

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: August 6, 2009

TO: Office of Commission Clerk (Cole)

FROM: Division of Economic Regulation (Slemkewicz, Draper, Kummer, Maurey)
Office of the General Counsel (Brubaker, Fleming, Klancke)

RE: Docket No. 080318-GU – Petition for rate increase by Peoples Gas System.

AGENDA: 08/18/09 – Regular Agenda – Decision on Motion for Reconsideration – Oral Argument Has Not Been Requested – Participation is Limited to Commissioners and Staff

COMMISSIONERS ASSIGNED: All Commissioners

PREHEARING OFFICER: Skop

CRITICAL DATES: August 11, 2009 (12 month deadline for final agency action pursuant to Section 366.06(3), F.S., has been waived through August 18, 2009)

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\080318.RCM.DOC

Case Background

This proceeding commenced on August 11, 2008, with the filing of a petition for a permanent rate increase by Peoples Gas System (PGS or Company). The Company is engaged in business as a public utility providing gas service as defined in Section 366.02, Florida Statutes (F.S.), and is subject to the jurisdiction of the Commission. PGS requested an increase in its retail rates and charges to generate \$26,488,091 in additional gross annual revenues. PGS based its request on a historical base year ended December 31, 2007, and a projected test year ending

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December 31, 2009. Intervention was granted to the Office of Public Counsel (OPC)¹ and Florida Industrial Gas Users (FIGU)² in this proceeding.

The Commission held an administrative hearing on PGS' proposed rate increase on March 4-5, 2009. Thereafter, on June 9, 2009, upon consideration of the evidentiary record, the post-hearing briefs of the parties, and staff's recommendations, the Commission issued Order No. PSC-09-0411-FOF-GU (Final Order)³ granting PGS an increase in its rates and charges to generate \$19,152,365 in additional gross annual revenues.

On June 24, 2009, PGS filed a Motion for Reconsideration (Motion), contesting the Commission's calculation of the Company's weighted average cost of capital and revenue requirements. Thus, PGS has only requested the reconsideration of those portions of the Final Order which reconcile the rate base to the capital structure to determine the weighted average cost of capital used in determining the Company's revenue requirements. PGS has not requested oral argument on its Motion for Reconsideration. No response to PGS' Motion has been filed by the intervenors.

This recommendation addresses PGS' Motion. The Commission has jurisdiction pursuant to Sections 366.06(2) and (4), and 366.071, F.S.

¹ See Order No. PSC-08-0532-PCO-GU, issued August 18, 2008, in Docket No. 080318-GU, In re: Petition for rate increase by Peoples Gas System.

² See Order No. PSC-08-0532-PCO-GU, issued August 18, 2008, in Docket No. 080318-GU, In re: Petition for rate increase by Peoples Gas System.

³ Order No. PSC-09-0411-FOF-GU, issued June 9, 2009, in Docket No. 080318-GU, In re: Petition for rate increase by Peoples Gas System.

Discussion of Issues

Issue 1: Should the Commission grant PGS' Motion for Reconsideration requesting recalculation of the Company's weighted average cost of capital?

Recommendation: PGS' Motion for Reconsideration should be granted in part. In addition, staff recommends the Commission correct a separate error related to rate base discovered during staff's review of the merits of PGS' request. As a result, the appropriate weighted average cost of capital for PGS should be revised from 8.50 percent to 8.51 percent. This revised rate of return reflects the net effect of the recommended adjustment related to the Company's Motion for Reconsideration and the correction of the unrelated error discovered during staff's review of this matter. (Maurey, Klancke)

Staff Analysis:

PGS' ARGUMENT

In its Motion, PGS requests the Commission reconsider that portion of the Final Order which reconciles the rate base to capital structure to determine the weighted average cost of capital. PGS' concern relates to whether the plant-related adjustments necessary to reconcile rate base and capital structure should be made over only investor sources of capital (or 100 percent out of common equity in the case of adjustments to remove non-utility assets) as the Commission decided in the Final Order, versus first reducing the accumulated deferred income tax (ADIT) component of the capital structure for the amount of ADIT related to the items removed from rate base, and spreading the remaining amount pro rata over investor sources of capital (or 100 percent common equity depending on the nature of the adjustment). PGS alleges that the Commission's calculation of the weighted average cost of capital is incorrect because it may violate the normalization rules under former Section 167(1) and Section 168(i)(9)(B) of the Internal Revenue Code (IRC) and Sections 1.167(a)-11(b)(6) of the Income Tax Regulations.⁴

In determining the appropriate weighted average cost of capital for PGS' 2009 projected test year, the Commission approved the Company's adjustments to rate base that were removed

⁴ Normalization requirements are outlined in Section 168 of the Internal Revenue Code (IRC). In pertinent part, Section 168 permits the use of accelerated depreciation methods. However, accelerated depreciation is permitted with respect to public utility property only if the taxpayer uses a normalization method of accounting for ratemaking purposes. Under a normalization method of accounting, a utility calculates its ratemaking tax expense using depreciation that is no more accelerated than its ratemaking depreciation (typically straight-line). In the early years of an asset's life, this results in ratemaking tax expense that is greater than actual tax expense. The difference between the ratemaking tax expense and the actual tax expense is added to a reserve (the accumulated deferred income tax reserve, or ADIT). The difference between ratemaking tax expense and actual tax expense is not permanent and reverses in the later years of the asset's life when the ratemaking depreciation method provides larger depreciation deductions and lower tax expense than the accelerated method used in computing actual tax expense. This accounting treatment prevents the immediate flow through to utility ratepayers of the reduction in current taxes resulting from the use of accelerated depreciation. Instead, the reduction is treated as a deferred tax expense that is collected from current ratepayers through utility rates, and thus is available to utilities as cost-free investment capital. When the accelerated method provides lower depreciation deductions in later years, only the ratemaking tax expense is collected from ratepayers and the difference between the actual tax expense and ratemaking tax expense is charged to ADIT, depleting the utility's stock of cost-free capital. (<http://edocket.access.gpo.gov/2003/03-4885.htm>)

from the capital structure pro rata over investor sources of capital only and 100 percent from common equity for the adjustment related to non-utility property. In addition, the Commission approved two additional adjustments to rate base and removed the associated amounts from the capital structure pro rata over investor sources of capital only. In doing so, the Commission stated that this treatment was consistent with prior Commission precedent and cited the order from PGS' last rate case.⁵ PGS states that it has since learned these methods of making the adjustments could have tax-related consequences for the Company. PGS asserts that, because the ADIT included in the capital structure was not reduced by the ADIT associated with the items excluded from rate base, the Company could be in violation of the IRC's normalization requirements.

The normalization rules imposed by the IRC employ an accounting and ratemaking concept, normalization, to ensure that the capital subsidies associated with accelerated depreciation provide an investment incentive for regulated utilities. Normalization is a comprehensive system of control over the reflection of the benefits of accelerated depreciation in ratemaking. As part of these rules, any ratemaking adjustment with respect to a utility's tax expense, depreciation expense, or reserve for deferred taxes must also be consistently applied with respect to the other two items and with respect to rate base. The consequence of a normalization violation is that the taxpayer loses the ability to use accelerated tax methods of depreciation with respect to all of its jurisdictional assets. This outcome would be detrimental to the interests of consumers due to the loss of "cost free" capital in the form of deferred taxes from the capital structure.

The Company states that, by prorating rate base disallowances across only investor sources of capital, or as specific adjustments to common equity, without first reducing the ADIT related to the excluded items, the Commission excluded plant-related items from rate base but failed to adjust the ADIT associated with the excluded items. It is now the Company's position that the ADIT included in the capital structure contains amounts related to excluded rate base components. PGS argues that fairness and consistency require that any ADIT balances related to net plant removed from rate base should also be removed from the capital structure. PGS also cites to a Private Letter Ruling (PLR) from the Internal Revenue Service (IRS) to support its position.

In order to avoid a potential normalization violation, PGS requests the Commission reconsider the reconciliation of rate base and capital structure, recalculate the Company's weighted average cost of capital, and recalculate the resulting revenue requirements accordingly. In its Motion, PGS estimates the impact of the Company's proposed treatment of ADIT will result in an increase in the annual revenue requirements of \$169,912.

INTERVENORS' POSITION

The intervenors did not file a response to PGS' Motion.

⁵ Order No. PSC-03-0038-FOF-GU, issued January 6, 2003, in Docket No. 020384-GU, In re: Petition for rate increase by Peoples Gas System.

STAFF ANALYSIS

The applicable standard of review for a motion for reconsideration is whether the motion identifies some point of fact or law that was overlooked or not considered by the decision maker in rendering its order. Diamond Cab Co. v. King, 146 So. 2d 889 (Fla. 1962); Stewart Bonded Warehouse, Inc. v. Bevis, 294 So. 2d 315 (Fla. 1974); Pingree v. Quaintance, 394 So. 2d 161 (Fla. 1st DCA 1981). The mere fact that a party disagrees with the order is not a valid basis for reconsideration. Diamond Cab Co. v. King, 146 So. 2d 889, 891 (Fla. 1962). Further, reweighing of the evidence is not a sufficient basis for reconsideration. State v. Green, 104 So. 2d 817 (Fla. 1st DCA 1958).

In large measure, PGS' Motion is not a request for the Commission to reverse specific adjustments ordered by the Commission in the Final Order, but rather is a request for the Commission to correct a perceived deficiency in the Company's original MFR filing. In other words, PGS is alleging the Commission made a mistake of fact or law by accepting adjustments the Company proposed in its own rate case filing.

It is unclear if the Company-proposed adjustments included in the Final Order would result in a normalization violation. Due to differences between the facts represented in the PLR and the facts in the instant case, staff does not believe the PLR cited by PGS is persuasive in this instance.⁶

There is no evidence in the record identifying amounts of ADITs associated with the items PGS removed from its rate base and capital structure. If the Company had presented record evidence related to the amount of ADIT associated with these adjustments, then the requested treatment may be possible. However, without an evidentiary record it would be speculative to grant the Company's requested treatment. Moreover, to arbitrarily assign some amount of ADIT to these items may in itself violate IRS normalization requirements.

The Commission rendered its decision based on the information in the record. PGS has failed to identify any factual or legal point the Commission overlooked or failed to consider when it rendered the Final Order in this proceeding. For these reasons, staff does not believe the Commission can grant the relief the Company has requested with respect to the adjustments included in its original MFR filing.

Similarly, with respect to the Commission-ordered adjustment for overprojected plant in service, there is insufficient detail in the record to support the adjustment to deferred taxes PGS has proposed in its Motion. In the absence of a demonstration that a particular project or group of projects actually gave rise to deferred taxes reflected in the Company's filing, the treatment proposed by PGS in its Motion could itself result in a normalization violation.

⁶ PLR 200418001, 2004 WL 933116 (IRS PLR) issued April 30, 2004. The cited PLR is not for PGS or any related company. A PLR is directed only to the taxpayer who requested it. Section 6110(k)(3) of the IRC provides that such rulings may not be used or cited as precedent in other cases. Moreover, the facts alleged in the cited PLR are distinguishable from the facts in the instant case.

In contrast to the case of the Company-proposed adjustments to rate base and capital structure included in PGS' MFR filing and the Commission-ordered adjustment for overprojected plant discussed immediately above, based on the detail reflected on MFR Schedules G-1, page 23 and G-2, page 27, there is evidence in the record that the Company recognized the impact on deferred taxes when it initially projected the amount of cost of removal. Staff agrees with PGS that if an adjustment is made to the depreciation reserve account related to the cost of removal, as was done in the Final Order, a concurrent adjustment should also be made to recognize the deferred taxes associated with this adjustment. Since deferred taxes associated with the cost of removal can be identified in the record, staff recommends the Company's Motion be granted with respect in part to this adjustment.

Although not referenced in the Company's pleading, during staff's analysis of the Company's Motion it was discovered that an error had been made in the calculation of the amount of the adjustment to the depreciation reserve account for the cost of removal. The correct amount of the adjustment to the depreciation reserve account for the 2009 test year should have been \$1,590,741 instead of the \$795,371 reflected in the Final Order. As a result of this error, the amount of rate base reflected in the Final Order was overstated by \$795,370. Staff recommends that this error be corrected through a reduction to rate base in the amount of \$795,370. The deferred taxes associated with the correct amount of the adjustment for cost of removal is \$613,628.

CONCLUSION

There are three elements discussed in this recommendation: 1) PGS' request for the Commission to revise certain adjustments the Company included in its MFR filing, 2) PGS' request for the Commission to revise certain Commission-ordered adjustments, and 3) staff's recommendation to correct an error in rate base.⁷ For purposes of this recommendation, staff removed the Company-proposed adjustments from rate base and capital structure in the same manner that these investments were removed by the Company in its MFR filing. With respect to the Commission-ordered adjustment to over-projected plant in service, in the absence of detail in the record to do anything else, staff removed this amount from the capital structure through a pro rata adjustment over investor sources of capital consistent with Commission precedent.⁸ With

⁷ Section 367.081, F.S., provides that the Commission has exclusive jurisdiction over the rates of each public utility and must "either upon request *or upon its own motion*, fix rates which are just, reasonable, compensatory, and not unfairly discriminatory." (emphasis added). Pursuant to Section 367.081, F.S., the Commission has the authority to determine whether there were mistakes in its prior order and has a duty to correct such errors. Sunshine Utilities v. Florida Public Service Com'n, 577 So. 2d 663, 665-666 (Fla. 1st DCA 1991); Reedy Creek Utilities v. Florida Public Service Commission, 418 So. 2d 249 (Fla.1982) (holding that "where a substantial change in circumstances, or fraud, surprise, mistake, or inadvertence is shown . . . the PSC must have the power to alter previously entered final rate orders."); Peoples Gas Systems, Inc. v. Mason, 187 So. 2d 335, 339 (Fla.1966) (recognizing an exception to the doctrine of administrative finality where there is a demonstrated public interest).

⁸ Order No. PSC-09-0375-PAA-EI, issued May 27, 2009, in Docket No. 080366-EI, In re: Petition for rate increase by Florida Public Utilities Company; Order No. PSC-08-0436-PAA-GU, issued July 8, 2008, in Docket No. 070592-GU, In re: Petition for rate increase by St. Joe Natural Gas Company, Inc.; 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; Order No. PSC-04-0128-PAA-GU, issued February 9, 2004, in Docket No. 030569-GU, In re: Application for rate increase by City Gas Company of Florida; Order No. PSC-03-0038-FOF-GU, issued January 6, 2003, in Docket No. 020384-GU, In re: Petition for rate increase by Peoples Gas System; Order No. PSC-01-1274-

respect to the adjustment to the depreciation reserve account for the cost of removal, staff made a specific adjustment to reduce the balance of deferred taxes by the amount of ADIT associated with the corrected amount of the adjustment to rate base and removed the remaining amount through a pro rata adjustment over investor sources of capital. Finally, staff reduced the amount of rate base by \$795,370 to correct the error uncovered during staff's review of the Company's Motion.

Granting the Company's Motion in part results in an increase in the weighted average cost of capital. In isolation, a higher cost of capital increases annual revenue requirements. Correcting the error in the adjustment to the depreciation reserve account for the cost of removal results in a reduction to rate base. On its own, a lower rate base decreases annual revenue requirements. The net effect of this recommendation is an increase in the weighted average cost of capital from the 8.50 percent approved in the Final Order to the 8.51 percent reflected on Schedule 2 attached herein. However, because the impact of the reduction to rate base to correct an error in the Final Order more than offsets the impact of the increase in the weighted average cost of capital, the net impact of staff's recommendation represents a decrease in the annual revenue requirements of \$15,346. The determination of the impact on revenue requirements is addressed in Issue 2 and is shown on Schedule 5.

PAA-GU, issued June 8, 2001, in Docket No. 001447-GU, In re: Request for rate increase by St. Joe Natural Gas Company, Inc.; and Order No. PSC-01-0316-PAA-GU, issued February 5, 2001, in Docket No. 000768-GU, In re: Request for rate increase by City Gas Company of Florida.

Issue 2: Should the annual base rate revenue increase granted in Order No. PSC-09-0411-FOF-GU be revised to reflect the revised weighted average cost of capital?

Recommendation: Yes. Staff recommends that the approved annual base rate revenue increase should be reduced from \$19,152,365 to \$19,137,019, a \$15,346 decrease, to reflect the revised weighted average cost of capital. (Slemkewicz)

Staff Analysis: Per Order No. PSC-09-0411-FOF-GU, PGS was granted an annual base rate revenue increase of \$19,152,365, effective June 18, 2009. The calculation of this revenue increase was based on an overall rate of return of 8.50 percent. Based on the error identified in staff's analysis of the methodology for reconciling the rate base with the capital structure in Issue 1, the recommended overall rate of return should be 8.51 percent. As a result, the revenue increase calculations should be revised to reflect the 8.51 percent overall rate of return. The calculation of the revised revenue increase is shown on Schedules 1 through 5. A summary of those calculations is as follows:

Line No.		As Approved	Staff Adjusted	Difference
1.	Rate Base	\$560,844,757	\$560,049,387	
2.	Overall Rate of Return	8.50%	8.51%	
3.	Required Net Operating Income (1)x(2)	47,671,804	47,660,203	
4.	Achieved Net Operating Income	36,019,112	36,016,848	
5.	Net Operating Income Deficiency (3)-(4)	11,652,692	11,643,355	
6.	Net Operating Income Multiplier	1.64360	1.64360	
7.	Operating Revenue Increase (5)x(6)	\$19,152,365	\$19,137,019	(\$15,346)

Schedule 1 shows the calculation of the 2009 projected test year rate base. Due to the adjustment related to the calculation of the 13-month average for the cost of removal, the rate base decreased from \$560,844,757 to \$560,049,387.

Schedule 2 is a recalculation of the 2009 projected test year weighted average cost of capital based on the recommendation discussed in Issue 1. The weighted average cost of capital increased from 8.50 percent to 8.51 percent.

Schedule 3 recalculates the 2009 projected test year net operating income (NOI). As a result of the revisions of the dollar amount of the capital structure components for long-term debt and short-term debt, the interest synchronization adjustment to income taxes increased from \$54,057 to \$56,322. Therefore, the amount of NOI decreased from \$36,019,112 to \$36,016,848.

Schedule 4 is the calculation of the NOI multiplier. The 1.63490 NOI multiplier was not affected by the recommendation to recalculate the weighted average cost of capital in Issue 1.

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Schedule 5 shows the revenue increase calculation for the 2009 projected test year. Based on the revised rate base of \$560,049,387 (Schedule 1), the revised overall rate of return of 8.51 percent (Schedule 2), and the revised NOI of \$36,016,848 (Schedule 3), the revenue increase decreased from \$19,152,365 to \$19,137,019, a decrease of \$15,346.

Issue 3: How should the Commission account for the annual base rate revenue decrease of \$15,346?

Recommendation: Base rates should not be reduced. Instead, the annual base rate revenue decrease of \$15,346 should be added to the annual storm damage accrual effective September 1, 2009. (Draper)

Staff Analysis: Staff recommends in Issue 2 that the approved annual base rate revenue increase be reduced from \$19,152,365 to \$19,137,019, a \$15,346 decrease. That represents a 0.08 percent reduction in the previously-approved base rate increase. Based on staff's review of the approved cost of service study, staff believes that the \$15,346 amount has no effect on most rate classes and a nominal one cent bill decrease for the larger residential rate class. Staff is also mindful that should the Commission order that PGS reduce base rates, PGS will incur additional costs to rerun the cost of service study and administer any potential rate changes.

The Commission approved in its Final Order that PGS be allowed to establish a storm damage reserve and an annual accrual in the amount of \$57,500. PGS had requested a \$100,000 annual accrual for the storm reserve. Staff believes that in this instance it would not be cost effective to change base rates, as the cost of administering a rate change could potentially outweigh any miniscule reduction in customer bills. Therefore, staff recommends that the annual base rate revenue decrease of \$15,346 should be added to the annual storm damage accrual resulting in a revised annual accrual of \$72,846. A higher storm damage reserve may benefit ratepayers in the future in the event of a storm or significant weather event by reducing the potential for recovering any future storm-related costs through a surcharge or other mechanism. The Commission approved a similar accounting treatment in Order No. PSC-07-0671-PAA-GU, when it ordered the gas division of Florida Public Utilities Company (FPUC) to apply 2005 excess earnings to the storm reserve.⁹

⁹ Order No. PSC-07-0671-PAA-GU, issued August 21, 2007, in Docket No. 070107-GU, Investigation into 2005 earnings of the gas division of Florida Public Utilities Company.

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Issue 4: Should this docket be closed?

Recommendation: Yes. This docket should be closed upon the expiration of the time for appeal. (Klancke, Fleming)

Staff Analysis: This docket should be closed upon the expiration of the time for appeal.