

MEMORANDUM

September 22, 2015

To: Mayor Brian M. Barefoot

From: Terry Deason

Cc: Vice Mayor Gerard A. Weick
Councilman Richard M. Haverland
Councilman Michael B. Ochsner
Councilman Thomas F. Slater
Town Manager, Robert H. Stabe Jr.

Re: Indian River Shores Sale/Transfer Rate Impact Analysis

You asked me to conduct a preliminary review of the Indian River Shores Sale/Transfer Rate Impact Analysis (“Rate Impact Analysis” or “Analysis”) performed by the City of Vero Beach (“City”) in response to an offer from Florida Power & Light Company (“FPL”) to purchase the City’s electrical system in Indian River Shores (the “Shores” or “IRS”). I would like to provide you my initial thoughts based on my review of the City’s Analysis. Before doing so, I must emphasize that my thoughts and resulting calculations are of a preliminary nature, based on an initial review of summary information primarily obtained from the City’s website under the heading “Estimated NPV of Rate Impact of Shores Transfer,” which is attached as Composite Exhibit “A.” Presumably, this information has been provided to the City’s Utility Commission and will be discussed at an upcoming meeting of that advisory body. I have not had the benefit of an in-depth analysis of the supporting work papers, the benefits of discussions with individuals responsible for performing the Analysis, and no independent investigation into the appropriateness of the analytical approaches and the corresponding assumptions contained therein.

Contrary to its title, the Rate Impact Analysis is not an actual analysis of the rates that may result from a purchase of the Shores electrical system by FPL. A true rate impact analysis would have to be based on the resulting net revenue requirements stated on a per customer basis and a per unit of consumption (kWh) basis. In addition, the benefit of the sales proceeds along with the resulting net cost reductions would need to be part of a true rate impact analysis. The City’s Analysis does not do this.¹ Instead, the City’s Analysis attempts to estimate the “cost” impact on the City’s system as a whole, if the Shores sale to FPL were to be executed. It purports to show that there would be a cost of \$64.5 million on a present value (PV) basis. However, the Analysis suffers from a number of infirmities which causes its conclusion to be questionable. In addition, reliance on this Analysis to estimate the value of the Shores system would be misplaced.

As a general proposition, the value of a utility system should be based upon market considerations, i.e., a willing buyer and a willing seller based on current economics. To the extent the City’s Analysis purports to justify a sales price of \$64.5 million, it is being used for the wrong

¹ You should recall that in November of last year, the City’s Finance Director performed a financial analysis of the impact of losing all electric customers in the Shores without receiving any compensation in return. That analysis, which is attached as Composite Exhibit “B,” showed that impact to be only a 1% increase over current rates.

purpose. Perhaps it is being used for the proposition that the City is unwilling to sell the Shores system because of the belief that there would be adverse rate impacts on remaining City customers. But the City's Analysis does not show what the rate impacts would be. In addition, some of the "costs" included in the City's Analysis do not appear to be legitimate costs to be paid by either FPL or Shores customers. Depending on the assumptions and analytical techniques used, the costs also appear to be overstated. In summary, the City's approach is to ignore the market value based on current economics and base its "ask" of \$64.5 million on a guarantee to recover costs, many of which are either inappropriate or are overstated. Moreover, a purchase price of \$64.5 million to provide this guarantee would never be approved by the Florida Public Service Commission, which must consider book costs and the rate impacts on FPL's existing customers.

The City's Analysis covers five categories of "costs". I will address each one individually.

Cost Categories

1. **General Fund Transfer** – This assumes that the transfer of a portion of electric utility revenue to the City's General Fund is a legitimate cost to provide service. The City's Analysis calculates that IRS customers currently contribute \$473,000 annually in their electric rates to the City's General Fund and seeks to have this continue for 30 more years. However, this raises a fundamental question of fairness: Is it appropriate to ask IRS to continue subsidizing the City's services through their electric rates, even after they leave the system? Beyond the current annual contribution, the City's Analysis seeks to escalate the annual \$473,000 allocation to IRS by 2.5% every year for the next 30 years, which results in a PV over 30 years of \$11.2 million.

The basis for the guaranteed 2.5% annual increase in "profits" is not justified. To achieve this increase, the City would presumably have to incur additional investments and operating costs to earn the incremental revenue. However, these costs would not be incurred after IRS leaves the system. Thus, the City is asking IRS customers to pay more now for costs that would never be incurred for their benefit. As a point of reference, the City is assuming only 0.5% sales growth in its Bulk Power Cost Model.

If this cost category is to be included, a more appropriate calculation would not include any escalation, and should be discounted over an appropriate number of years at an appropriate rate of return. It could also be argued that a period of 30 years could be shortened. For example, the PV of \$473,000 over 10 years discounted @ 10% = \$3.2 million. This assumes that 10 years is adequate time for the City to address its general fund budget, its cost structure and any long term commitments necessary to plan for the departure of the IRS customers. This further assumes that a 10% rate is appropriate since the City refers to this category as "Return on Equity." If a 30 year period as asserted by the City were used, the PV would be \$4.9 million. Using either the 10 year period or the 30 year period and discarding the 2.5% escalation rate results in a substantially lower PV than the City's calculated PV of \$11.2 million.

2. **Outstanding Electric Fund Debt** – This category is also suspect. The outstanding debt is merely a source of capital to fund investments and electric operations. It is not an indicator of the value of the system in a purchase and sale context. To the extent the debt supports assets within IRS that will be sold, the sales proceeds can be used to pay off the debt. As a matter of reference, if the book value of the IRS system is \$3 million, the portion of the purchase price to cover book value is

more than adequate to retire IRS' allocated portion of the outstanding debt and provide a premium of \$0.5 million to the City.

- 3. Non Departmental Fixed Costs** – This category of costs is calculated incorrectly. The City compares the amount of these costs with and without IRS customers. It then takes the costs without the Shores and allocates 8.7% of those costs to IRS, as if they are costs which should be paid by IRS customers (FPL) as part of the purchase price. This defies logic. The correct approach would be to determine the per customer cost of the “with IRS scenario” and per customer costs of the “without IRS scenario.”

This calculation shows the per customer cost of the “without IRS scenario” to be lower than the per customer costs of the “with IRS scenario.” This means that on a per customer basis there are actually savings for the remaining COVB customers. Here is the calculation:

$$\begin{array}{l} \text{Per customer costs with IRS} \} \quad \$8,749,109 \div 34,301 \text{ customers} = \$255 \\ \text{Per customer costs without IRS} \} \quad \$7,289,921 \div 31,324 \text{ customers} = \$233 \end{array}$$

The difference of \$22 per customer multiplied by the 31,324 remaining customers equals savings of \$689,128 per year. Recognizing this amount of annual savings (without the City's 2.5% escalation factor) over 30 years and discounted at 6% equals a PV of savings of \$10.1 million. Over a 10-year period, the PV of savings is \$5.4 million.

- 4. Other Electric Fund Expenses** – This category of cost appears to be more variable in nature. As such, it is suspect as to whether any of these costs should be allocated to IRS. The rationale being that these costs can be adequately managed for the departure of the IRS customers. Nevertheless, the City's calculation is incorrect, just like the Fixed Costs category previously discussed. The City allocates 8.7% of the costs in the “without IRS scenario” to IRS-- once again defying logic. The resulting annual cost allocation to IRS of \$728,538 is then escalated by 2.5% per year to result in a PV over 30 years of \$17.2 million.

If this cost category were to be included at all, the calculation should be done on a per customer basis. Following the same approach as shown in the discussion of the Fixed Costs category, the amount of annual variable costs allocated to IRS would be \$407,000, not \$729,000 as claimed by COVB.

The PV of the \$407,000 should not be escalated by COVB's 2.5% escalation factor nor should it be calculated over a 30-year period. Given that these costs are variable in nature, 5 years would be more than adequate for the City to manage these costs. The PV of the \$407,000 over 5 years discounted at a 6% rate would be \$1.8 million. This is substantially less than the City's calculated PV of \$17.2 million.

- 5. Bulk Power Supply Differential** – This cost category is also suspect. It can legitimately be argued that IRS customers, being served pursuant to a franchise agreement which expires next year, should not be allocated any of these costs as a matter of principle. Beyond principle, there is the fact that the Bulk Power Supply costs are being attributed to the Orlando Utilities Commission (OUC) Revised Contract and the use of a market supplier when the OUC contract expires in 2024.

This raises the question as to why the OUC contract cannot be revised to exclude the IRS load, such that no cost differential would be allocated to IRS.

The City calculates the bulk power supply differential by calculating the cost differential per MWH between the “with IRS scenario” and the “without IRS scenario.” The annual per MWH differential is then multiplied by the number of MWHs forecasted for each year under the “without IRS scenario.” The resulting amounts of annual cost differentials are then calculated as a PV over 26 years. This yields the City’s calculated PV cost differential of \$18.6 million.

If these costs are to be included, a more realistic calculation should be limited to the 7 years over which the revised OUC contract will be in effect. Doing this and accepting the City’s annual differentials for the first 7 years and using a 6% discount rate would result in a PV cost differential of \$14.2 million.

Summary

In an analysis of this sort, there is no one correct answer. However, it is clear to me that the City’s calculated PV of \$64.5 million is overly inflated and results in a per customer cost of almost \$22,000. This is significantly above any acquisition in Florida with which I am familiar.

Another point of reference to analyze the potential impact of the IRS acquisition by FPL would be to use the same five cost categories used by the City and substitute what I believe to be more appropriate values:

General Fund Transfer	\$ 4.9 million
Electric Fund Debt	2.5 million
Non Departmental Fixed Costs	(10.1) million
Other Electric Expenses	1.8 million
Bulk Power Supply	<u>14.2 million</u>
Total	\$13.3 million

In simple terms, this approach shows that a purchase price of \$13 million, as was initially offered by FPL, would fall only \$300,000 short of accomplishing the following:

- 1.) Provide coverage of the current General Fund Transfer for the next 30 years.
- 2.) Provide resources to retire 100% of debt allocated to IRS.
- 3.) Recognize 30 years of fixed cost savings on a per customer basis.
- 4.) Provide 5 years of coverage of the increase in per customer variable costs attributable to the IRS acquisition. To the extent the City could reduce its variable costs more quickly than 5 years, there would be additional benefits for the City that they presumably could pass through to the remaining City customers.
- 5.) Provide for the increase in bulk power costs attributable to the IRS acquisition under the revised OUC contract. If the City could negotiate a provision in the revised OUC contract for the potential loss of the IRS customers, there would be substantial additional benefits for the City that they presumably could pass through to the remaining City customers.