FLORIDA PUBLIC SERVICE COMMISSION
Capital Circle Office Center ● 2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

RECEIVED
OCT 23 1997
12:20
FPSC - Records/Reporting

MEMORANDUM

OCTOBER 23, 1997

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

FROM: DIVISION OF AUDITING & FINANCIAL ANALYSIS (REVELL, DRAPER, LESTER)
DIVISION OF ELECTRIC AND GAS (BREMAN)
DIVISION OF LEGAL SERVICES (PAUGH)

RE: DOCKET NO. 971227-EI - FLORIDA PUBLIC UTILITIES COMPANY - INVESTIGATION INTO 1996 EARNINGS OF FLORIDA PUBLIC UTILITIES COMPANY - FERNANDINA BEACH ELECTRIC DIVISION

AGENDA: 11/04/97 - REGULAR AGENDA - PROPOSED AGENCY ACTION - INTERESTED PERSONS MAY PARTICIPATE

CRITICAL DATES: NONE

SPECIAL INSTRUCTIONS: S:\PSC\AFA\WP\971227.RCM
ATTACHMENTS 1 AND 2 NOT AVAILABLE
R:\PSC\AFA\123\971227.WK4 - ATTACHMENTS 3-5

CASE BACKGROUND

Due to the Commission's continuing earnings surveillance program, it was noted in 1995 that the earnings of the Fernandina Beach Division of Florida Public Utilities Company (Fernandina Beach or the Company) were in excess of the maximum authorized return on equity (ROE) of 12.60%. Staff met with the Company, and as a result of that meeting, the Company agreed to cap its earnings at 12.60%. The Company submitted a letter to Staff dated September 5, 1996, in which it also agreed to cap its 1996 earnings at a 12.60% ROE. (Attachment 1) The disposition of any excess earnings was left to the discretion of the Commission. The Company, however, did reserve the right to request alternative dispositions such as additional contributions to its storm damage reserve or the reduction of any depreciation reserve deficiencies. An Audit Report for the 1996 calender year was issued on July 10, 1997. The Company's response to the audit report was received on July 30, 1996.

On October 3, 1997, the Company submitted a letter agreeing with the Staff's calculation of 1996 excess earnings of $132,340, plus interest of $3,679. In addition, the Company requested that the total amount of $136,019 be contributed to the Storm Damage Reserve in Fernandina Beach. (Attachment 2)

DOCUMENT NUMBER-DATE
10933 OCT 23 97
FPSC-RECORDS/REPORTING

DISCUSSION OF ISSUES

ISSUE 1: What is the appropriate amount of rate base for Florida Public Utilities Company-Fernandina Beach Division for determining the amount of excess earnings for 1996?

RECOMMENDATION: The appropriate rate base for Florida Public Utilities Company-Fernandina Beach Division for 1996 is $14,902,638. (REVELL)

STAFF ANALYSIS: Per the December 1996 Earnings Surveillance Report, the Company reported a total "FPSC Adjusted" rate base of $15,243,888. Based on the adjustments discussed below, the Staff recommends that the appropriate rate base is $14,902,638. (Attachment 3)

Construction Work in Progress: Per Audit Exception 3, the Company calculated a 13-month average expenditure of $106,759 on a work order. The Company accrued Allowance for Funds used During Construction (AFUDC) on this amount. The Company also included this amount in the Construction Work in Progress (CWIP) account. To do so provides a double return on the investment. The $106,759 included in AFUDC should be removed from the 13-month average rate base to eliminate the double counting. Per its response to the audit report, the Company agrees with this adjustment.

Working Capital: Per Audit Exception 4, the Company did not follow the Commission's normal procedure of excluding net fuel underrecoveries from working capital. In this instance the amount that should be removed from working capital is $213,168. Per its response to the audit report, the Company recognizes past Commission practice on this issue. While the Company does agree to the amount of excess earnings for the purpose of closing this docket, the Company believes that working capital should be adjusted to zero. The Company also states that it recognizes the Commission's past practice of removing underrecoveries from working capital. However, the Company believes that both underrecoveries and overrecoveries, when they occur, should be excluded from working capital.

Provision for 1995 and 1996 rate refunds: In it's surveillance report, the Company decreased working capital $37,298 on a 13-month average basis for rate refunds related to overearnings. The account contains amounts related to both 1995 and 1996. The amount related to 1995 is $31,606, and the amount related to 1996 is $5,692. These working capital entries should be reversed simply in order to determine the total amount of the excess earnings for 1996.

Application of 1995 overearnings to the Storm Damage Reserve: In December, 1996 the Company transferred $63,506 in accruals for overearnings from the Rate Refunds Pending account to the Storm Damage Reserve account. The Commission, however, accepted the subsequent recommendation of Staff and ordered the increase in the reserve be made effective January 1, 1996. Changing the date of the increase from December 1996 to January 1996 increased the 13-month average balance for this account by $58,621. Since this account is a liability account in working capital, this change had the effect of reducing working capital by $58,621. Therefore, Staff recommends that working capital be reduced by $58,621.

ISSUE 2: What is the appropriate overall rate of return for Florida Public Utilities Company-Fernandina Beach Division for determining the amount of excess earnings for 1996?

RECOMMENDATION: For measuring excess earnings, the appropriate overall rate of return for the Fenandina Beach Division is 9.04% based on the ROE cap of 12.60% and a 13-month average capital structure for the period ending December 31, 1996. (DRAPER)

STAFF ANALYSIS: Staff began with the 13-month average capital structure from the Company's earnings surveillance report for the period ending December 31, 1996. In its earnings surveillance report, the Company removed its investment in Flo-Gas entirely from common equity in a manner consistent with previous cases. The Company specifically identified deferred taxes, investment tax credits and customer deposits.

Staff specifically included the amount of $5,692 as deferred revenue in the capital structure with an effective interest rate of 5.70%. This amount represents excess earnings for the 1996 year. The cost rate on deferred revenue is the 30 day commercial paper rate as stated in Rule 25-6.109, Florida Administrative Code. The treatment of excess earnings as an item in the capital structure is consistent with the treatment of deferred revenue in the recent earnings review of Tampa Electric Company (see Order No. PSC-97-0436-FOF-EI, issued April 17, 1997). Staff reconciled the remaining adjustments to rate base on a pro rata basis over investor-supplied sources of capital. The Commission established the return on common equity for Fernandina Beach as 11.60% with a range from 10.60% to 12.60%. Staff calculated the weighted average cost of capital as 9.04%. (Attachment 4) This is the rate of return used to measure excess earnings.

ISSUE 3: What is the appropriate net operating income for Florida Public Utilities Company-Fernandina Beach Division for determining the amount of excess earnings for 1996? (REVELL)

RECOMMENDATION: The appropriate net operating income of the Fernandina Beach Division for 1996 is $1,427,238. (REVELL)

STAFF ANALYSIS: Pursuant to the December 1996 Earnings Surveillance Report, the Company reported a "FPSC Adjusted" net operating income of $1,385,236. Based on the adjustments discussed below, Staff recommends that the appropriate net operating income is $1,427,238. (Attachment 3)

Refund Provision: In 1996, the Company reduced revenues $5,776 and $74,000, respectively, related to the 1995 and 1996 overearnings. In order to properly determine the amount of 1996 overearnings, these amounts should be included in revenues. Staff is simply reversing these amounts in order to determine the total amount of the excess earnings for 1996.

Medical self insurance expense under allocated: In Audit Exception 5, the Company made an error of $9,900 in the allocation of medical self insurance expenses between the Fernandina Beach Division and Flo-Gas. Flo-Gas is a wholly-owned unregulated subsidiary of Florida Public Utilities Company. The error caused the expenses to Fernandina Beach to be lower than actual expenses by this amount. To reflect the proper amount of expense for Fernandina Beach, expenses should be increased by $9,900. As stated in its response to the audit report, the Company agrees with this adjustment.

Interest income on cash in Working Capital: In Audit Disclosure 3, the Company included interest earning cash in working capital but did not include the related interest income in revenues. In the Company's Modified Minimum Filing Requirements review in Docket 930720-EI, the Commission determined that the interest income should be included in revenues if the interest bearing cash is included in working capital. Therefore, operating revenues should be increased by $1,425. As stated in its response to the audit report, the Company agrees with the statement of facts, but believes it did record the interest income adjustment properly based on Order PSC-0170-FOF-EI, the order for the Marianna Electric Division.

<u>Revenue reduction for imputed negative interest:</u> In the surveillance report, the Company had a negative cash position for the 13 months ending December 31, 1996. Therefore, the Company made an adjustment to reduce revenues of Fernandina Beach by an allocated amount of $6,432. The stated rationale was that if the Company had to add interest income to revenues for any interest earned on a positive cash position, it could impute negative interest earned on a negative balance of cash and make a corresponding reduction to revenues. Staff disagrees with the Company adjustment and recommends that the $6,432 reduction to revenues the Company made because of negative imputed interest be added back to operating revenues. The Company did not pay any interest on the negative balance of cash. The Company should not make reductions to revenue to benefit from this fact. It should be noted that many companies routinely carry negative balances of cash due to aggressive cash management policies. A negative balance of cash does not necessarily indicate cash flow or other financial problems.

In its response to the audit report, the Company agrees with the statement of facts. The Company, believes, however, that the interest income adjustment was reported properly based on Order No. PSC-94-0170-FOF-EI. The section on interest bearing cash in that order states that any interest earned on cash in working capital is to be included in revenues. This order does not address Company adjustments to revenue for imputed negative interest.

<u>Interest Synchronization:</u> This is a fallout adjustment based on the reconciliation of the rate base and the capital structure due to the Staff adjustments to the rate base. In this instance, income taxes should be increased by $6,480.

ISSUE 4: What is the amount of excess earnings for Florida Public Utilities Company-Fernandina Beach Division for 1996?

RECOMMENDATION: The amount of excess earnings for the Fernandina Beach Division for 1996 is \$132,340, plus interest of \$3,679. (REVELL)

STAFF ANALYSIS: Based on the recommendations in the previous issues, Staff has determined that the excess earnings for 1996 are \$132,340, plus interest of \$3,679. (Attachment 5) This represents an earned ROE of 14.16%, which exceeds the maximum authorized ROE of 12.60%.

ISSUE 5: What is the appropriate disposition of the 1996 excess earnings of Florida Public Utilities Company-Fernandina Beach Division?

RECOMMENDATION: The total amount of 1996 excess earnings of $136,019, including interest, should be contributed to Fernandina Beach's Storm Damage Reserve. This amount should be booked effective January 1, 1997, for ratemaking, earnings surveillance, and overearnings review purposes. (REVELL)

STAFF ANALYSIS: During the last overearnings review for this division, the Company requested that the excess earnings be contributed to the Storm Damage Reserve. The Company cited the current disparity of the reserve and accrual levels between its Marianna and Fernandina Beach Divisions. As of December, 1996, the level of the reserve balances for the two divisions are approximately equal. However, Staff agrees that there appears to be a deficiency in the Storm Damage Reserve for Fernandina Beach, even with the addition of the excess earnings for 1995, and that the current annual accrual seems to be inadequate for the purposes of building a sufficient reserve in the short term. Therefore, Staff recommends that the $136,019 of excess earnings be included in the Storm Damage Reserve for Fernandina Beach.

Since the excess earnings occurred during 1996 and interest has only been calculated for that year, Staff is also recommending that the increase be made effective as of January 1, 1997, for all regulatory purposes. This would eliminate the need for the calculation of any additional amounts of interest and would include the increased reserve in the determination of earnings for 1997.

ISSUE 6: 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. (PAUGH)

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.

FLORIDA
PUBLIC UTILITIES COMPANY

P O Box 3395
West Palm Beach
FL 33402-3395

September 5, 1996

Mr Timothy J Devlin Director
Division of Auditing and Financial Analysis
FLORIDA PUBLIC SERVICE COMMISSION
2540 Shumard Oak Blvd
Tallahassee FL 32399-0865

Dear Mr. Devlin:

Florida Public Utilities Company agrees to cap its earned return on equity (ROE) for calendar year 1996 at 12.60% for the Fernandina Beach Electric Division. This cap represents the maximum authorized ROE for this division.

The calculation of the earned ROE will be based on the "FPSC Adjusted Basis" in the Earnings Surveillance Reports for December 1996, using the same adjustments approved in our last FPSC Fernandina Beach rate case. All reasonable and prudent expenses and investment will be allowed in the calculation, but no annualized or pro forma adjustments will be allowed. The calculation is subject to fine tuning by Florida Public Utilities Company and Commission audit.

The disposition of any excess earnings shall be left to the discretion of the Commission. In addition to a direct cash refund, the Company may request consideration of other alternatives such as additional contributions to the storm damage reserve or the reduction of any depreciation reserve deficiencies.

Sincerely,

Darryl L. Troy
Vice President

cc: Jack Shreve, Office of Public Counsel
Wayne Schiefelbein, Gatlin, Woods, et al.
F Cressman, FPU
J Brown, FPU
J English, FPU
G Bachman, FPU
VPRES.DT #2 fpsc-dev-roe.dt

FLORIDA
PUBLIC UTILITIES COMPANY

October 3, 1997

Mr Timothy J Devlin Director
Division of Auditing & Financial Analysis
FLORIDA PUBLIC SERVICE COMMISSION
2540 Shumard Oak Blvd
Tallahassee FL 32399-0865

Re: 1996 Over-earnings - Fernandina Beach Electric Docket No. 97-1227-EI

Dear Mr. Devlin:

With our September 5, 1996, letter (copy enclosed) Florida Public Utilities Company (Company) agreed to cap its return on equity (ROE) for calendar year 1996 at 12.60% for our Fernandina Beach electric operations. This cap represents the maximum authorized ROE for this electric operation. In that letter, the Company also requested that the Commission consider alternatives to a cash refund of any excess earnings. The alternatives to be considered are additional contributions to the Storm Damage Reserve or the reduction in any Depreciation Reserve deficiencies.

The Florida Public Service Commission staff has determined the Fernandina Beach excess revenues for calendar year 1996 to be $132,340, with $3,679 in accrued interest. The Company accepts this figure and requests that the total of $136,019 be contributed to the Storm Damage Reserve in Fernandina Beach. We believe the Storm Damage Reserve to be deficient due to the following reasons.

1. The Company's first attempt to establish a Storm Damage Reserve was in our Marianna Rate Case, Docket No. 880558-EI (1988) Although the Company requested an annual allowance of $54,050 based on damages from Hurricane Kate, the Commission thought this was excessive and reduced the annual accrual to $17,300.

2. The Company again sought to establish a storm damage accrual in our Fernandina Beach Rate Case, Docket No. 881056-EI (1988). We again requested an annual accrual of $54,050 based on our argument in the previous Marianna case, the greater potential for loss due to a 25% larger gross plant investment and a more vulnerable coastal location. The final decision was to allow an annual accrual of $21,625 which was 25% larger than that allowed in the Marianna case.

3. In 1993, the Company again filed for rate relief in the Marianna division. In this Rate Case, Docket No. 930400-EI (1993), we requested the annual accrual be increased to $200,000 from the previous authorized level of $17,300. We also requested the Storm Damage Reserve be capped at $1 million. The reasons for this increase were the impact that Hurricane Andrew (1992) had on electric distribution property and on the insurance industry's coverage rates making it impossible to obtain coverage at a reasonable cost. The Final Order in Docket No. 930400-EI reads:

   "Accordingly, we shall establish a storm damage reserve of $1 million, with the accrual period for the reserve set at 10 years at $100,000 per year." (Order No. PSC-94-0170-FOF-EI, p.23)

4. The current accumulated Storm Damage Reserves in Marianna and Fernandina Beach are as follows:

	Accumulated Reserve	**Annual Accrual**
Marianna	$277,000	$100,000
Fernandina Beach	222,000	21,600

It is apparent from items (1) through (4) that there is a deficiency in the Fernandina Beach accumulated Storm Damage Reserve. We are therefore requesting the 1996 excess revenues and interest of $136,019 be transferred to the Fernandina Beach Storm Damage Reserve.

Sincerely,

Darryl L. Troy
Vice President

Enc: Letter to Mr. Devlin dated 9-5-96
cc:
J. Shreve
W. Schiefelbein
Frank Cressman
Jack English
Jack Brown
George Bachman
Pat Foster
c/fpscroefb.96.dt

ATTACHMENT 3

FERNANDINA BEACH ELECTRIC DIVISION
DOCKET NO. 971227-EI
REVIEW OF 1996 EARNINGS

	As Filed FPSC Adjusted Basis	Remove CWIP from Rate Base [X 3]	Reduce W/C for Fuel Underrecov [X 4]	Provision for 1995 Rate Refund	Provision for 1996 Rate Refund	Additional Storm Damage 1995 Excess Earnings	Underalloc. Medical Self Insurance [X 5]	Interest Income on Bank Balances [AD 3]	Reverse Negative Imputed Interest Income	Interest Reconciliation	Total Adjustments	Total Adjusted Rate Base
RATE BASE												
Plant in Service	$23,689,652										0	$23,689,652
Accumulated Depreciation	8,508,695										0	8,508,695
Net Plant in Service	15,180,957	0	0	0	0	0	0	0	0	0	0	15,180,957
Property Held for Future Use	0										0	0
Construction Work in Progress	165,684	(106,759)									(106,759)	58,925
Net Utility Plant	15,346,641	(106,759)	0	0	0	0	0	0	0	0	(106,759)	15,239,882
Working Capital	(102,753)		(213,168)	31,606	5,692	(58,621)					(234,491)	(337,244)
Total Rate Base	$15,243,888	($106,759)	($213,168)	$31,606	$5,692	($58,621)	$0	$0	$0	$0	(341,250)	$14,902,638
INCOME STATEMENT												
Operating Revenues	$5,689,684			$5,776	$74,000			$1,425	$6,432		$87,633	$5,777,317
Operating Expenses:											0	0
Operation & Maintenance - Fuel	(2)										0	(2)
Operation & Maintenance - Other	1,651,498						9,900				9,900	1,661,398
Depreciation & Amortization	824,613										0	824,613
Taxes Other Than Income	1,415,050										0	1,415,050
Income Taxes - Current	251,724	0	0	2,174	27,846	0	(3,725)	536	2,420	6,480	35,731	287,455
Deferred Income Taxes (Net)	187,487			0							0	187,487
Investment Tax Credit (Net)	(25,922)										0	(25,922)
(Gain)/Loss on Disposition	0										0	0
Total Operating Expenses	4,304,448	0	0	2,174	27,846	0	6,175	536	2,420	6,480	45,631	4,350,079
Net Operating Income	$1,385,236	$0	$0	$3,602	$46,154	$0	($6,175)	$889	$4,012	($6,480)	$42,002	$1,427,238
EQUITY RATIO	43.52%										0.00%	43.52%
OVERALL RATE OF RETURN	9.09%										0.49%	9.58%
RETURN ON EQUITY	12.69%										1.47%	14.16%

ATTACHMENT 4

FERNANDINA BEACH ELECTRIC DIVISION
DOCKET 971227-EI
REVIEW OF 1996 EARNINGS

CAPITAL STRUCTURE AS FILED - FPSC ADJUSTED	Amount	Ratio	Cost Rate	Weighted Cost
Long Term Debt	$5,431,474	35.63%	9.97%	3.55%
Short Term Debt	1,331,579	8.74%	6.19%	0.54%
Preferred Stock	143,062	0.94%	4.75%	0.04%
Customer Deposits	597,462	3.92%	6.57%	0.26%
Common Equity	5,321,426	34.91%	12.60%	4.40%
Deferred Income Taxes	2,017,200	13.23%	0.00%	0.00%
Tax Credits - Zero Cost	724	0.00%	0.00%	0.00%
Tax Credits - Weighted Cost	400,961	2.63%	10.32%	0.27%
Total	$15,243,888	100.00%		9.07%

		Adjustments					
ADJUSTED	Amount	Specific	Pro Rata	Adjusted Total	Ratio	Cost Rate	Weighted Cost
Long Term Debt	$5,431,474		($154,112)	$5,277,362	35.41%	9.97%	3.53%
Short Term Debt	1,331,579		($37,782)	1,293,797	8.68%	6.19%	0.54%
Preferred Stock	143,062		($4,059)	139,003	0.93%	4.75%	0.04%
Customers Deposits	597,462			597,462	4.01%	6.57%	0.26%
1996 Deferred Revenue	0	5,692		5,692	0.04%	5.70%	0.00%
Common Equity	5,321,426		($150,989)	5,170,437	34.69%	12.60%	4.37%
Deferred Income Taxes	2,017,200			2,017,200	13.54%	0.00%	0.00%
Tax Credits - Zero Cost	724			724	0.00%	0.00%	0.00%
Tax Credits - Weighted Cost	400,961			400,961	2.69%	10.64%	0.29%
Total	$15,243,888	$5,692	($346,942)	$14,902,638	100.00%		9.04%

INTEREST RECONCILIATION

	Amount	Cost Rate	Interest Exp.	Tax Rate	Effect on Income Tax
Long Term Debt	5,277,362	9.97%	526,153		
Short Term Debt	1,293,797	6.19%	80,086		
Customer Deposits	597,462	6.57%	39,253		
1996 Deferred Revenue	5,692	5.70%	324		
Tax Credits - Weighted Cost	400,961	5.10%	20,449		
Staff Interest Expense			666,266		
Company Interest Expense			683,485		
Staff Adjustment			17,219	37.63%	6,480

DOCKET NO. 971227-EI
DATE: October 23, 1997

ATTACHMENT 4
PAGE 1 OF 1

ATTACHMENT 5

FLORIDA PUBLIC UTILITIES COMPANY
FERNANDINA BEACH ELECTRIC DIVISION
DOCKET NO. 971227-EI
REVIEW OF 1996 EARNINGS

Adjusted Rate Base			$14,902,638
Achieved Rate of Return	9.58%		
Maximum Rate of Return	9.04%		
Excess Rate of Return		X	0.54%
Excess Net Operating Income			80,474
Revenue Expansion Factor		X	1.6445
Excess Revenues			$132,340