BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Application for a Rate Increase for Marianna electric operations by Florida Public Utilities Company	DOCKET NO. 930400-EI ORDER NO. PSC-94-0170-FOF-EI ISSUED: 02/10/94

The following Commissioners participated in the disposition of this matter:

J. TERRY DEASON, Chairman
SUSAN F. CLARK
JULIA L. JOHNSON
DIANE K. KIESLING
LUIS J. LAUREDO

NOTICE OF PROPOSED AGENCY ACTION

ORDER GRANTING CERTAIN INCREASES

BY THE COMMISSION:

Notice is hereby given by the Florida Public Service Commission that the action discussed herein is preliminary in nature and will become final unless a person whose interests are substantially affected files a petition for formal proceeding pursuant to Rule 25-22.029, Florida Administrative Code.

CASE BACKGROUND

On September 1, 1993, Florida Public Utilities-Marianna Operating Division (FPUC, Marianna, or the company) filed a petition for an increase in its rates and charges and approval of a fair and reasonable rate of return. The petition seeks a permanent increase in Marianna's rates and charges pursuant to Section 366.06(5), Florida Statutes. The petition cites costs associated with increased utility operation costs, increased plant replacement costs and the need for additional plant investment. The requested increase of $857,520 represents an 8.48% return on rate base.

By Order No. PSC-93-1640-FOF-EI, issued November 8, 1993, the Commission voted to suspend the permanent increase and grant an interim increase of $137,172, effective November 18, 1993. A customer service hearing was held in Marianna on November 29, 1993. At the utility's request, this matter was handled as a Proposed Agency Action, as permitted under 366.05(5), Florida Statutes. We considered this matter at the agenda conference on January 18, 1994.

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I. TEST PERIOD, FORECASTS

A. Test Period

We find that FPUC's request for permanent rate relief based on a historical test period of calendar year 1992 and a projected test period of calendar year 1994 is appropriate.

The company used actual data for the 1992 rate base, net operating income and capital structure. It then used this historical data as a basis to project the 1994 test year. The 1992 data has been audited by the Commission Auditors and analyzed by the Commission staff.

The historical test year has the advantage of using actual data for much of rate base, net operating income, and capital structure; however, the pro forma adjustments usually do not represent all the changes which occur from the end of the historical period to the time new rates are in effect. Therefore, this option generally does not present as complete an analysis of the expected financial operations as a projected test year.

The main advantage of a projected test year is that it includes all information related to rate base, NOI and capital structure for the time new rates will be in effect. However, the data is projected and its accuracy depends on the company's ability to forecast. Many companies are not able to forecast accurately enough to use the forecast for setting rates.

The purpose of the test year is to represent the financial operations of a company during the period in which the new rates will be in effect. New rates for FPUC will go into effect 30 days after the January 18 agenda, or about February 17, 1994. Therefore, 1994 is an appropriate test year.

In this Order we have made certain adjustments to FPUC's proposed test years. With the inclusion of these adjustments, we believe that 1992 and the projections of FPUC's financial operations for 1994 are accurate enough to use as a basis for setting rates.

B. FPUC's Forecasts Of Customers, KWH, And KW For The 1994 Projected Test Year

We find that FPUC's forecasts of customers, KWH, and KW for the 1994 projected test year are both reasonable and appropriate.

We have reviewed the load forecast by revenue class and found these forecasts to be consistent with historical growth patterns and with economic conditions anticipated for the FPUC service territory. We also reviewed the billing determinant forecast by rate class and found these forecasts to be consistent with historical growth patterns and anticipated customer and load growth in the test year.

Although we are not making a change to FPUC's load forecast or billing determinant forecast, we do not endorse the methodology used by the company to construct its test year forecast. Typically, a utility will first produce a load forecast by revenue class, and then decompose the load forecast into billing determinants by rate class. The advantage to this process is that the company's sensitivity to variations in economic and demographic forces are more readily measured on a revenue class basis, and that these effects can be passed through to the rate classes by decomposing the load forecast into the rate class billing determinants. FPUC, on the other hand, has chosen to forecast billing determinants directly, and has bypassed the initial load forecast step. The load forecast contained in the MFRs was used only as a check against the billing determinant forecast. This simplification may be appropriate for FPUC because of the stable nature of the company's service territory, and the relatively small number of rate classes.

However, we view this procedural shortcut as inappropriate for larger electric utilities, and do not endorse its use.

II. RATE BASE

To establish FPUC's overall revenue requirements, we must determine its rate base. The rate base represents that investment on which the company is entitled to earn a reasonable return. A utility's rate base is comprised of various components, including 1) Plant-in-Service, 2) depreciation reserve, 3) construction work in progress (CWIP) (where appropriate), 4) property held for future use, and 5) working capital.

A. Appropriate Accounting Treatment For The Hydraulic Production Plant Land

Effective December 1993, the company removed its Hydro - Production plant from service. The company properly removed from rate base its investment in these facilities except for the $1,837 investment in land. Therefore, it would be appropriate to reduce plant-in-service by $1,837 in the projected test year and transfer the cost of this land to non-utility property. The removal of related property taxes is addressed in the net operating income section of this Order.

Therefore, we find that Plant-in-Service shall be reduced by $1,837 in the 1994 projected test year to transfer the cost of this land to non-utility property since this property is no longer used and useful. Any future gains or losses resulting from the sale or other disposition of this property shall be recorded in a deferred credit or debit account until final disposition of the gain or loss is approved by this Commission.

B. Proposed Level Of Plant Additions For 1994

During the review of Marianna's proposed capital additions, it was discovered that a building addition to the general offices in West Palm Beach, and the purchase of an adjacent parcel of land and related paving for an additional employee parking lot, were not going to be added to Rate Base in late 1993 or early 1994 as anticipated and reflected in the MFRs. Since these projects will not be completed when anticipated by the MFRs, the 13-month average for Plant-in-Service is reduced. Therefore, an adjustment to Plant-in-Service for Marianna's allocated portion is necessary.

In addition, construction work in progress (CWIP) should be reduced by $16,202. This CWIP relates to the building addition.

It was originally intended to be placed in Plant-in-Service in late 1993. Due to the revisions to the construction timetable for the building addition, this will not take place until 1994.

Therefore we find that plant additions in 1994 shall be reduced by $96,426, the associated accumulated depreciation reduced by $1,321, the associated depreciation expense reduced by $2,643, and CWIP reduced by $16,202.

C. Requested Level Of Plant-in-Service

Based on the foregoing adjustments to the 1994 projected test year, we find that the appropriate level of Plant-in-Service is $15,909,833 for 1992 and $18,462,783 for 1994.

We examined Plant-in-Service records of the company for 1992 to determine the proper historical year amounts. We found that the historical test year, ending December 31, 1992, was accurate and no adjustments were necessary. The adjustments for 1994 relate to the disposition of the hydro plant and plant additions for 1994.

D. Depreciation Reserve

We find that the appropriate amount of accumulated depreciation is $5,845,931 for 1992 and $6,392,593 for 1994. This is a calculation based on new depreciation rates approved in Docket No. 930453-EI (Order No. PSC-93-1839-FOF-EI, issued December 27, 1993) and adjustments addressed elsewhere in this Order.

E. Requested Level Of Construction Work In Progress (CWIP)

It is the Commission's practice to include CWIP that does not earn an Allowance for Funds Used During Construction (AFUDC) in rate base and to include additional CWIP, that would otherwise earn AFUDC, in an amount needed to assure adequate financial integrity. The company included CWIP in rate base in 1992 and 1994. We believe this is appropriate since the CWIP does not earn AFUDC. We find that $289,255 is the appropriate amount of CWIP for 1992, as proposed by the company. However, the company submitted a revised amount for CWIP based on an analysis of its future construction. This updated analysis results in a decrease of $16,202 in CWIP for 1994 as discussed previously in this Order. Therefore, we find that the appropriate amount of CWIP for 1994 is $21,923.

F. Removal Of Interest Bearing Cash From Working Capital

Ordinarily, we remove interest bearing cash from working capital. The company has indicated that to remove all interest bearing cash would discourage it from investing this cash which it considers a prudent business practice. The company also asserts that to remove all interest bearing cash from working capital would encourage it now or in the future to simply ask its bank to make this cash non-interest bearing so it would not be removed from working capital by the Commission.

As an alternative, the company has offered to include the interest earned on cash in revenues for 1992 and 1994 if the cash is allowed in working capital. This would effectively make this cash non-interest bearing for rate making purposes. We agree that it would be proper to allow cash in working capital, with interest included in 1992 and 1994 revenues. Total operating revenues of the company are discussed in the Net Operating Income section of this Order.

However, we do not agree with the company as to the proper level of cash which should remain in working capital. Our adjustments for 1992 and 1994 reduce cash to the five-year average for the period 1988-1992. We believe that allowing the five-year average of cash in working capital for rate making purposes gives the Company an adequate level of cash. This is approximately 50% of the total cash in working capital.

Therefore, we find that $165,360 shall be removed from working capital for 1992 and that $188,084 shall be removed from working capital for 1994. Revenues shall be increased by $7,664 for 1992 and by $8,461 for 1994 to reflect the interest earned on these funds.

In addition, we find that the company shall include in its future surveillance reports only the five-year average of cash, or the actual amount, whichever is less.

G. Inclusion Of Unamortized Rate Case Expense In Working Capital

The company recorded an asset of $47,800 in unamortized rate case expense for 1994. In calculating the working capital allowance, the company made an adjustment to remove this item from working capital consistent with the Commission's decision in the company's last rate case. (Order No. 21532, issued July 12, 1989)

There have been a number of other cases where the Commission has removed this item from working capital. For instance, the Commission stated in Order Nos. 14030 and 23573 in Docket Nos. 840086-EI and 891345-EI, respectively, that Commission policy is to exclude unamortized rate case expense from working capital. The rationale for this position was to adopt a sharing concept whereby the cost of a rate case would be shared between the ratepayer and stockholder; that is, include the expense in O&M expenses, but not allow a return on the unamortized portion.

This policy is predicated on the concept that stockholders should share in the cost of a rate case. It is true that stockholders "may" benefit from a rate case if increased earnings result. They also benefit when the company reduces its costs, but that does not justify a disallowance.

We believe that the company should be given the opportunity to recover prudently incurred costs. Not including the unamortized portion of rate case expense in working capital is a partial disallowance. It is analogous to allowing depreciation expense, but not allowing a return on rate base. Rate case expense is a cost of doing business not unlike other administrative costs. Further, PSC rules, such as the MFR rule, influence the level of rate case expense.

We believe, that if it is determined that rate case expense is prudent and reasonable, the company should be allowed to earn a return on the unamortized balance. Rate case expense is a necessary expense of doing business in the regulated arena. As such, a utility should be allowed to earn a return on its unamortized balance. Therefore, we find that unamortized rate case expense of $31,896 shall be added to working capital for 1994.

Concurring Opinion on Unamortized Rate Case Expense

Commissioner Lauredo agreed with the result to allow unamortized rate case expense in working capital. However, his decision was based solely on the facts and circumstances involved with this case. He emphasized this result should not be standing Commission policy and that no precedential value should be assigned to his concurrence.

H. Storm Damage Reserve

FPUC has requested a storm damage reserve of $51,912 for the 1992 historical test year and $150,933 for the 1994 projected test year to be included as a credit to working capital. Given our

decision (discussed in the net operating income section of this Order) to reduce the annual accrual from the company's proposal of $200,000 to $100,000, we find that the appropriate amounts to be included in the calculation of working capital to be $51,912 for 1992 and $100,933 for 1994.

I. Requested level of Working Capital Allowance

Based on the foregoing adjustments to working capital, we find that the appropriate amount of working capital is $34,931 for 1992 and $74,529 for 1994.

J. Rate Base

Based on the resolution of all other rate base issues, we find that the appropriate rate base is $10,291,758 for the 1992 historical test year and $12,041,445 for the 1994 projected test year appropriate.

III. COST OF CAPITAL

A. Appropriate Return On Common Equity Capital

To establish a fair overall rate of return, it is necessary that we use our judgment to establish an allowable rate of return on common equity capital (ROE). The company has requested an ROE of 12.35% in its MFR filing. This rate represents the bottom of the range of the last authorized ROE of 13.35% approved by the Commission in FPUC-Marianna's last rate proceeding (See Order No. 21532). We believe that investors' required return on equity for an electric utility of comparable risk to FPUC-Marianna has fallen to a rate lower than the 12.35% requested by the company.

Since May 1989, when we approved FPUC-Marianna's ROE of 13.35%, the yield on Baa-rated utility bonds has fallen 260 basis points, from an average of 10.29% in May 1989 to an average of 7.69% for November 1993. This decline in rates is indicative of the change in market conditions over that period of time. Likewise, equity investors are requiring lower returns under current market conditions. High equity returns are not necessary for investors during times of low interest rates.

Low interest rates do not mean that the risk of companies such as FPUC has changed, however. It is not our belief that FPUC-

Marianna's operations have become less risky. Our determination simply reflects that capital costs have declined since the company's last rate case.

Therefore, we find that the appropriate return on common equity capital (ROE) for FPUC is 10.85%, with an allowed range of plus or minus 100 basis points for ratemaking purposes.

Although interest rates have declined, our decision leaves the risk premiums that investors required in 1989 relatively intact. Risk premiums are the additional returns above the cost of debt that is required by equity investors because equity securities are more risky than debt securities. In 1989, the premium from an average Baa-rated utility debt instrument to the allowed return for FPUC-Marianna was 3.06%. Currently, the premium between the November average rate on Baa-rated utility debt and our decision for the appropriate ROE is 3.16%.

Given projected economic and market conditions, we believe that a 10.85% return will continue to be reasonable. According to DRI's November 1993 Review of the U.S. Economy, the yield on Baa corporate bonds is estimated to average 7.34% in 1994, 7.58% in 1995, and 7.60% in 1996. Therefore, the risk premium discussed above should remain in a relatively narrow range.

B. Zero Cost Investment Tax Credits (ITCs)

FPUC maintains by division, separate records for its zero cost ITCs and the related ITC amortization. The balances and activity in the historical records of the Marianna division appear to be reasonable and have been accepted.

For its 1992 test year, the company used the historical net zero cost ITCs in its capital structure prior to and following reconciliation to rate base, without adjustment. We believe this to be appropriate. For the 1994 projected test year, the company used the 1992 net ITCs adjusted for projected 1993 and 1994 amortization in its capital structure prior to and following reconciliation to rate base. We believe this to be reasonable, despite the fact that the 1994 amortization does not consider the approved January 1, 1994 reduction in depreciation rates, the effect of which is believed to be immaterial.

Therefore, we find that FPUC's requested unamortized zero cost Investment Tax Credits (ITCs) of $7,366 for the 1992 historical test year and $4,300 for the 1994 projected test year are appropriate.

C. Cost Rated Investment Tax Credits (ITCs)

FPUC maintains, by division, separate records for its weighted cost ITCs and the related ITC amortization. The balances and activity in the historical records of the Marianna division appear to be reasonable and have been accepted.

For its 1992 test year, the company used the historical net weighted cost ITCs in its capital structure prior to and following reconciliation to rate base, without adjustment. We believe this is appropriate. For the 1994 projected test year, the company used the 1992 net ITCs adjusted for projected 1993 and 1994 amortization in its capital structure prior to and following reconciliation to rate base. We believe this is reasonable and accept it, regardless of the fact that the 1994 amortization does not consider the recommended January 1, 1994 reduction in depreciation rates, the effect of which is believed to be immaterial.

Regarding cost rates, FPUC's cost rates of 11.19% for the 1992 test year and 10.97% for the 1994 projected test year were based on the respective capital structures, as filed, assuming that ITCs are replacement capital for common equity, preferred stock and long-term debt. The approved cost rates of 9.41% for 1992 and 9.76% for 1994 are based on the approved capital structure and assumes that the ITCs are replacement capital for common equity, preferred stock, long-term and short-term debt. We included short-term debt in the calculation following discussions with the company wherein it was determined that short-term debt is used for construction purposes on a temporary basis, pending permanent long-term debt financing arrangements.

Therefore, we find that the appropriate cost rates are 9.41% for 1992 and 9.76% for the 1994 projected test year. We find that unamortized ITCs of $326,770 for 1992 and $289,700 for the 1994 test year are appropriate as filed.

D. Accumulated Deferred Income Taxes

Consistent with its method of tracking ITCs, FPUC maintains by division, separate records for its accumulated deferred taxes. The balances and activity in the historical records of the Marianna division appear to be reasonable and have been accepted. However, in the 1992 test year, while the company made an adjustment for 1991 out-of-period taxes which increased deferred tax expense by $47,076, it neglected to reflect the corresponding capital structure adjustment to accumulated deferred income taxes.

Consequently, we increased accumulated deferred taxes and decreased common equity by the average, $23,538 ($47,076/2).

For the 1994 projected test period, although the company projected plant additions by project, its 1994 accumulated deferred taxes were projected by trending. We are not making an accumulated tax adjustment to incorporate our Plant-in-Service adjustment. However, to reflect the deferred tax effect of the NOI adjustments, accumulated deferred taxes were increased by $4,423.

Therefore, we find that the appropriate Accumulated Deferred Income Taxes are $1,994,863 for the 1992 test year and $2,052,923 for the 1994 projected test year.

E. Implementation of SFAS 109

In response to SFAS 109, Accounting for Income Taxes, and Rule 25-14.013, Florida Administrative Code, the company restated its accumulated deferred taxes at the current statutory rate. This was accomplished by creating a regulatory asset/deferred tax asset for prior flow-through items and temporary differences, which were not considered timing differences prior to implementation of SFAS 109, and by creating a regulatory liability/deferred income tax liability to reduce the accumulated deferred income tax balance to the current statutory tax rate.

Also, in its filing, the regulatory asset and liability were "collapsed" into its cost of capital schedule. The result is that the amount reflected in its cost of capital, after SFAS 109 implementation, is the same as the amount that would have been reflected without SFAS 109 implementation. Therefore, as intended, the implementation of SFAS 109 is revenue neutral regarding the cost of capital.

Regarding the income statement effect, the company states that prior to implementation of SFAS 109, it historically reported its cost of service income tax expense at the then existing statutory rate. Further, it states that the resulting difference between income tax expense reported for financial purposes and for cost-of-service purposes was recorded below-the-line. Consequently, based on this method of presentation, the customer does not reap the benefit of the flowback of excess deferred income tax or the negative effect of the regulatory asset being written off.

Therefore, we find that the implementation entry appears to be calculated appropriately. However, the amortization of the regulatory asset and regulatory liability created by SFAS 109 is

not reflected appropriately for regulatory purposes. Therefore, we find that the company shall properly reflect the amortization in its cost of service income tax calculations on a prospective basis.

F. Weighted Average Cost Of Capital

The company has filed for an 8.40% cost of capital for 1992 and an 8.48% weighted average cost of capital for 1994. After making several adjustments to the Company's filing, we find that a 7.52% cost of capital for 1992 and a 8.02% weighted average cost of capital for 1994 are appropriate.

We have adjusted the cost rates for three of the sources of capital. We have set the cost of equity at 10.85%. We have updated the cost of short-term debt to 5.66% to reflect the Company's line of credit costs. We reduced the cost rates of the costed ITCs to 9.76% in 1994, due to the approved capital structure and the inclusion of short-term debt. Accumulated deferred income taxes have been increased by $4,423.

In 1992, the company netted all of its treasury stock against its non-regulated investment before removing the non-regulated investment directly from common equity. We believe that a lesser amount of treasury stock should be netted against the non-regulated investment. We believe that the company's treasury stock is related to FPUC as a whole, rather than associated only with the non-regulated operations. After making this adjustment to 1992, we increased the amount of common equity by the same yearly percentages as the company indicated in its response to question seven of staff's second set of interrogatories to calculate the 1994 balance.

The company addressed the practice of removing non-regulated investment 100 percent from common equity. In a letter, the company states that:

> since all cash and credit is on a consolidated basis and Flo-Gas Corporation (the non-regulated affiliate) is an integral part of our credit posture, the funds owed to Florida Public Utilities Company by Flo-Gas Corporation should be proportionately removed from equity and debt for the cost of capital computation purpose.

The purpose of removing the non-regulated investment from equity is that unregulated operations tend to have more business risk than regulated operations, thus increasing the cost of capital for the regulated utility. Therefore, the adjustment is based on

a position that is separate from how the unregulated investment has been financed.

We believe that Flo-Gas Corporation (the non-regulated affiliate) contributes to the financial capacity of the consolidated operations and enhances FPUC's credit worthiness. However, the business risk of Flo-Gas cannot be overlooked. We believe FPUC is the type of company that will manage its operations well whether regulated or unregulated, which will bring about strong credit worthiness, but FPUC's cost of capital would be even less had Flo-Gas been regulated rather than unregulated. Although Flo-Gas contributes to the strength of the consolidated operations, if the investment had been in a regulated electric utility rather than in Flo-Gas, the overall cost of capital would be lower. FPUC's financial risk and credit worthiness probably would not change, but its business risk would be less.

As for FPUC's cost of long-term debt, it should be noted that of the twenty-five companies under Commission jurisdiction in the telephone, electric, and natural gas industries, FPUC's twelve-month average cost of debt is currently the third highest of the twenty-five companies. Therefore, we find that the non-regulated investment shall be removed directly from equity rather than proportionately from debt and equity.

Because we have adjusted the amount of non-regulated investment removeD from common equity, the ratios or percentages of common equity, long-term debt, short-term debt, and preferred stock vary from the company's filing.

IV. NET OPERATING INCOME

A. Allocated Expenses

The company allocates a percentage of its corporate assets and expenses to each of its operating divisions. The general office facilities are located in West Palm Beach. These general facilities contain activities pertaining to the regulated electric, water, and natural gas operations, as well as non-utility merchandising and LP gas operations. In determining the allocation to the Marianna Division, the company removed gas, non-utility and merchandising activities and the remainder was allocated to the regulated electric operations. The Common Plant allocated to Marianna was 11.83% of the total in each plant category with the exception of computer equipment which was allocated at 15.40% of the total. Expenses, depending on the type of expense, are