additions in 2006 alone represent nearly 45 percent of the growth. Retirements have generally been sporadic, with a retirement rate during the 2004-2008 period averaging 1.7 percent.

FPUC believes a reduction in average service life from 17 years to 15 years is indicated based on the average age of the investments retiring. Staff disagrees. A 15-year average service life with an R2 retirement pattern and an average age of three years indicates more retirements than the minimal amount this account has actually experienced. Staff recommends maintaining the existing 17-year average service life.

Staff also recommends maintaining the currently prescribed zero net salvage. In the past 14 years, this account has realized minimal gross salvage in only one year. The limited salvage

and retirement activity does not indicate the need to revise the net salvage component.

Issue 4: Should the current amortization of investment tax credits and flowback of excess deferred income taxes be revised to reflect the approved depreciation rates?

Recommendation: Yes. The current amortization of investment tax credits (ITC) and the flowback of excess deferred income taxes (EDIT) should be revised to match the actual recovery periods for the related property. FPUC 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, 2009. (P. Lee)

Staff Analysis: In earlier issues, staff has recommended approval of revised remaining lives, to be effective July 1, 2009. 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 its underlying Regulations (REGs) found in Sections 46, 167, and 168, and 1.46, 1.67, and 1.68, respectively.

Staff, the Internal Revenue Service, and independent outside auditors examine a company's books and records and 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 the current amortization of ITC and the flowback of EDIT be revised to reflect the approved remaining lives.

Section 46(f)(6), IRC, states that “the amortization of ITC 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 revised remaining lives, it is also important to change the amortization of ITC to avoid violation of the provisions of Sections 46, IRC, and 1.46, REGs.

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, F.A.C., Accounting for Deferred Income Taxes Under SFAS 109, 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.

Issue 5: Should this docket be closed?

Recommendation: Yes. If no substantially affected person files a protest to the Proposed Agency Action Order within 21 days of its issuance, this docket should be closed upon the issuance of a consummating order. (Jaeger)

Staff Analysis: If no substantially affected person files a protest to the Proposed Agency Action Order within 21 days of its issuance, this docket should be closed upon the issuance of a consummating order.