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March 15, 2018

Luly Massaro, Clerk
RI Public Utilities Commission
89 Jefferson Boulevard
Warwick, RI 02888

Re: Interstate Navigation Company – Docket No. 4373 – Earnings Report

Dear Luly:

As you know, this office represents Interstate Navigation Company. Enclosed please find a complete original and one complete copy, together with two redacted copies, of Interstate Navigation Company's Earnings Report for the period ending May 31, 2017. The complete original and one complete copy boldly indicate on the front page "Contains Privileged Information – Do Not Release", as required by Commission Rule 1.2 (g)(3).

Pursuant to Commission Rule 1.2(g)(2), request is made that the Commission make a finding that the information redacted from the Report is exempt from the mandatory public disclosure requirements of the Access to Public Records Act, R.I.G.L. § 38-2-1, et seq. ("the Act").

The grounds upon which this request is made are that the information referred to above is proprietary and confidential and its disclosure would do substantial harm to Interstate Navigation Company's competitive position with competing ferries.

Very truly yours,

Michael R. McElroy

MRMc:tmg
cc: Susan E. Linda
David Bebyn

Interstate/Annual Report/Annual-Massaro20

Docket No. 4373 – Interstate Navigation Co. – Limited Rate Change Application
Service List as of 12/17/15
***Requested to receive hard copy of all pleadings.**

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File an original & nine (9) copies w/: Luly E. Massaro, Commission Clerk Public Utilities Commission 89 Jefferson Blvd. Warwick RI 02888	Luly.massaro@puc.ri.gov; Cynthia.WilsonFrias@puc.ri.gov; Alan.nault@puc.ri.gov;	401-780-2107

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March 15, 2018

Michael R. McElroy, Esq.
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Subject: Interstate Navigation Company FYE May 31, 2017 Earnings Report to the Public Utilities Commission (PUC).

Dear Mike,

This letter is the Interstate Navigation Company FYE May 31st 2017 "Earnings Report". This report provides the earned "Return on Equity" (ROE) informational calculation required to be filed with the Division of Public Utilities and Carrier (DPUC) and the Public Utilities Commission (PUC). This filing requirement is part of the "Settlement Agreement" which is attached as "Appendix A" to the PUC's Order in Docket No. 4373.

The Parameters on How to Calculate Earned ROE

The method for calculating the earned ROE is described in Section III.D.1.a. of the "Settlement Agreement" as follows:

> **"This annual earnings report will calculate the earned ROE from the Company's financial statements on the basis of Generally Accepted Accounting Principles (GAAP)."** See page 4.

The description of how the ROE is calculated is shown on page 5 of the "Settlement Agreement" in Section III.D.1.b. and is as follows:

> **"The return on common equity will be calculated by dividing the net income available for common equity by the common equity applicable to rate base. The common equity applicable to rate base shall be calculated by multiplying the common equity ratio required by this subsection by Interstate's average rate base."** See page 5.

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While rate base is calculated each year by using Interstate's average rate base, the common equity ratio is set based on the capital structure approved in Docket No. 4373 which is shown on pages 4 and 5 of the "Settlement Agreement" in Section III.D.1.b, as follows:

> **"...Interstate shall use the capital structure and associated costs of capital approved by the Commission in this Docket No. 4373."** See page 4.
>
> **"...there will be no adjustments to actual results to recognize or annualize prospective known and measurable changes."** See page 5.

Further descriptions of items included in the earnings for the ROE calculation are shown on pages 6, 8 and 9 of the "Settlement Agreement" in Section IV., and are as follows:

Section IV.A.

> **"All earnings reports required by Section III, above, will include pre-tax profits earned by Interstate's Fast Ferry Athena. The actual pre-tax profit earned by the Fast Ferry Division will be calculated employing the debt service method, as shown on the "Analysis of Revenues and Expenses – Interstate Fast Ferry" in the 2012 Annual Report of Water Carriers filed with the Commission. The debt service will include annual interest and principal repayments on all debt used by Interstate to acquire the operations of Island Hi-Speed Ferry in 2006."** See page 6.

Section IV.D.1.

> **"For the purpose of all earning reports required by Section III, above, Interstate will amortize the actual cost of this rate case over three years. The amortization will be complete on May 31, 2016, and no amortization will be recognized as an expense subsequent to that date."** See page 8.

Section IV.D.3.

> **Sale of MV Nelseco. "The net proceeds from the sale of the MV Nelseco will be amortized on the Company's books of account over five years. The amortization will be included in earnings reports required by Section III, above, and the unamortized balance of the proceeds will be deducted from the Company's rate base in said earnings reports."** See page 9.

Lastly, there is a need to include a calculation of the earnings over 12%. The settlement agreement caps the return on equity at 11% and details the procedure to share these earnings with customers as described in Section III.D.2., and is as follows:

> **"Earnings in excess of 12% will be shared 50% for the stockholders and 50% for the ratepayers. Prior to proposing a method of crediting earnings above**

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the 12.00% threshold applicable to the ratepayers, Interstate will consult with the Division to propose a mutually acceptable method. The agreed upon method will then be filed with the Commission for review and approval. If the parties cannot reach agreement, Interstate shall file its proposal directly with Commission subsequent to consulting with the Division and the Commission will make the ultimate determination." See page 5.

FY 2017 ROE Calculations and Schedules

In preparing this filing for FY 2017 ROE report, I have utilized the same format as the FY 2016 ROE report to calculate earned ROE and any earning above the earnings cap. The FY 2017 schedules conform with all the requirements mentioned above, which include maintaining the capital structure and associated cost of capital approved by the Commission in Docket No. 4373. These requirements break down into six essential calculations as follows:

1. A calculation of the average rate base as required by page 5 of the "Settlement Agreement" in Section III.D.1.b. Schedule DGB-ROE-2.

2. A calculation of the net income available for common equity as required by page 5 of the "Settlement Agreement" in Section III.D.1.b. This calculation will be adjusted for items to be included in the earnings for the ROE calculation which are shown on pages 6, 8 and 9 of the "Settlement Agreement" in Section IV. Interest calculated based on debt supporting rate base will be used instead of actual interest to maintain the requirement of keeping the capital structure of Docket 4373 as required by pages 4 and 5 of the "Settlement Agreement" in Section III.D.1.b. Lastly since the return on common equity is after-tax, a tax with a rate of 34% is also applied. The tax rate is consistent with the capital structure of Docket 4373. Furthermore, the new tax rates recently enacted were not in effect for FY 2017. Schedule DGB-ROE-1.

3. A calculation of common equity applicable to rate base as required by page 5 of the "Settlement Agreement" in Section III.D.1.b. The equity ratio used in the calculation maintains the equity ratio used in the capital structure of Docket 4373 as required by pages 4 and 5 of the "Settlement Agreement" in Section III.D.1.b. Schedule DGB-ROE-1.

4. A calculation of return on common equity as required by page 5 of the "Settlement Agreement" in Section III.D.1.b. This calculation uses the net income available for common equity from calculation 2 above and the common equity applicable to rate base from calculation 3 above. Since calculations 2 and 3 above maintain the capital structure of Docket 4373, this calculation meets the requirement of pages 4 and 5 of the "Settlement Agreement" in Section III.D.1.b. Schedule DGB-ROE-1.

5. A calculation of the earnings in excess of the ROE ceiling is presented using the net income available for common equity from calculation 2 and earnings at the ROE ceiling. The ROE ceiling is calculated using the common equity applicable to rate base from calculation 3 above and multiplying it by 12% as required by page 5 of the "Settlement Agreement" in Section III.D.2. This complies with page 9 of the "Settlement Agreement" in Section IV.D.3. Since calculation 3 above maintains the capital structure of Docket 4373, this calculation meets the requirement of pages 4 and 5 of the "Settlement Agreement" in Section III.D.1.b. Schedule DGB-ROE-1.

6. Lastly, a calculation of ratepayers share of earnings in excess of the ROE ceiling is presented using the earnings in excess of the ROE ceiling from calculation 5 above and multiplying it by 50% as required by page 5 of the "Settlement Agreement" in Section III.D.2. Schedule DGB-ROE-1. The excess earnings are included on the report in the balance of excess earnings. Schedule DGB-ROE-3.

I have completed three compliance schedules and two attachments as follows:

1. A "Earnings Report – Based on Capital Structure-Docket 4373" schedule for FYE May 31, 2017. Schedule DGB-ROE-1.

2. An "Average Rate Base" schedule for FYE May 31, 2017. Schedule DGB-ROE-2.

3. A "Ratepayers Portion of Accumulated Earnings Above 12% ROE Ceiling" schedule for FYE May 31, 2017. Schedule DGB-ROE-3.

4. Attachment-1 "Deferred Regulatory Revenue-Nelseco Sale" showing the Unamortized Balance of the Sale of MV Nelseco for FYE May 31, 2017. This report complies with page 9 of the "Settlement Agreement" in Section IV.D.3.

5. Attachment-2 "Analysis of Revenue and Expenses – Interstate Fast Ferry". This complies with page 6 of the "Settlement Agreement" in Section III.D.1.b and was previously filed with Interstate's May 31, 2017 Annual Report.

Results

My calculations on Schedule DGB-ROE-1 resulted in a return on equity of 119.5% which is higher than the 12% on page 5 of the "Settlement Agreement", Section III.D.2. My calculations resulted in earnings in excess of the 12% ceiling in the amount of $1,536,769. Section III.D.2., of the "Settlement Agreement" states that "Earnings in excess of 12% will be shared 50% for the stockholders and 50% for the ratepayers." Thus, this provision in the settlement states that excess earnings of $768,384 (50% of $1,536,769) for FY 2017 should be used to benefit ratepayers.

The Division, in its review of Interstate's FY 2014 ROE filing, grossed up the earnings by income taxes to provide an excess revenue which was to be shared 50/50. Interstate agreed to reserve the Division's number but did not agree with the Division's final calculation. Section III.D.2., of the "Settlement Agreement" does not mention anything about sharing "excess revenue" but only "Earnings in excess of 12%". Net income is a company's total earnings (or profit). In a basic sense net income is the excess of revenues over expenses. However, for generally accepted accounting principles (GAAP), net income includes all expenses. Net income is calculated by taking revenues and adjusting for the cost of doing business, depreciation, interest, taxes and other expenses. Earnings before tax (EBT) reflects how much operating profit has been realized before accounting for taxes. Considering EBT as bottom line net income or earnings is not consistent with GAAP.

Schedule DGB-ROE-1 shows that adjusted pre-tax operating income on total operations was \$2,733,222. The adjusted pre-tax operating income on Fast Ferry operations, which is included in the calculation for ROE, was \$1,068,996. Therefore, about 40% of the adjusted pre-tax operating income was generated from the Fast Ferry operations. The settlement agreement set the profit subsidy to the Traditional Service at \$481,981.

As a result of the FY 2014 ROE filing, Interstate agreed to maintain a record of excess earnings with the ultimate disposition to be determined later. Schedule DGB-ROE-3 presents the balance of the excess earning as of the end of FY 2017. This results in a total accumulated balance of excess earnings to be shared with ratepayers of \$1,819,710 at the end of FY 2017.

Capital Reserve Proposal

The last issue I would like to cover is the applying of the excess earnings to the benefit of ratepayers as described in Section III.D.2. of the Settlement Agreement. That provision allows for Interstate to consult with the Division to propose a mutually acceptable method. I am proposing, as I did with the FY 2016 ROE filing, to the Division that the total accumulated balance of \$1,819,700 at the end of FY 2017 be placed in a reserve for capital projects. These capital projects would include fixed asset purchases such as new vessels and/or major overhauls of vessels, buildings, ramps, docks, pilings, etc. The ratepayers would be credited when Interstate excludes the depreciation on the appropriate portion of any asset paid for from this reserve. The depreciation would be pro-rated if only a portion of the asset was paid for from this reserve. In addition, any portion of assets purchased from the reserve would be excluded from rate base.

I believe that this Capital reserve makes sense for several reasons. First, there are a few potential capital projects which could funded or partially funded with this reserve. One of these projects is the repowering of the Carol Jean and the Anna C, which we expect will cost well over \$1,000,000. Interstate has recently been notified that it has been awarded a grant from the EPA which should cover a small portion of the cost.

We are also currently rebuilding our loading ramps in Point Judith.

Another project is the potential addition of a new Fast Ferry for the Pt Judith run. The current fast ferry run has been running at full capacity on the high demand runs during the summer.

In addition to the above projects, having this reserve would allow Interstate to purchase assets potentially without the need for financing, saving the ratepayers interest and borrowing costs.

Lastly, the reserve avoids mismatching crediting ratepayers both in time and by service. If the credit flowed back in rates there is mismatching in crediting one set of ratepayers who contributed to the excess earnings to another set who would receive the benefit. In addition to the timing, there is also the question of which service (Fast Ferry or Traditional Service) contributed to the excess earnings.

[redacted]

We hope that the Division and Commission agree that funding a Capital Reserve is the appropriate arrangement. If I can be of any additional assistance, please do not hesitate to contact me directly.

Sincerely

David G. Bebyn CPA
President

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Earnings Report - Based on Capital Structure-Docket 4373
For Fiscal Year Ended May 31, 2017
Interstate Navigation Company

Schedule DGB-ROE-1

		Total
Calculation of Net Income available for Common Equity		
Revenues	Annual Report	$ 15,595,165
Operation and Maintenance Expenses *	Annual Report	11,765,666
Total Depreciation Expense	Annual Report	1,178,354
Pre-Tax Operating Income		2,651,145
Adjustments:		
Fast Ferry Depreciation & Amortization	$168,000 + $94,166 annually	262,166
Fast Ferry Principal	Annual Report-FF Schedule	(157,060)
Fast Ferry Interest	Annual Report-FF Schedule	(232,000)
Excess HL Expenses over settlement of $315K	Annual Report-HL Schedule	28,971
Amortization of Gain on Nelseco	See Attachment-1	180,000
Total Adjustments		82,077
Adjusted Pre-Tax Operating Income		2,733,222
Interest on Debt Supporting Rate Base	Rate Base** X Wtd Debt Cost***	144,832
Adjusted Pre-Tax Income		2,588,390
Income Taxes		880,053
Net Income available for Common Equity		$ 1,708,337
Calculation of Common Equity Applicable to Rate Base		
Common Equity Supporting Rate Base	Equity Ratio**** X Rate base	$ 1,429,738
Calculation of the return on Common Equity and Percentage above ROE Ceiling		
Return on Common Equity	Net Income / CE supp RB	119.5%
ROE Ceiling from Settlement		12.0%
Percentage of Earnings Above 12%	Return on CE - ROE Celing	107.5%
Calculation of Earnings in Excess of ROE Ceiling		
Earnings	Net Income available for CE	$ 1,708,337
Earnings at ROE Ceiling from Settlement	CE supp RB X 12%	171,569
Earnings in Excess of 12%		$ 1,536,769
Per Settlement Section III. D. 2. on page 5		
Customer Share	50% of Earnings in Excess of 12%	$ 768,384

* Operation and Maintenance Expenses above include amortization of Rate Case Expense in compliance with Settlement Section IV.D.1. on page 8

** Rate Base	5,465,361	See Schedule DGB-ROE-2
*** Weighted Debt Cost	2.65%	See Schedule DGB-ROE-2
**** Equity Ratio	26.16%	See Schedule DGB-ROE-2

Average Rate Base
For Fiscal Year Ended May 31, 2017
Interstate Navigation Company

Schedule DGB-ROE-2

Average Rate Base Per Settlement Section III. D. 1. on page 5 & Section IV. D. 3. on page 9

		5/31/2015	5/31/2016	Average
Net Plant	Annual report page 5	$ 8,613,649	$ 7,928,908	$ 8,271,279
Athena				
Plant In Service	Annual report page 12	4,200,000	4,200,000	4,200,000
Accumulated Depreciation	Annual report page 12	1,601,040	1,769,040	1,685,040
Net Plant - Athena		2,598,960	2,430,960	2,514,960
Net Plant Excluding Athena		6,014,689	5,497,948	5,756,319
Accumulated Deferred Income Taxes	AR page 5a	(54,412)	-	(27,206)
Deferred Gain on Nelseco	See Attachment-1	(353,752)	(173,752)	(263,752)
Rate Base		$ 5,606,525	$ 5,324,196	$ 5,465,361

Settlement Capital Structure per Docket 4373

	Percent of Total	Cost Rate	Weighted Cost
Long Term Debt	73.85%	3.59%	2.65%
Common Equity	26.16%	11.00%	2.88%
Total Capital	100.01%		5.53%

Ratepayers Portion of
Accumulated Earnings Above 12% ROE Ceiling
For Fiscal Year Ended May 31, 2017
Interstate Navigation Company

Schedule DGB-ROE-3

		Total
FY 2014 Results	Previously agreed to with Division	$ 135,000
FY 2015 Results	(Revised December 2017)	126,890
FY 2016 Results		789,426
FY 2017 Results		768,384
Balance at May 31, 2017		$ 1,819,700

As result of the FY 2014 filing Interstate's agreed to maintain a record of excess earnings due to the ratepayers with the ultimate disposition to be determined at a later time.

Deferred Regulatory Revenue-Nelseco Sale
Interstate Navigation Company
5/31/17

G/L # 1990

Balance per General Ledger at 5/31/17	(173,752.00)
Balance per detailed analysis at 5/31/17	(173,752.00)
Variance	-

Analysis of Deferred Nelseco Sale Rev:

Balance at 5/31/16	(353,752.00)
	-
Additions	-
	-
Yearly Amortization	180,000.00
	-
Balance per detailed analysis at 5/31/17	(173,752.00)

Analysis of Revenue and Expenses
Interstate Fast Ferry

	Actual FYE 5/31/16	Actual FYE 5/31/17
Revenues:		
Passenger Revenue	$ 2,505,271	$ 2,274,745
Other Revenues (Bar, bike, etc)	132,910	134,378
Charter Revenue	116,200	30,400
Total Revenue	2,754,382	2,439,522
Expenses:		
Salaries and wages	174,705	163,636
Payroll taxes	13,266	12,416
Fuel	242,667	205,485
Maintenance:		
Vessel Maintenance-Athena	141,720	233,106
Lube Oil	9,336	9,457
Other Vessel Expenses	17,147	37,280
Insurance	33,139	33,027
Advertising	65,435	148,258
Bar expense	37,835	45,293
General and Administrative Expense	315	903
Legal and accounting	4,389	375
General office supplies	112	19,326
Gross Receipts Taxes	31,315	31,641
Boat Charter	39,625	39,900
Fees (coast guard, banking, etc)	3,656	1,365
Debt service on $5,600,000:		
Principal	146,960	157,060
Interest	336,956	232,000
Total Expense	1,298,578	1,370,527
Net Income Before Taxes	**1,455,803**	**1,068,996**
Federal Income Tax	455,432	327,934
Net Income	$ 1,000,372	$ 741,062