FLORIDA PUBLIC SERVICE COMMISSION
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January 22, 1998

TO: DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYO)

FROM: DIVISION OF AUDITING & FINANCIAL ANALYSIS (L. ROMIG, DRAPER, LESTER, C. ROMIG)
DIVISION OF ELECTRIC & GAS (MAKIN)
DIVISION OF LEGAL SERVICES (C. KEATING)

RUE ALM

RE: DOCKET NO. [redacted] - PEOPLES GAS SYSTEM - INVESTIGATION INTO THE 1996 EARNINGS OF PEOPLES GAS SYSTEM

AGENDA: 02/03/98 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: S:\PSC\AFA\WP\971310.RCM
R:\PSC\AFA\123\971310.WK4 - SCHEDULE 1-2

CASE BACKGROUND

In a letter dated July 11, 1996, Peoples Gas System, Inc. (Peoples Gas or Company) stated that any revenues contributing to a return on equity in excess of 12.25% for the calendar year 1996 would be held subject to Commission jurisdiction and disposition. The Company stated that it anticipated its earnings would remain within the authorized range for the remainder of the 1996 calendar year. However, in the event that earnings were above the range, the Company urged the Commission to defer the excess earnings to a later period. According to Peoples Gas, the deferral would provide a longer period of stable rates benefitting its customers.

Nevertheless, in contrast to its prediction that its earnings would remain within the authorized range for 1996, the Company's December 31, 1996 earnings surveillance report (ESR) showed approximately $600,000 of excess revenues based on its 12.25% ROE ceiling.

Staff's recommendation regarding the Company's 1996 earnings was originally scheduled to be heard at the November 4, 1997 Agenda Conference. However, following its review of that recommendation, the Company called staff, stating that it believed that the Company may have erred in its calculation of the $43,000 interest

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reconciliation adjustment in its ESR, based on staff's inclusion of the intercompany payable in capital structure. After a brief review of the additional support submitted by the Company, staff believed that there was merit to the Company's assertion that the Company's $43,000 interest reconciliation adjustment was incorrect. For this reason, staff requested that the Commission defer this item to allow staff more time for an in-depth review. Staff's request for deferral from the November 4, 1997 Agenda Conference was granted.

Upon a more in-depth review, staff is now convinced that the Company's $43,000 interest reconciliation adjustment is incorrect whether or not the intercompany payable was included or excluded from the capital structure. Furthermore, review of the interest reconciliation adjustment uncovered that one of the components of interest expense used to calculate "per books tax expense" was $264,000 of interest on tax deficiencies. Further, by correctly making the mechanical interest reconciliation adjustment, that $264,000 of interest would not be recovered. Based on this finding, the Company requested above-the-line O&M treatment of this amount.

DISCUSSION OF ISSUES

ISSUE 1: What is the appropriate rate base for Peoples Gas 1996?

RECOMMENDATION: The appropriate rate base is $249,983,000. (Schedule 1) (L. ROMIG)

STAFF ANALYSIS: Per the December 1996 Earnings Surveillance Report, the Company reported a total "FPSC Adjusted" rate base of $253,138,000. Based on the adjustments discussed below, the appropriate rate base is $249,983,000 for 1996.

Adjustment 1: Deferred Environmental Costs - Correction of Error - By Order No. 16313, issued July 8, 1986, in Docket No. 850811-GU, Peoples Gas was first authorized to amortize $1.2 million in estimated and projected environmental clean-up costs associated with its manufactured gas production plants over a five year period. The effective date of the new base rates was July 18, 1986. The Company began its amortization in October 1986, which coincided with the first month of its fiscal year. Staff believes the Company should have begun the amortization in August 1986, the first full month in which the new rates were in effect, in order to have a proper matching of revenues and expenses. Therefore, Deferred Environmental Costs should be reduced $40,000, and working capital should similarly be reduced $40,000.

By Order No. 23858, issued December 11, 1990, in Docket No. 891353-GU, the Company was authorized to increase its amortization of environmental clean-up costs from $240,000 to $1,248,000 annually, effective November 1, 1990. In the Company's last rate case (Docket No. 911150-GU), the Staff auditors determined that the Company made an error in calculating the amortization for the fiscal year ended September 1991 by using the wrong monthly amortization amount for 11 months of the historical test year. As a result, the Company understated 1991 expenses and overstated 1996 deferred costs by $220,000.

Based on the above, Staff recommends that the Company be ordered to record additional amortization of $260,000 for years prior to 1996. In addition, Staff recommends that working capital for 1996 be reduced by $260,000 to correct these errors.

Adjustment 2: Conservation and Gas Overrecovery - The Company made adjustments to remove conservation and fuel overrecoveries from working capital, thereby increasing working capital by $1,935,000 and $960,000, respectively. Based on Commission practice, recovery clause overrecoveries are included as reductions to working capital.

In its response to this Staff adjustment, Peoples takes the position that its accounting for PGA/ECCR overrecoveries is consistent with the method used in its last rate case and no Staff adjustment should be made. Upon review of the Company's last rate case, it appears that staff inadvertently failed to make a similar adjustment for overearnings.

Including overrecoveries in working capital is a long standing Commission practice. In Order No. 13537, Docket No. 830465-EI, the Commission reaffirmed its action in this area by stating:

> In Order No. 9273, Docket No. 74680-CI, we determined that interest should be applied to over/under recoveries in order to counter any incentive to bias projections in either direction. If the ratepayer has to provide the interest on both over/under recoveries, the Company will have no incentive to make its projections as accurate as possible.
>
> In FPL's last rate case and in subsequent rate cases involving other electric utilities, we have consistently determined that adjustment clause over recoveries should be included as a reduction to working capital.

In addition, the Commission, in Order No. PSC-93-0165-FOF-EI, Docket No. 920324-EI, stated:

> By stipulation, the Company [Tampa Electric Company] has agreed that the Commission's policy of including net over recoveries in working capital and excluding net under recoveries is the appropriate treatment. Net under recoveries, which are assets, are excluded from working capital, and net over recoveries, which are liabilities, are included. We accept and approve the stipulation. In its filing, the Company incorrectly removed both over recoveries and under recoveries.

Further, the Commission stated in Order No. PSC-94-0452-FOF-GU, Docket No. 930091-GU:

> This would result in the ratepayers providing the interest that the Company [West Florida Natural Gas Company] would return to them. By the same token, unrecovered costs should be excluded from working capital. To include those costs would allow the Company to earn a return on the under recovery plus recover the interest through the recovery clause.

Most recently, in Order No. PSC-97-0136-FOF-GU, Docket No. 970023-GU (Chesapeake Utilities), the Commission stated:

> It has been our policy that these over recoveries should be treated as cost-free liabilities which are used to reduce a utility's working capital allowance. See Docket No. 830012-A. (Tampa Electric Company) and Docket No. 960502-GU (City Gas Company). If over recoveries are not recognized in Working Capital, Rate Base is increased and the utility earns a return on the over recovery. In other words, the ratepayer provides the interest on the over recovery. By including over recoveries as a reduction to Working Capital, a Company will have an incentive to make its projections for the cost recovery clause as accurate as possible and avoid large over recoveries.

As stated in the above orders, the rationale for including overrecoveries as a reduction to working capital is 1) to provide an incentive to utilities to make their projections as accurate as possible, and 2) to protect the ratepayer from paying interest on the overrecovery.

Ratepayers pay interest to the Company on underrecoveries and the Company pays interest to ratepayers on overrecoveries at the commercial paper rate. If an overrecovery is not included in working capital, then the ratepayer is paid the commercial paper rate by the Company but at the same time, the Company is allowed to earn the overall rate of return on the increased rate base. This gives the Company a bonus instead of a penalty when cost overrecoveries occur because the overall cost of capital is higher than the commercial paper rate. Peoples' overall rate of return is

9.27% for 1996 and the average commercial paper rate was 5.70% for 1996. Therefore, the Company earns more than it is paying out. For instance, in this case the Company would earn approximately $432,000 on a higher rate base and pay the customer $165,000 at the commercial paper rate. When the overrecovery is included in working capital, rate base is reduced and the Company must pay interest to the ratepayer at the commercial paper rate. Only in this case is there a penalty to the Company.

Therefore, Staff recommends that working capital be reduced $1,935,000 and $960,000 to include conservation and fuel overrecoveries, respectively. Staff also recommends that all future surveillance reports reflect similar treatment of overrecoveries.

ISSUE 2: What is the appropriate weighted average cost of capital for Peoples Gas for the period ending December 31, 1996?

RECOMMENDATION: Based on the return on equity cap of 12.25%, the appropriate weighted average cost of capital for measuring excess earnings is 9.27%. (LESTER)

STAFF ANALYSIS: Rate base is the utility's investment in plant and working capital and is primarily derived from the assets side of the balance sheet. Total capital represents the sources of capital for the Company and is primarily derived from the liabilities and common equity side of the balance sheet. In reconciling capital structure and rate base, the Company is showing its investment in rate base and how it financed that investment.

Utilities file Earnings Surveillance Reports with the capital structure reconciled to rate base. Typically, sources of funds cannot be traced to uses of funds. Funds are fungible, i.e., interchangeable. Therefore, the Commission usually reconciles differences between capital structure and rate base with pro rata adjustments over total capital. However, under certain circumstances it is appropriate to make specific adjustments to capital structure components. In these cases, specific adjustments are necessary to more accurately reflect the true cost of providing service. After all specific adjustments have been made, any additional adjustment necessary to reconcile capital structure and rate base will be made on a pro rata basis. From the reconciled capital structure, the overall rate of return is calculated and applied to rate base to calculate the allowed net operating income.

In its December 1996 Earnings Surveillance Report Summary, Peoples Gas reconciled capital structure and rate base with specific and pro rata adjustments. The pro rata adjustments were made over all sources of capital. Unusually, these pro rata adjustments were positive, meaning the beginning balance of total capital was increased to match rate base. This occurred because the Company prorated an intercompany payable, amounting to $7,724,000, over all sources of capital. This adjustment is consistent with the treatment allowed by Order No. 23858, issued December 11, 1990, in Docket No. 891353-GU. For the rate case in Docket No. 911150-GU, capital structure and rate base were reconciled with pro rata adjustments over investor sources of capital and customer deposits.

As represented in the rate case in Docket No. 891353-GU, the intercompany payable is an interest-bearing account and is the sum of all transactions that occur between Peoples Gas and any of its non-utility affiliates. This amount was not included as a liability in the calculation of working capital, therefore it increased working capital and was reconciled to the capital structure as a pro rata increase to all sources of capital.

As discussed in Order No. 23858, issued December 11, 1990, the reason for this treatment in Docket No. 891353-GU was that the Company used the intercompany payable to balance the balance sheet for the projected test year, and the pro rata increase in capital was analogous to the pro rata decrease in capital that results when temporary cash investments are removed from working capital. Furthermore, as discussed in the staff recommendation to the Commission in Docket No. 891353-GU, filed October 4, 1990, because the intercompany payable was a balancing amount, at the time of the rate case Staff believed that the payable might not actually exist during the projected test year.

The Company believes the pro rata treatment of the intercompany payable should continue. In a letter to Staff, the Company states that the Commission has historically removed from rate base all intercompany accounts whether payables or receivables. It further states that in every rate case in the Company's history, this adjustment has been made on a pro rata basis over all sources of capital. Finally, the Company notes that specifically identifying the intercompany payable as a source of capital is completely inconsistent with the treatment prescribed in Peoples' last rate case or any previous case.

Staff believes that it is important to distinguish between an earnings review and a rate case. Although each company must file earnings surveillance reports consistent with Commission adjustments in its last rate case, further adjustments are necessary to accurately measure earnings. For example, a Company's last rate case is usually based on a projected test year, but the subsequent surveillance reports are always historical. Also, a rate case may contain amortization of an item that is appropriately expensed entirely during the historical surveillance period.

Staff believes the intercompany payable should be included in the capital structure as short-term debt for the following reasons. First, during 1996, the intercompany payable existed as an interest-bearing amount. That is a historical fact. Unlike the rate case in Docket No. 891353-GU, it is not a balancing entry for projection purposes. Second, the intercompany payable is tied to a specific interest expense. By including the intercompany payable as short-term debt in the capital structure, the Commission will allow the Company to recover its appropriate interest expense. If the intercompany payable is prorated over all sources of capital, it will earn the overall rate of return, which is higher than its interest rate. Finally, Staff notes that the payable was interest bearing. In this respect, it is like any other debt instrument in the Company's capital structure. The intercompany payable supplied funds to the Company that otherwise would be supplied by investors. Therefore, Staff recommends that the Commission include the intercompany payable as short-term debt in the capital structure.

On Schedule 2, attached to this recommendation, Staff included $7,724,000, the amount of the intercompany payable, as a specific increase to short-term debt. Staff calculated the 6% interest rate by dividing interest expense for the year by the amount of the payable.

In order to reflect Staff's adjustment expensing environmental costs, Staff reduced common equity and deferred taxes by $754,000 and $455,000, respectively. The Commission set the Company's return on equity at 11.25%, with a range of plus or minus 100 basis points. (See Order No. PSC-93-1773-FOF-GU, issued December 10, 1993, in Docket No. 931101-GU.) Using the top of the range, 12.25%, for measuring excess earnings, Staff has calculated the weighted average cost of capital at 9.27%.

ISSUE 3: What is the appropriate net operating income for Peoples Gas for 1996?

RECOMMENDATION: The appropriate net operating income is $23,752,098 for 1996. (Schedule 1) (L. ROMIG, C. ROMIG)

STAFF ANALYSIS: Per the December 1996 Earnings Surveillance Report, the Company reported a "FPSC Adjusted" net operating income (NOI) of $24,051,000. Based on the adjustments discussed below, the appropriate net operating income is $23,752,098 for 1996.

Adjustment 3: Overaccrual - IBM Studies - In May 1996, the Company accrued $250,000 to expenses for a study being performed by IBM. According to the Company, the actual cost of the study was $188,600. In March 1997, the Company credited expenses $61,400 to reflect the actual cost. Therefore, it would be appropriate to reduce 1996 expenses by $61,400. (Audit Disclosure No. 3) Peoples Gas agrees with the adjustment.

Adjustment 4: Directors' Fees - Two of the Company's directors, who are also employees of the Company, were paid $2,000 each in 1996 for director fees. Expenses should be reduced by $4,000.

The Commission, in Order No. PSC-95-0964-FOF-GU, issued August 8, 1995, and in Order No. PSC-96-1188-FOF-GU, issued September 23, 1996, denied West Florida Natural Gas and St. Joe Natural Gas, respectively, the allowance of directors' fees for those directors who were already compensated through the payment of salaries. The Commission found it appropriate to reduce expenses for director fees in each of these overearnings dockets. Similar adjustments were not made in prior rate cases or other earnings dockets for these companies.

The Company believes that no adjustment should be made based on the disclosure for the following reasons: 1) the expenses are paid to the employees in recognition of the services performed as directors in addition to their regular duties, and 2) no adjustment was made for these expenses in the Company's last rate case.

Staff believes that it is appropriate to distinguish between an earnings review and a rate case. Although the companies must file their earnings surveillance reports consistent with Commission adjustments made in their last rate case, further adjustments may be appropriate to accurately measure earnings and also reflect current Commission policy. For example, a Company's last rate case is usually based on a projected test year, but the earnings reports are based on historical data. Staff, therefore, recommends that expenses be reduced by $4,000.

Adjustment 5: **Charitable Contributions and Chamber of Commerce Dues** - During the audit of the 1996 surveillance report, a sample of the transactions recorded in the managers' working funds was reviewed for the proper treatment of employee activities or civic/social club dues. Based on this review, it was determined that expenses included $18,767 and $6,040 for charitable contributions and Chamber of Commerce dues, respectively. Since similar adjustments were made in the Company's last case, it would be appropriate to reduce expenses by the above amounts. (Audit Disclosure No.6) The Company accepted the disclosure in its response to the audit report.

Adjustment 6: **Taxes Other Than Income** - Staff auditors reviewed the tax returns and property tax assessments paid by the Company and determined that Taxes Other Than Income is understated by $11,784. This amount is based on two adjustments. First, property taxes should be increased by $8,893 to the amount that was paid in 1996. (The resultant amount recommended is net of maximum discounts available.) Second, Regulatory Assessment Fees should be increased by $2,891 for a credit adjustment relating to November 1995 taxes that was not booked until January, 1996. Because the adjustment was not booked until 1996, the Regulatory Assessment Fees reflected in the general ledger and in the ESR were understated for the calendar year 1996. In its response to the Audit Report, the Company agrees with these adjustments.

Adjustment 7: **Tax Deficiencies** - Subsequent to filing its ESR, staff and the Company determined that through its interest reconciliation adjustment the Company had eliminated consideration in its ESR of the recovery of $264,000 of interest it had paid in 1996 for tax deficiencies of prior years. Following a series of discussions between staff and a Company representative, the Company requested that this amount be "reclassified" as an above-the-line O&M expense. Subsequent to its request, the Company provided staff with information about the deficiencies; copies of the check requests prepared by the Company, with supporting documentation for the tax and interest; several cost/benefit analyses demonstrating that the ratepayers received more benefit than the $264,000 of interest paid out; and the Internal Revenue Code and Treasury Regulation Sections (Internal Revenue Code Section 450 and Treasury Regulations Section 1-451-5) that the Company relied on when it took its position on Customer Advances that eventually led to the majority of the $264,000 interest on the deficiencies.

The interest Peoples paid in 1996 for tax deficiencies was a result of an Internal Revenue Service (IRS) audit of tax years 1988 through 1990. The final settlement of the audit resulted in a net deficiency of tax. The interest was computed on the tax deficiency from the due date of the original tax returns to the date the final settlement was reached and paid. No interest was accrued in anticipation of the outcome of the audit. Therefore, the earliest any part of the interest or the tax liability could have been recorded on the books was in January, 1996 when the final settlement was reached and the Company prepared a check request for payment to the IRS.

Peoples states that:

> The final settlement with the Appeals Division of the IRS included some adjustments of taxable income arising in these years and some adjustments that carried over from previous examinations. The carryover items were primarily depreciation related and resulted in additional deductions in these years. The amount of these net adjustments was an increase to taxable income of $888,144.
>
> The primary issue that was raised in these years related to the timing of income recognition. This item accounted for $783,092 of the $888,144 increase to taxable income. PGS was recognizing advances in advances in aid of construction as taxable income after the end of the second year following the year of receipt if the advance had not been refunded by then. The company believed there was authority for this position in the tax code. The IRS argues that the contribution should be included in taxable income when received, and in the context of an overall settlement that is how the issue was decided.
>
> By virtue of the company taking this position, its customers had the benefit of higher deferred tax balances from the time the tax returns were filed until the deficiency was paid in 1996.

Per conversations with the Company, the net $888,144 is comprised of:

Year	Tax Settlement Deficiencies/("Overpayments")	Deferred Taxes
1988	$ 285,000	$ 107,245
1990	$ 761,000	$ 286,365
	$1,046,000	$ 393,610
1989	(159,000)	
	$ 887,000 (a)	

(a) Rounded from $888,144.

Staff reviewed the information provided by Peoples, paying particular attention to its cost/benefit analyses. The Company's analyses show customer benefits ranging from $203,335 to $297,149. However, without further research and study, staff cannot support the Company's methods that include inflation factors and/or opportunity cost. Nevertheless, staff did its own simple, conservative cost/benefit analysis. Staff's method used the final capital structure schedule from the Company's last rate case (Docket No. 911150-GU, Order No. PSC-92-0924-FOF-FU) as a basis for its analysis and estimated the interest paid per year.

According to the Company, the deferred tax balance in the capital structure of that Order No. PSC-92-9024-FOF-FU) was $394,000 higher because of the Company's position on Customer Advances and other issues, the majority of which relate to Customer Advances. The NOI requirement in that order is $21,539,695. Staff's analysis reduced the deferred tax balance by the $394,000 (thereby reflecting that the Company had paid the income taxes on the Customers Advances and other issues)and moved this amount proportionately to equity and long-term debt. The resulting NOI requirement was $21,583,695, or $44,184 more than reflected in the order. Grossing up the $44,184 by the revenue tax factor approved in that proceeding results in a revenue requirement that is $71,229 greater than the revenue requirement that was approved in that order. For comparative purposes and to reflect four years of interest, Staff believes it appropriate to allocate the $264,000 interest between pre-1992 and the four-year period we are examining. Therefore, for simplicity, we used a simple average of the amount of interest paid per year times the number of years under examination. The result is $176,000 of interest paid for the four years ($264,000/6 years x 4 years). Assuming that this savings was realized from 1992 through 1996, staff calculated the savings to the ratepayers to be $108,916 (($71,229*4)-$176,000).

Staff believes this method of analyzing the benefits to be a conservative approach and that using this conservative approach results in savings to Peoples' customers. Based on the foregoing, staff believes that above-the-line O&M treatment is appropriate.

However, it should be noted that the above-the-line treatment for Peoples is recommended solely upon the merits of staff's cost/benefit results. Therefore, the above-the-line treatment of interest on subsequent tax deficiencies should not be assumed to be appropriate. The appropriate accounting and recovery should be decided on a case by case basis, following the careful examination of the unique circumstances of each underlying position taken by the Company that gave rise to the interest.

Adjustment 8: **Tax Effect of Other Adjustments** - The tax effect of staff's adjustments to net operating income results in a reduction to income taxes of $71,586.

Adjustment 9: **Interest Reconciliation** - The Company made an adjustment of $43,000 to reduce income taxes. The Company intended this $43,000 adjustment to adjust the interest included in the Company's calculation of the per books income tax expense to that interest that is inherent in the Company's adjusted capital structure, i.e., the capital structure that has been reconciled to its rate base. However, upon review and based on staff's inclusion of the intercompany payable in capital structure, staff believes that the Company's interest reconciliation adjustment as filed is incorrect. Per its ESR, the Company included interest of $9,763,000 in its per books tax expense. Then, in its calculation of the interest reconciliation adjustment, it reduced the per books interest expense by the interest on the intercompany payable ($466,000) and the amortization of the debt issuance costs ($87,000), or by $553,000 in total. Adding back the $553,000 in interest, including the intercompany payable in capital structure and reflecting staff's other adjustments to the Company's ESR, results in a calculated interest reconciliation adjustment of $141,911, increasing income tax expense. Consequently, the adjustment that is required to reflect staff's interest reconciliation adjustment and reverse the Company's interest reconciliation adjustment is $184,911($141,911 + $43,000).

<u>ISSUE 4</u>: What is the amount of Peoples Gas' overearnings for 1996?

<u>RECOMMENDATION</u>: The amount of overearnings for 1996 is $947,236 plus interest of $26,336 for a total amount of $973,572. (Schedule 1) (L. ROMIG)

<u>STAFF ANALYSIS</u>: Based on the recommendations in the previous issues the amount of overearnings for 1996 is $947,236 plus interest of $26,336 for a total amount of $973,572. The $26,336 in interest was calculated for the year ended December 1996.

ISSUE 5: How should the $973,572 in overearnings for 1996 be disposed of?

RECOMMENDATION: The $973,572 in overearnings and interest should be credited to the deferred environmental clean-up costs effective December 31, 1996 for earnings surveillance purposes as a reduction to working capital. (L. ROMIG)

STAFF ANALYSIS: By Order No. PSC-92-0924-FOF-GU, in Docket No. 911150-GU, the Company's last rate case, the Commission authorized the Company to amortize $1,248,000 in environmental costs annually based on a 5-year amortization period beginning on November 1, 1990. The Commission then opened Docket No. 931101-GU to investigate the appropriate equity return for Peoples Gas. In Order No. PSC-93-1773-FOF-GU, issued December 10, 1993, the Commission reduced the Company's ROE from 12.00% to 11.25%, plus or minus 100 basis points, beginning January 1, 1994. In the same Order, the Commission ordered Peoples Gas to fully amortize $2,496,000 in environmental clean-up costs by September 30, 1994.

Since then, the Company has incurred approximately $2.5 million in environmental costs. For the year ended December 31, 1996, the Company incurred $1,629,373. As of December 31, 1996 and December 31, 1997, the Company had deferred balances of $2,081,725 and $1,315,494, respectively. The reason for the decrease from 1996 to 1997 was the receipt of approximately $935,000 in insurance proceeds. The current balance should be further reduced $260,000 as recommended under Adjustment 1.

Based on information provided by the Company the environmental clean-up projects are expected to continue for several more years. Currently there are at least eight sites that have been determined to fall under regulatory oversight for possible clean-up of hazardous materials. No estimate of future clean-up costs has been provided at this time.

In prior cases the Commission has disposed of overearnings by crediting the overearnings to the accumulated clean-up costs, most recently doing so in Docket No. 970023-GU, Order No. PSC-97-0136-FOF-GU, Chesapeake Utilities. Staff recommends that it would also be appropriate to apply the $973,572 in overearnings in this docket to the accumulated clean-up costs effective December 31, 1996 for earnings surveillance purposes as a reduction to working capital.

ISSUE 6: How should the Company account for environmental costs?

RECOMMENDATION: The Company should be ordered to expense the $260,000 as a prior period correction (adjustment 1) and credit the $973,572 in 1996 overearnings to the deferred environmental account effective December 31, 1996 for earnings surveillance purposes. The remaining balance of $81,922 should be expensed in 1997. In the future, all environmental costs should be expensed as incurred until the Company formally requests and receives Commission authority to account for these costs using reserve accounting or other treatment. (L. ROMIG)

STAFF ANALYSIS: The Company has been deferring all environmental costs since September 30, 1994, instead of expensing them. "The Company's position supporting deferral accounting was then and remains today, that environmental costs are outside the Company's control in either magnitude or timing, and are so unpredictable and erratic from year to year that deferral accounting is the only appropriate accounting method with which to account for them." The Company also believes that its accounting for these costs is correct and consistent with the method used in its last rate case.

Staff believes that the Company should be expensing these costs because it was allowed $1,248,000 in expenses in its last rate case and does not have the specific Commission authority to defer these costs. Staff reviewed prior Peoples' orders addressing environmental costs and did not find Commission authorization for Peoples to utilize deferral accounting on an ongoing basis.

We believe that the environmental costs constitute a regulatory asset as stated in the Uniform System of Accounts (USoA). Regulatory assets result from rate actions of regulatory agencies. Regulatory assets arise from specific revenues, expenses gains or losses that would have been included in net income determinations in one period under the general requirements of the USoA but for it being probable: 1) that such items will be included in different period(s), for developing the rates the utility is authorized to charge for its utility services.

Generally, for a utility to capitalize or defer costs that would otherwise be expensed under Generally Accepted Accounting Principles (GAAP), a specific Commission finding is required.

As stated in Issue 5, the balance at December, 1997 was $1,315,494. After making the $260,000 correction and crediting the overearnings of $973,572, the remaining balance is $81,922. The Company should expense this amount in 1997 and continue expensing environmental costs as incurred, until it receives Commission authorization to account for these costs differently.

Further, if the Company desires to defer these costs, it should request reserve accounting treatment or other treatment of future environmental costs and request a reasonable monthly accrual. Other gas companies have Commission authority to account for its environmental costs using reserve accounting and a levelized monthly accrual.

ISSUE 7: Should this docket be closed?

RECOMMENDATION: Yes. If no person whose substantial interests are affected by the Commission's proposed agency action timely files a protest within 21 days of the issuance of the order, this docket should be closed. (C. KEATING)

STAFF ANALYSIS: Pursuant to Rule 25-22.029(4), Florida Administrative Code, any person whose substantial interests are affected by the Commission's proposed agency action shall have 21 days after issuance of the order to file a protest. If no timely protest is filed, the docket should be closed.

DOCKET NO. 971310-GU
DATE: JANUARY 22, 1998

PEOPLES GAS SYSTEM, INC

Docket No. 971310-GU

Schedule 1
22-Jan-98

CALCULATION OF 1996 EXCESS REVENUE

Adj. No.			
	NET OPERATING INCOME PER ESR		$24,051,000
	Staff Adjustments:		
3	Overaccrual - IBM studies	61,400	
4	Director Fees	4,000	
5	Charitable Contributions	18,767	
5	Chamber of Commerce	6,040	
6	Taxes Other - Understated	(11,784)	
7	Interest on Tax Deficiencies	(264,000)	
8	Income Taxes	71,586	
9	Interest Reconciliation	(184,911)	
	Total Adjustments		(298,902)
	Adjusted NOI		$23,752,098
	RATE BASE PER ESR		$253,138,000
	Staff Adjustments:		
1	Unamortized Environmental Costs - Correct Errors	(260,000)	
2	Conservation Overrecovery	(1,935,000)	
2	Gas Overrecovery	(960,000)	
	Total Adjustments		(3,155,000)
	Adjusted Rate Base		$249,983,000
	ROR @ 12.25% ROE		x 9.27%
	Maximum allowed NOI		23,173,424
	Achieved NOI		23,752,098
	NOI in excess of authorized ROE		578,674
	NOI Multiplier		x 1.6369
	Revenue in excess of 12.25% ROE		$947,236
	Interest 1/1/96 - 12/31/96		$26,336
	TOTAL EXCESS REVENUE		$973,572

PEOPLES GAS SYSTEM
DOCKET NO 971310-GU

Schedule 2
22-Jan-98

1998 CAPITAL STRUCTURE

		COMPANY ADJUSTMENTS			STAFF ADJUSTMENTS							
	PER BOOKS	SPECIFIC	PRORATA	TOTAL COMPANY	REVERSE COMPANY PRO RATA	SPECIFIC	TOTAL PRIOR TO PRO RATA ADJUSTS	PRO RATA	ADJUSTED	RATIO (%)	COST RATE (%)	WEIGHTED COST (%)
LONG TERM DEBT	82,338,000	(929,000)	3,502,000	84,911,000	(3,502,000)	0	81,409,000	64,656	81,344,344	32.54%	8.97%	2.92%
SHORT TERM DEBT	0	0	0	0	0	7,724,000	7,724,000	6,134	7,717,866	3.09%	6.03%	0.19%
COMMERCIAL DEPOSITS	19,912,000	0	857,000	20,769,000	(857,000)	0	19,912,000	15,814	19,896,186	7.96%	7.00%	0.56%
RESIDENTIAL DEPOSITS	4,010,000	0	172,000	4,182,000	(172,000)	0	4,010,000	3,185	4,006,915	1.60%	6.00%	0.10%
INACTIVE DEPOSITS	36,000	0	2,000	37,000	(2,000)	0	36,000	0	36,000	0.01%	0.00%	0.00%
COMMON EQUITY	118,338,000	(5,848,000)	4,838,000	117,328,000	(4,838,000)	(159,705)	112,327,295	89,211	112,238,084	44.90%	12.25%	5.50%
DEFERRED INCOME TAXES	21,958,000	0	946,000	22,903,000	(946,000)	(100,295)	21,857,705	0	21,857,705	8.74%	0.00%	0.00%
TAX CREDITS-ZERO COST	0	2,887,000	124,000	3,011,000	(124,000)	0	2,887,000	0	2,887,000	1.15%	0.00%	0.00%
TAX CREDITS-WEIGHTED COST	0	0	0	0	0	0	0	0	0	0.00%	0.00%	0.00%
TOTAL	246,589,000	(3,891,000)	10,440,000	253,138,000	(10,440,000)	7,464,000	250,162,000	(179,000)	249,983,000	100.00%		9.27%