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March 20, 2002

Ms. Blanca S. Bayó, Director
Division of the Commission Clerk
and Administrative Services
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0870

RE: Docket No. 010949-EI

Dear Ms. Bayó:

Enclosed are an original and fifteen copies of Citizens' Statement of Issues and Positions and Brief for filing in the above referenced file.

Also enclosed is a 3.5 inch diskette containing Citizens' Statement of Issues and Positions and Brief in WordPerfect for Windows 6.1. Please indicate receipt of filing by date-stamping the attached copy of this letter and returning it to this office. Thank you for your assistance in this matter.

Sincerely,

Stephen C. Burgess
Deputy Public Counsel

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Enclosures

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Request for Rate Increase	)	
by Gulf Power Company	)	Docket No.: 010949-EI
	)	Date: March 20, 2002

CITIZENS' STATEMENT OF ISSUES AND POSITIONS AND BRIEF

The Citizens of the State of Florida, through their attorney, the Public Counsel pursuant to and consistent with Order No. PSC-02-0219-PHO-EI, hereby file this Statement of Issues and Positions, and Brief.

BASIC POSITION:

A number of adjustments should be made to reflect a test year that reasonably reflects future operational conditions for Gulf. Between 1990 and 2000, O&M expenses went from $116.8 million [T-594] to $165.1 million [T-596], an average annual increase of $4.8 million. By covering an entire decade, this 10-year annual average covers a wide array of special challenges that a utility encounters from time to time.

Gulf's efficiency during the 1990's mirrored the entire electric industry in Florida, all of which added unprecedented efficiency to their operations. It is no accident that this industry-wide efficiency building took place during a time in which numerous jurisdictions moved into significant restructuring. Each year, some type of restructuring also has appeared to be a very real possibility in Florida. It was under this environment that Gulf demonstrated that it could continue high quality customer service, actually reduce the number of employees, and meet major operational challenges,

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all with an average annual O&M increase of $4.8 million. Now, however, Gulf says it will no longer be able to achieve the efficiencies of the past decade.

Gulf is adding Smith Unit 3, and the Citizens recognize that the costs of Smith 3 force Gulf to seek a rate increase. Accordingly, Gulf has chosen its test year to coincide with the projected in-service date of the new plant.

While the addition of Smith 3 dictated the choice of test year, the salient point is that the projected test year shows a remarkable departure from the efficient operations of the past decade. The Citizens believe that the only reason for this inefficient turn of events is that Gulf seeks rates to be established on its projected numbers.

As the Commission examines this case on an issue-by-issue basis, it needs to remain cognizant of Gulf's projected departure from the norms that the utility itself established over the past decade. For any given excess above the historical norm, Gulf will state a reason for the excess. Much like a large government agency, it is often difficult to disprove the usefulness of any particular proposed project. A utility, like any economic entity, will find a way to spend money if that money is made available.

It is clear, however, that under the threat of competition for the past decade, Gulf was creative enough to find and implement efficiencies. The Commission should not expect Gulf's creativity to disappear in 2002-2003, merely because it is a test year for setting rates.

ISSUE 1: Is Gulf's projected test period of the 12 months ending May 31, 2003 (May 2003 projected test year) appropriate?

OPC: No. The Commission would have received far more reliable data from a historic actual test year, with the projected costs associated with Smith 3 superimposed and a historically-based earnings attrition allowance.

DISCUSSION:

The Citizens concede Gulf's need to cover the costs associated with Smith 3. The Citizens, however, are skeptical of the projections filed by Gulf because they depart significantly from the operating norms of the last decade. Other than the specific effects of Smith 3, there is no valid reason to expect Gulf's situation to vary from that of the past ten years. To properly assess Gulf's needs, the Commission would be served best by using the most recent historic period with an earning attrition allowance, and superimposing the costs of Smith 3. The past operational realities would provide a more credible picture of Gulf's needs than Gulf's projections for the May, 2003 test year.

The difficulty with relying on projected, rather than actual, information was explained by OPC witness Schultz, as follows:

> The Company's presentation of the rate year ended May 2003 was based on its budgeted amounts for the rate year. The use of budgeted information provides significant difficulty in determining what is an appropriate level of future plant and cost of operations. The difficulty arises because the budget is at best a guess as to what is anticipated or what is hoped for.
>
> If the Commission is to rely on the budgets for the applicant in the establishment of rates, then the budget must be in sufficient enough detail to determine whether assumptions used by the company and the costs budgeted by the company are reasonable.
>
> [T-821]

In this case, the Citizens do not believe that Gulf supplied the detail necessary for the Commission to properly examine the utility's assumptions. As Mr. Schultz stated:

> Exhibit HWS-2 is the company's response to a request for the O&M budget in the most detailed format available. (emphasis added) The test year has $31,473,000 budgeted for Plant Crist that can be determined from a review of this document. What is not evident is

how much is payroll, how much is training costs, how much is maintenance, et cetera. There is no detail.

[T-821-822]

Upon asking for the most detailed format available, Mr. Schultz was reasonable to expect greater detail than that shown on Exhibit 43; HWS-2. Mr. Schultz pointed out two examples of cases in which he is currently involved that supply much greater detail as a matter of course:

> I have a railroad client with a revenue of approximately $7 million that has a level of detail that overwhelms the company's most detailed format of budget information provided.
>
> I recently reviewed budgeted costs of a major utility in another rate proceeding that provided far more detail than was provided by Gulf Power in response to my data request, and that information was part of the information actually supplied with the filing itself.
>
> [T-822]

Mr. Schultz voiced his greatest concern because Gulf's projections reflect a significant departure from the historic trends generated over the last decade. Mr. Schultz explained why he made a number of adjustments to reflect the historic trends, rather than Gulf's budget, as follows:

> Historical trends seem to be ignored. This is not appropriate. The company made its choices over the years to spend on maintenance in a manner that they determined was best. They made efforts to contain costs, yet to provide a quality of service that was acceptable to the majority of their customers.
>
> I have made a number of recommendations for adjustments based upon a historical level of spending that was considered sufficient over the past years to provide the quality of service that the company says its customers expect. It would only be appropriate to take into consideration the historical spending which established the rates, when establishing the rates on a going-forward basis, especially when considering the lack of detail in the company's budget. To ignore what the company determined to be sufficient historically

would only suggest that the company has deferred expenses intentionally. By utilizing historical spending, I have taken the position that the historical spending was representative of what is necessary to provide the quality of service that the company has provided.

[T-822 - T-823]

The Citizens agree with Mr. Schultz' conclusion that based on its projections, Gulf has not met its legal burden. Mr. Schultz stated:

> The company has the burden of proof in a rate proceeding, and the so-called detailed budget provided by the company, to me, does not appear to be sufficient support for $201 million of costs.
>
> [T-822]

For all the foregoing reasons, the Citizens believe Gulf's test period of the 12 months ending May 31, 2003 is not appropriate.

Quality of Service

ISSUE 3: Should Gulf be required to establish a mechanism that would provide for a payment or credit to retail customers if frequent outages occur?

OPC: Yes. As Mr. Breman pointed out, customers would be well served by a mechanism that provides a financial incentive to maintain an effective program to curb frequent outages.

Rate Base

ISSUE 7: Should an adjustment be made to transmission and distribution related additions included in Plant in Service?

ISSUE 8: Should an adjustment be made to general plant related additions included in Plant in Service?

OPC ON ISSUES 7 AND 8: Yes. The $162,822,000 of distribution, transmission and general plant additions should be removed.

DISCUSSION:

In his testimony, OPC witness Mr. Schultz recounted the initial support offered by Gulf to support the total construction budget of $413,891,000. Mr. Schultz found adequate detail in the production portion of the construction budget, but concluded that the distribution, transmission and general plant construction budgets were inadequate support. Mr. Schultz testified:

> The Company has the burden of proof for the amount requested for plant. The information included in the Company's filing as justification for additions is not adequate. As mentioned above, the budgeted production additions are listed out by project. The summary provided some indication regarding what the additions are and specific inquiries were possible. The transmission, distribution and general plant additions are not identified by the Company. The Company's failure to provide a description of the $162,822,000 of distribution, transmission and general plant additions is an attempt to shift the burden of proof.

Based on Mr. Schultz' conclusion, OPC recommends the Commission disallow $162,822,000 of distribution, transmission and general plant additions.

ISSUE 9A: Should the deferral of the return on the third floor of the corporate offices be allowed in rate base?

OPC: No. It would be unfair for current customers to be forced to pay the earnings from past years that were deferred because the third floor was not in use during those years.

DISCUSSION:

Section 366.06, Florida Statutes, provides that rates cover costs only for those items that are used and useful in serving the public. The third floor of the corporate office building did not meet that standard, so in 1989 the Commission excluded the third floor from rate base. Instead, the Commission allowed Gulf to defer the earnings from the third floor.

The third floor was initially to be used for storage space, that would serve as additional office space to accommodate Gulf's anticipated growth. [T-796]. That growth in employees, however, never materialized. In 1989, Gulf employed 1,626 people, but in 2000, it employed only 1,319. [T-796]. As a result, the third floor was never converted into the office space that was expected. Instead, the third floor is being used strictly as a storage and supply area.

Gulf is now seeking the Commission to require current customers to pay the deferred earnings over a three-year period. Gulf's suggested treatment would require current customers to pay for something that is not providing service.

To require current customers to pay current rates to make up lost profits from a past period is patently unfair. Gulf was denied a profit on the third floor because it was not in use during that time. Surely, if it was improper to require the customers at that time to pay Gulf a profit for the third floor from 1989-2000, it is manifestly more improper to require the customers of 2002 to pay Gulf a profit for those same years 1989-2000.

Consistent with the foregoing, the Citizens recommend the Commission protect current customers from paying past profits and adjust Gulf's working capital and amortization expense consistent with the testimony of Mr. Schultz. [T-795]. The working capital allowance should be reduced by $2,893,000 and amortization expense should be reduced by $1,157,000.

ISSUE 9B: Should the third floor of the corporate offices be allowed in rate base?

OPC: Only one-half of the third floor of the corporate office should be allowed in rate base.

DISCUSSION:

The Citizens accept the PSC staff audit conclusion that the third floor is currently being used for storage space, and therefore provides some value to the public service. The Citizens, however, would raise two concerns with Gulf's proposed treatment.

The first concern is that the third floor was not initially intended to be used for storage and supply. Initially, the floor was intended to be used as additional office space for Gulf corporate headquarters. As such, the current "storage rooms" occupy space in a near waterfront building whose exterior is finished in a more aesthetic (and more expensive) fashion than would normally be associated with storage space. Gulf's customers do not need such a gold-plated storage area.

The fact of the matter is that the current situation is a result of a miscalculation by Gulf . The use as a storage facility is simply Gulf's effort to make the best of a bad situation. While the Citizens appreciate Gulf's effort to make some use of the office space, the Commission should not lose sight of the fact it was Gulf's decisionmaking which has led to the current circumstance. Gulf should be entitled to recover only the value of comparable storage area. The Citizens have no numbers to offer as a specific adjustment, but continue to believe this merits the Commission's attention.

The Citizens second concern is that in addition to paying for a gold-plated storage area, Gulf's customers are being asked to pay double the gold-plated value. The third floor has not been depreciated in the 12 ½ years since the 1989 PSC order. The depreciable life of the corporate office building is approximately 25 years. [T-644]. Thus, if the entire value of the third floor is depreciated over the remaining life of the building, its depreciation rate will be double the normal life rate. It

would be grossly unfair to current and future customers to double the depreciation rate for a storage area that is already overvalued because it was originally intended to be office area.

In fact, the treatment sought by Gulf has the extraordinary result of charging current customers more for storage space than for office space. Mr. Labrato testified as follows:

BY MR. BURGESS

> Q. If it's 25 years and we've taken the first 12 years and deferred income and have not had any depreciation expense, and then we take those amounts and collect them from future customers, then am I correct that on a rough basis, the third floor is costing the customers about twice as much as either of the other two floors? Is that right?
>
> A. I'm not sure I'm following you.
>
> Q. If you've gone 12 and a half years without a return that has been deferred into the future, 12 and a half years without depreciation that's being deferred into the future, and it's a 25-year life, then we're ending up charging the future customers about double for that floor than we did for the others from this point forward.
>
> A. I don't -- I would agree that it's somewhat more. I'm not sure it would be double.
>
> [T-645]

It should beyond debate that Gulf's current customers should not be forced to pay more for storage than a fair-market value for office space.

The Citizens recommend that the Commission allow Gulf to collect its original depreciation rate for the third floor, and treat the remaining balance in a consistent fashion. Plant should be reduced by approximately $1,900,000 and depreciation expense should also be reduced by approximately half the projected expense for the third floor.

ISSUE 13: Should the capitalized items currently approved for recovery through the Environmental Cost Recovery Clause be included in rate base for Gulf?

OPC: Yes. The Citizens believe that capital items are more appropriately recoverable in base rates. Although they are allowed for recovery in the Environmental Cost Recovery Clause, Section 366.8255(5), Florida Statutes, suggests their incorporation into base rates during a rate case.

ISSUE 16: Is Gulf's requested level of Plant in Service in the amount of $1,966,492,000 ($2,015,013,000 system) for the May 2003 projected test year appropriate?

OPC: No. Plant in Service should be adjusted to reflect Commission decisions on all related issues.

ISSUE 18: Is Gulf's requested level of accumulated depreciation in the amount of $854,099,000 ($876,236,000 system) for the May 2003 projected test year appropriate?

OPC: Adjustments must be made consistent with Commission decisions on related issues.

ISSUE 24: Should any adjustments be made to Gulf's fuel inventories?

OPC: Yes. The coal inventory should be calculated by using the actual average balances for the historical year 2000, plus the in-transit amount requested by Gulf.

DISCUSSION:

This issue involves the difference between theory and practice. Gulf is seeking an allowed coal inventory based on a conservative strategy designed to avert shortage under virtually every conceivable scenario. Gulf witness Robert Moore stated in his rebuttal testimony:

> Based on my experience, it is prudent and in the customers' best interest to maintain an average inventory level of 36 NFL days, which is equivalent to 52 projected burn days. During the test year, this translates to the 695,829 tons that Gulf requested in its MFRs. The coal market is dynamic, and Gulf utilizes stockpile modeling, significant operating experience, market intelligence and sound judgement to set target inventory levels that are sensitive to market conditions, will assure reliability and provide adequate price protection to the customer. It would not be adviseable to arbitrarily use historical data in setting inventory targets for the future, as Mr. Schultz suggests. Inventory levels should reflect not only historical trends, but also experience-based knowledge such as operational and

> capacity factors, changes in economic conditions, fuel markets, weather patterns, reliability, and other additional risks, including those arising out of the events of September 11, 2001.
>
> [T-986]

Mr. Moore is correct that the greater the inventory level, the greater the reliability. That equation is axiomatic. In fact, even if one doubled the inventory that Mr. Moore is seeking, one could just as validly assert that such a doubling would increase reliability above that proposed by Mr. Moore. Such is the nature of the relationship between inventory level and reliability. According to this logic, one could go down the continuum to an infinite inventory level and continue to justify any increase based on increased reliability.

The relevant consideration, however, is Gulf's business practice under actual operating conditions. Once again, this illuminates the problem of setting rates on Gulf's protjection of "best practice" conditions, rather than actual working circumstances. Suppose, for example, the Commission grants Gulf's conservative inventory projection, but at various times Gulf finds it reasonable and acceptable to operate with a lower level of inventory. The result would be that the customers would be paying for something they are not receiving, i.e., a more reliable inventory level.

The solution, of course, is to examine Gulf's business practices during an actual period that Gulf did not anticipate would be used for ratesetting. This would reveal Gulf's actual decisionmaking during normal working conditions. This is the approach taken by Mr. Schultz, as he stated:

> The average amount of coal inventory maintained in the historic test year was 476,481 tons. The Company's request for 695,289 tons plus the in-transit exceeds what should be allowed.
>
> [T-794]

The Citizens believe that Mr. Schultz' approach of examining actual historical results presents a more credible picture of what to expect under actual operating conditions. Once rates are set, Gulf has the discretion to unilaterally determine the inventories that actually will be implemented. The Citizens beieve it is improper to charge customers for an inventory level that does not reflect the likely future practice.

The Citizens recommend the inventory level specified in Mr. Schultz' testimony, with three modifications. The first modification to Mr. Schultz' initial testimony is the allowance of Gulf's entire in-transit amount, rather than the 80% recommended by Mr. Schultz. The second modification is to reverse Mr. Schultz' Plant Scherer adjustment [T-838]. The third modification is the removal of additional allowance of 76,223 tons that Mr. Schultz included for Plant Smith.

As a result of these modifications, the Citizens recommend that the coal inventory be based on the actual 2000 historical amount, plus Gulf's requested in-transit amount.

ISSUE 25: Is Gulf's requested level of Working Capital in the amount of $67,194,000 (69,342,000 system) for the May 2003 projected test year appropriate?

OPC: No. It should be adjusted in accordance with Commission decisions on related issues.

ISSUE 27: Is Gulf's requested rate base in the amount of $1,198,502,000 ($1,227,644,000 system) for the May 2003 projected test year appropriate?

OPC: No. It should be adjusted in accordance with Commission decisions on related issues.

COST OF CAPITAL

ISSUE 29: What is the appropriate amount of accumulated deferred taxes to include in the capital structure?

OPC: The Citizens do not take issue with Gulf's accumulated deferred taxes as a proportionate amount of Gulf's capital structure. The actual dollar amount however, is dependent on the Commission's adjustments to rate base.

ISSUE 30: What is the appropriate amount and cost rate of the unamortized investment tax credits to include in the capital structure?

OPC: The Citizens do not take issue with Gulf's investment tax credits as a proportionate amount of the capital structure. The dollar amount will depend on Commission adjustments to rate base. The cost rate will depend on the allowed ROE.

ISSUE 31: Have rate base and capital structure been reconciled appropriately?

OPC: The Citizens do not take issue with Gulf's method of reconciliation. The actual reconciled amounts of capital sources, however, will depend on the rate base allowed.

ISSUE 35: What is the appropriate ROE to use in establishing Gulf's revenue requirement?

OPC: The appropriate ROE to use in establishing Gulf's revenue requirement is 10.0%.

DISCUSSION:

OPC witness Jim Rothschild concluded that 10.0% accurately represents the cost of common equity for Gulf Power Company. Mr. Rothschild determined Gulf's cost of equity by applying two different versions of the DCF method and two different versions of the Risk Premium/CAPM method [T-170]. Mr. Rothschild employed a constant-growth version of the DCF method, a multi-stage version of the DCF model, a risk premium/CAPM method that compares earned equity return to the inflation rate and a risk premium/CAPM method adding risk premium to debt cost [T-171-173].

Mr. Rothschild described his first method, the constant growth DCF method, as follows:

> One of the two versions of the DCF method I used is based upon the commonly used simplified, or constant growth, or single-stage

> version of the DCF model. This version determines the cost of equity by summing the dividend yield and a future expected growth rate. This constant growth version of the DCF model only produces a valid result if the value used for the growth rate is reasonably representative of investors' future expectation of a constant growth rate for earnings, dividends, book value, and stock price. As will be explained later in this testimony, should the growth rate used in this constant growth formula not be representative of the anticipated growth rate for any one of these factors, then this simplified version of the DCF method should not be used because it will produce a result that is not a valid indicator of the cost of equity.
>
> [T-171]

In applying the constant growth version, Mr. Rothschild emphasized the overriding importance of using a growth rate that accurately represents the constant growth rate for dividends, earnings, book value and stock price. Mr. Rothschild stated:

> The derivation of the constant growth formula is based upon the principle that investors buy stock solely for the right to future cash flows obtained as a result of that ownership. The cash flows are obtained through dividend payments and/or stock price appreciation. The constant growth version of the DCF formula will accurately quantify investors' expectations only if investors expect the dividend yield (defined as dividend payment divided by stock price) and the growth in dividends to best be estimated at one constant growth rate for many years into the future. The dividend yield and growth rate that are used in the constant growth formula must be selected carefully.
>
> [T-184]

Mr. Rothschild described three specific circumstances under which the respective growth rates may not be equal, and he explains how under each circumstance the DCF method would result in an inaccurate determination of the actual cost of equity [T-184-188]. To assure that the constant growth rate variable used in the DCF will result in a consistent constant growth rate indicator for dividends, earnings, book value and stock price, one is best served using the "$b \times r + sv$" formula,

wherein: b is the earnings retention rate; r is the future expected return on book equity, and sv is a factor for sustainable growth caused by the sale of new stock. Mr. Rothschild explains in detail why this "$b \times r + sv$" formula best ensures that a reliable constant growth rate variable is used in the constant growth version of the DCF. [T-191-192]. Mr. Rothschild then explained how he implemented the constant growth DCF method, and described in detail the derivation of each component of the process [T-198-204]. He followed by describing his implementation of the multi-stage version of the DCF method [T-204-207].

Mr. Rothschild applied these two versions of the DCF method to the same group of electric distribution companies that was chosen as being representative by Gulf witness Mr. Benore [T-170]. The result of Mr. Rothschild's application of the DCF method was an indicated cost of equity for the subject utilities ranging between 8.86% and 10.36% [T-207]. These results are displayed in composite exhibit 28; JAR-2.

Mr. Rothschild next applied an inflation risk premium method, describing it as follows:

> I implemented the inflation risk premium method by adding investors' current expectation for inflation to the long-term rate earned by common stocks net of inflation. This result was modified, based upon beta, to obtain a result that was compatible with the risk of the average gas distribution utility.
>
> [T-209]

Mr. Rothschild explained how it is possible to guage investors' expectations for inflation:

> It has recently become possible to analytically determine investor's expectations for inflation. The U.S. government has issued inflation-indexed treasury bonds. The total return received by investors in these bonds is a fixed interest rate plus an increment to the principal based upon the actual rate of inflation that occurs over the life of the bond. These bonds pay a lower interest rate simply because investors know that in addition to the interest payments, they will receive the

> allowance for inflation as part of the increment to the principal. This is in contrast to conventional U.S. treasury bonds. The principal amount of a conventional bond does not change over the life of the bond. Therefore, whatever allowance for inflation investors believe they need can only be obtained through the interest payment. By comparing the interest rate on conventional U.S. treasury bonds with the interest rate on inflation-indexed U.S. treasury bonds, the future inflation rate anticipated by investors can be quantified.
>
> [T-211, 212]

Based on the inflation expectations of investors, Mr. Rothschild determined an indicated inflation premium cost rate of 7.67% to 8.03% [T-213]. The results are displayed on composite exhibit 28; JAR-9.

Mr. Rothschild's final method - the debt risk premium method - was described as follows:

> As shown on Schedule JAR 10, I separately determined the proper risk premium applicable to long-term treasury bonds, long-term corporate bonds, intermediate-term treasury bonds and short-term treasury bills. In this way, the debt risk premium method I present considers a wide array of data points across the yield curve. In this way, the results are less impacted by a temporary imbalance that may exist in the debt maturity "yield curve".
>
> [T-213]

Mr. Rothschild engaged in a detailed analysis of historical equity risk premiums. His analysis supports the conclusion of Federal Reserve Chairman Alan Greenspan, "[t]hat equity risk premiums have generally declined during the past decade is not in dispute." [This quote excerpted from an October 14, 1999 speech by Mr. Greenspan; T-208].

The result of applying the risk premium/CAPM method indicates a cost of equity of approximately 8.90%.

Based on the application of all four of the methods, as well as his analysis of the merits and weaknesses of each one, Mr. Rothschild concluded that Gulf Power's cost of equity is 10.0%. Mr. Rothschild further applied various judgments throughout the process that assure the 10.0% is, in his words, "conservatively high." [T-174]

Gulf Power witness Mr. Benore also testified on the proper authorized ROE for Gulf. Unfortunately, Mr. Benore's testimony "contains serious errors in the implementation of the equity costing methods he has presented." [T-166, 167]. The most serious error in Mr. Benore's approach is his insistence that the ROE be authorized with an intent of maintaining the publicly-traded stock price when it is in excess of its book value. This approach has been addressed explicitly and rejected unequivocally by both the FERC and the FCC.

The FCC rejected this argument when raised by Ameritech, stating in an excerpt cited by Mr. Rothschild:

> ...Ameritech places great reliance on its perception that unless this Commission applies the market-derived rate of return to its equity base, stockholders will see a massive decline in the value of their stock. It is true that prescription of a rate of return based on market data could lead to a decrease in the value of the stock if investors have been expecting continuation of a previously-authorized higher rate of return. On the other hand, a reduced rate of return might have no impact on stock price if, as often happens, the reduction had already been anticipated and discounted by the market. In any case, the requirement that we balance ratepayer and investor interests does not allow us to insulate investors from a diminution in the value of their stock (if in fact we could do so). In any event, if we prescribed a rate of return above that which market data showed to be reasonable, investors would increase their expectations as to the carrier's rate of return, market value would increase, and the carrier would seek a higher rate of return authorization so that these higher expectations are not thwarted. We would be remiss in our responsibilities to balance ratepayers' and investors' interests if we implemented procedures that effectively insulated a carrier from

> experiencing a decrease in its authorized return. Thus, our current market-based rate of return procedures meet the Bluefield/Hope criteria notwithstanding that their application herein may adversely impact carriers' high market-to-book stock ratios.
>
> Moreover, market-to-book ratios greater than one have been viewed traditionally as possible indicators that the company's return is greater than its required return.
>
> (FCC-90-315, P. 15.)
>
> [T-179]

Mr. Rothschild also cited an opinion from the FERC which likewise rejected the notion that a regulatory agency is obligated to maintain the market price of a utility's common stock. The FERC firmly rejected this approach, commenting on the circularity of the argument and implying that it violates the benchmark regulatory case of Hope Natural Gas Co.. Mr. Rothschild quoted the following pronouncement from FERC:

> Specifically, they claim that when a utility's market-to-book ratio is above one, applying a DCF-based allowed rate of return to a book value rate base results in earnings that are too low. Conversely, when a utility's market-to-book ratio is below one, applying a DCF-based allowed rate of return to a book value rate base results in earnings that are too high. Both commenters argue that the allowed rate of return should be applied to a market value rate based rather than to book value.
>
> The following example demonstrates the circularity of their claim. Equity capital costs generally rise as interest rates rise. Conversely, equity capital cost rates generally fall as interest rates fall. During periods of rising equity costs, utilities generally file for rate increases to cover these higher costs. This action protects utility shareholders from declines in the value of the stock. The result is a tendency to maintain a utility's existing market-to-book ratio during periods of rising equity costs.
>
> During periods of falling capital costs, the revenue required to meet shareholder capital costs requirements also declines. Until a utility

files for new rates at the lower capital cost, it continues to charge rates based on the higher equity capital costs that existed when the current rates were set. The result is a tendency for the utility to earn more than its shareholders currently require and a concomitant increase in the price of the utility's common stock and market-to-book ratio.

When capital costs are below those of the previous filing, applying the allowed rate of return to a market value rate base would perpetuate the unnecessarily high revenues at the expense of utility's customers. Applying the allowed rate of return to a book value rate base would reduce revenue to the level required by shareholders at the new lower cost of equity. These revenues will provide the utility with an opportunity to recover all costs including the cost of capital.

The argument over the application of an allowed rate of return to a market value rate base is an old one and the problem of circularity inherent in that approach has been long and widely recognized. The Suupreme Court's statement in Federal Power Commission v. Hope Natural Gas Co. that "rates cannot be dependent upon 'fair value' when the value of the going enterprise depends on earnings under whatever rates may be anticipated" reflects its recognition of that problem. The market value of an enterprise or its common stock depends upon its earnings or anticipated earnings, which in turn depends upon the rates allowed. Thus, market value is a result of the ratemaking process and may not properly be the beginning of the process as well.

Docket RM87-35-000, P. 3348 of the Federal Register/Vo. 53, No. 24, Friday Feb. 5, 1988. Emphasis added.

[T-176-178]

Clearly, the fundamental theory underlying Mr. Benore's approach is held in ddisrepute by both FCC and FERC. The circularity noted by FERC is further explained by Mr. Rothschild:

What Mr. Benore calls his DCF method is really a round-about series of computations that, once distilled to their true essence, do not compute the cost of equity. Mr. Benore starts out with what he calls a "standard" DCF method, which is the familiar dividend yield plus growth approach. This would result in the cost of equity demanded by investors if the dividend yield and growth rate were properly

determined. Leaving aside for the moment the very serious mathematical and conceptual errors he made in applying the "standard DCF", he totally destroys what the DCF model is intended to do when he converts his "standard DCF" result into what he calls his "End-Result DCF".

[T-222]

And:

The "End-Result DCF" is not a DCF method at all. Instead, it is a direct attempt on the part of Mr. Benore to set the return on equity high enough so that the current market price would be maintained whether or not that market price is the result of either excessive or deficient earnings prospects. The erroneous nature of this "End-Result DCF" is perhaps best illustrated by noting that by this end-result method, the higher the stock price of a utility company, the higher the return on equity he would recommend. In other words, Mr. Benore's approach to the DCF method provides an answer that is exactly the opposite of reality.

[T-224]

And further:

Mr. Benore's End-Result DCF fails the end result test. Assume, hypothetically, that a utility commission made a mistake by allowing a utility company a return on equity higher than the cost of equity. These excessive earnings would make the stock price of the utility company rise because new investors would be anxious to share in the windfall profits that would be expected to result from the commission's error. Under generally accepted regulatory principles, what should happen when a commission sets the return on equity too high is that in the next rate case, the commission should evaluate market data to recognize that the allowed return was too high. Once the excessive return was identified, the need to balance the interests of ratepayers and investors should lead the commission to lower the allowed return to the level that reflects current market conditions. However, under Mr. Benore's approach, this re-adjustment process would be negated. Under his scheme, once the stock price of a utility company gets too high (whether it is because of a commission mistake or a drop in capital cost rates causing the expected return on book equity to be higher than the cost of equity), he advises the

Commission to keep the stock price at its excessive level. His method effectively treats the allowed return as a one-way ratchet. It could go up, but it could not come down since any lowering of the allowed return could result in a decline in the stock price.

[T-225]

And finally:

The source of Mr. Benore's confusion is that he has juxtaposed the expected return on book equity with the cost of equity demanded by investors. Consider how superfluous regulation would become if Mr. Benore's beliefs were to be adopted. Assume a utility company is allowed a cost of equity of 15% back in a time when inflation and interest rates are very high. Then, assume the utility company begins to earn 15% on its book equity just as inflation and interest rates decline significantly. The logical response on the part of those investors who expected the 15% earned return to continue would be to bid up the stock price. The proper response on the part of regulators would be to recognize that when capital cost rates decline, it is necessary to lower the cost of equity even though lowering the cost of equity below 15% would cause rational investors to reconsider the stock price they are willing to pay. A lowering of the 15% prior equity cost allowance down to current equity cost levels would cause the stock price to return closer to the level it was prior to the time the utility company's stock rose due to the high earnings level. Yet, Mr. Benore's philosophy would never provide a mechanism for the allowed return on equity to be lowered irrespective of what happens to the cost of equity. Once investors' expectations for excessive profits is built into the stock price, he would have the allowed return on equity set high enough so that the excess profits and therefore the resulting high stock price would be maintained. His process would protect stockholders from a potential decline in stock prices, but would fail to balance the interests of investors and ratepayers because it would force ratepayers to support a return on equity that was higher than the current cost of equity.

[T-228]

In summary, Mr. Rothschild concluded the following:

I have shown that Mr. Benore's approach to the DCF method contains many substantive errors in mathematics and financial theory. The

> principles he relied upon to formulate his method have been rejected by the U.S. Supreme Court, FERC, the FCC, and most recently the Appeals Court in Illinois. Therefore, the Commission should give no weight to his DCF approach.
>
> [T-237]

In addition to the problems with Mr. Benore's "end-result" DCF method, Mr. Benore's CAPM method also suffers from fundamental flaws. Mr. Rothschild enumerated the major flaws as follows:

> The very serious problems with Mr. Benore's CAPM method are numerous:
>
> 1) The continued use of the flawed end-result adjustment.
> 2) The repetition of the errors in his standard DCF.
> 3) The use of arithmetic historic growth rather than compounded, or geometric growth.
> 4) The assumption that risk premiums today are the same as they were in the past.
> 5) The mistake of treating 30-year treasury bonds as if they were a risk-free investment.
>
> [T-238]

Mr. Rothschild then explained each of these problems in turn [T-238-253]. Just as with his DCF method, Mr. Benore's CAPM suffers from too many serious fundamental errors to be reliable. The Commission should not give any weight to Mr. Benore's CAPM approach.

Finally, Mr. Benore relied on a comparable earnings analysis. Once again, however, Mr. Benore's methods fail to recognize market realities and regulatory principles. The fundamental error with this approach is that it fails to distinguish between the required return (or cost of equity) and the earned return on book equity. The two are entirely different concepts and the comparison does

not provide a valid basis for setting rates. Mr. Benore's reliance on this analysis is misplaced, as Mr. Rothschild testified:

> Mr. Benore says that the comparable earnings method is the most widely used approach after the DCF model. From my experience, that is inaccurate. Out of the hundreds of cases in which I have testified, I do not recall even one in which a commission stated that it gave any weight to a method that merely assumes that the future expected return on equity is somehow equal to the cost of equity.
>
> Mr. Benore claims that the comparable earnings method is supported by U.S. Supreme Court decisions. I disagree. Mr. Benore is taking concepts out of context. To reach this conclusion, he must ignore capital attraction standards, and numerous other concepts expressed in the decisions.
>
> [T-255]

Mr. Rothschild goes on to point out other errors in Mr. Benore's reliance on his comparable earnings analysis [T-255-257]. The comparable earnings test simply does not provide the Commission with a valid means of setting the cost of Gulf's common equity.

Based on the foregoing conceptual errors, flaws and problems with Mr. Benore's analyses, the Commission should not rely on them for establishing the authorized ROE. Rather, the Commission should adopt the conservatively high 10.0% determined to be reasonable by Mr. Rothschild.

ISSUE 37: What is the appropriate authorized range on ROE to be used by Gulf for regulatory purposes on a prospective basis?

OPC: Based on an ROE of 10.00% and Gulf's revised imbedded cost rates and capital structure, the overall cost of capital is 7.07%.

ISSUE 40: Should the Commission accept Gulf Power's modified zero based budget as support for the requested increase?

OPC: No. Gulf's budgeting process has resulted in numerous illogical results, (see e.g., issues 64, 65, 66, 67, 68, 71A). Many account balances have been in a constant gradual growth pattern for years only to expand by an unprecedented increase in the projected test year.

DISCUSSION:

Gulf's budgeting process has resulted in numerous illogical results, (see e.g., issues 64, 65, 66, 67, 68, 71A). Many account balances have been in a constant gradual growth pattern for years only to expand by an unprecedented increase in the projected test year. Any utility has the ability to "load up" the test year for setting rates, but the Commission must decide whether the projected activity will be the new norm. In other words, Gulf has the discretion to unilaterally decide to engage in the activity projected for the test year, but that fact alone does not make those activity levels representative of Gulf's ongoing future needs.

ISSUE 41: Is Gulf's requested level of O&M Expense in the amount of $182,419,000 ($186,354,000 system) for the May 2003 projected test year appropriate?

OPC: No. OPC is recommending a number of adjustments on specific issues involving O&M. The aggregate O&M expense level should reflect the Commission's decisions on all related issues.

ISSUE 48: Should an adjustment be made to advertising expenses for the May 2003 projected test year?

OPC: Yes. Jurisdictional advertising expense should be reduced by $539,000 to remove image enhancing advertising expense.

DISCUSSION:

It is a long-held Commission practice to disallow advertising expenses spent for corporate image building by any regulated Florida utility. At the heart of this Commission practice is the recognition that by being economic captives of a monopoly, utility customers cannot exercise a

choice to obtain service elsewhere. There is no public need for the utility to try to enhance its image through advertising, and there certainly is no public good served by forcing customers to pay for such advertising.

In this case, however, Gulf is seeking the Commission to reverse this long-held policy. Gulf is seeking $1,144,952 in advertising expenses, which includes $550,221 for advertisements which are exclusively image-enhancement in nature. [T-767]. Examples of these types of image enhancement were detailed by OPC witness Kimberly Dismukes, who testified:

> For example, in response to OPC's POD 12, Gulf provided examples of the types of ads that have been disallowed in the past. The first example is an advertisement about reliability and talks about how different families use electricity. At the end it states, "A morning made possible by Gulf Power. Our proven reliability creates dependable relationships." The next example is similar, however, in it different families use electricity in the evening. At the end of the advertisement it states: "An evening made possible by Gulf Power. With some of the lowest rates in the country, it's what we call a valuable relationship." The third example, a TV ad, has a Gulf Power employee in a bucket truck, with a voice saying: "With the lowest rates in Florida, we make the power that puts you in control. Gulf Power and you. A valuable relationship. We stay on the go so you're not left standing still." A fourth example is similar to the third, and has a Gulf Power employee guiding a power pole into the ground, with a voice saying: "We go to great lengths so you don't have to. Gulf Power and you. A dependable relationship."
>
> [T-768]

The cited examples do not inform the customers about products or services, nor do they assist customers in any way. These advertisements are of the type that the Commission has uniformly disallowed.

Gulf witness Margaret Neyman, however, argues that such advertising serves the purpose of first earning the public's loyalty so that Gulf can market its products and programs, apparently

through other advertising venues. [T-1069-1070]. PSC Staff witness Edward Bass, however, disputed Ms. Neyman's premise. Mr. Bass testified that Gulf could communicate the substance of its educational messages, without engaging in these image enhancement types of advertising. [T-915].

The Commission should continue to adhere to its long held policy of disallowing image-enhancing advertising expenses.

ISSUE 50: Should an accrual for incentive compensation be allowed?

OPC: No. Because Gulf did not submit any support for the incentive compensation, the accrual should be disallowed and expenses reduced by $4,917,000 (system).

DISCUSSION:

The reason OPC recommends an adjustment to remove this incentive package is simple. Gulf simply has not provided the level of detail necessary to properly evaluate the reasonableness. As Mr. Schultz succinctly testified:

> No support for payment of any incentive compensation has been included in the Company's filing.
>
> [T-804]

Even in the rebuttal testimony filed by Gulf, there is additional verbiage, but not the level of detailed data necessary for the Commission to properly assure the public that the incentive compensation plan is fully justified. [T-940-943; T-946-948].

That lack of public assurance is the crux of the issue. The Commission should ask itself: with the level of detail that was supplied, would the Commission be able to fully defend the reasonableness of the incentive plan? As the public agency responsible for setting rates, the

Commission must be able to answer the foregoing question in the affirmative before it requires customers to pay for the incentive plan. The Citizens believe the detail is not adequate and the costs associated with the plan should be denied.

ISSUE 50A: Should an adjustment be made to employee relocation expense for the May 2003 projected test year?

OPC: Agree with Staff. Jurisdictional expenses should be reduced by $15,832 on a four year average consistent with the calculation of the adjustment made in Gulf's last rate case.

ISSUE 51: Should an adjustment be made to Gulf's requested level of Salaries and Employee Benefits for the May 2003 projected test year?

OPC: Yes. Because Gulf has not justified the increased number of "Non-Smith" employees, payroll expense should be reduced by $701,420 (system) and benefits by $131,177.

DISCUSSION:

Gulf's initial filing showed an increase of 48 employees for the projected test year, as compared to the year before (from 1,319 to 1,367). OPC sought to examine the purported justification through discovery. Gulf responded to OPC discovery by identifying 28 positions associated with the new Smith 3 unit that had been filled. [T-802]. As a result, Mr. Schultz recommended the removal of the 19 positions that Gulf did not address. Mr. Schultz testified:

> Since the projected test year includes an increase of 48 employees, and the Company specifically identified 29 employees for Smith Unit 3, 19 positions remain as unsupported. The 19 unidentified positions should be removed from the filing. The Company has not provided testimony and/or justification for increasing the employee complement beyond that needed for Smit Unit 3. In fact, through 1998 it appears downsizing was the trend. In 1999, eight positions were added, and five more positions were added in 2000. The

> Company is now apparently claiming that in the next 17 months, 19 unexplained positions are needed.
>
> [T-803]

The Commission should adjust Gulf's authorized payroll to remove the salary and benefits associated with these positions.

ISSUE 54: Should adjustments be made for the net operating income effects of transactions with affiliated companies for Gulf?

OPC: Yes. The allocation factor for costs from SCS did not incorporate the disproportionately high growth of its non-regulated affiliates. As these non-regulated affiliates grow, their allocated portion of allocated costs should increase, causing Gulf's percentage to decrease. Gulf's allocated costs should be reduced by $1,419,674.

DISCUSSION:

A significant amount of Gulf's expenses are allocated from affiliated companies. OPC is concerned about the costs allocated from Southern Company Services (SCS). SCS provides services to a number of the Southern Company subsidiaries, some of which are regulated and some of which are not.

As noted by OPC witness Kimberly Dismukes, there has been substantial growth in the Southern Company activities over the last several years. Ms. Dismukes lists detailed statistical demonstration of this growth in her testimony [T-760] and in composite exhibit 41; schedule 1. In addition to this clear historical trend, Southern Company intends to continue expanding in this direction. Ms. Dismukes noted:

> Southern Company intends to expand considerably in this area. According to a news release issued January 9, 2001, Southern Company received final approval from the Securities and Exchange Commission to form a new subsidiary that will own, manage and

> finance wholesale generating assets in the Southeast. The new subsidiary will market to wholesale customers in the fastest-growing wholesale electricity market in the nation.
>
> [T-760]

Because of the direction of this shift, it is important that the expenses that are allocated among the various Southern subsidiaries receive up-to-date allocation factors. Otherwise, Gulf's customers will end up subsidizing non-regulated activities. Unfortunately, Gulf filed the 2003 test year using with the SCS allocations based on 1999 data. In other words, the SCS allocation in Gulf's filing does not consider any relative growth in non-regulated operations for the period 1999 to 2003.

Accordingly, Ms. Dismukes adjusted the SCS allocation factor to reflect the relative growth of Southern's nonregulated subsidiaries to prevent Gulf's customers from subsidizing the nonregulated operations. Ms. Dismukes' adjustment is reflected on composite exhibit 41; Schedule 3, and amounts to an expense reduction of $1.4 million [T-766].

Gulf's witness Richard McMillan purports to undermine Ms. Dismukes' conclusion in his rebuttal testimony. Ms. McMillan's testimony, however, does not provide valid credible reasons to deny Ms. Dismukes adjustment.

Mr. McMillan first identifies a math error in Ms. Dismukes Schedule 1 which he stated "overstates the nonregulated amounts" [T-954]. What Mr. McMillan fails to point out, however, is that Schedule 1 was not used to make the adjustment at all, but rather was used only to graphically demonstrate the proposition that the nonregulated affiliates are growing relative to the regulated affiliates. Even with the error identified by Mr. McMillan, the nonregulated affiliates are showing the relative growth asserted by Ms. Dismukes. The mathematical error, then, is of no consequence.

Mr. McMillan then performs two exercises involving the recently completed 2002 SCS budget which he believes support the 2003 test year allocation. This purported support, however, suffers from a significant shortcoming. The Commission has not seen the document on which the support is supposed to be based. As Mr. McMillan himself agreed, the budget upon which he relied was not submitted as evidence in this case. [T-961]. Since Mr. McMillan has already needed to correct a $100,000 mistake since filing his testimony [T-961], the missing source documentation is particularly important to examine.

The Commission should adopt the $1.4 million allocation adjustment recommended by Ms. Dismukes.

ISSUE 55: Should an adjustment be made to the accrual for property damage for the May 2003 projected test year?

OPC: Yes. The current annual accrual of $3,245,000 should be reduced to $1,679,616.

DISCUSSION:

In a 1995 docket, Gulf was authorized an accrual that was intended to make up for previous years' shortfalls, as well as to fund its ongoing liabilities. Since 1996, the average annual charge against the reserve has been $1,536,600. The reserve balance has now reached a healthy level ($8,731,000 as of 2000, and $16,488,000 for the test year at the current rates). There is no longer any need to charge the customers an amount to make up for past deficiencies. An annual accrual of $1,679,616 (the historical average adjusted for the 2000-2002 multiplier) will allow the reserve to continue meeting all obligations.

ISSUE 58: Should an adjustment be made to Rate Case Expense for the May 2003 projected test year?

OPC: Yes. The total rate case expense should be no greater than $1,162,777, and should be amortized over a period no shorter than 6 years.

DISCUSSION:

OPC witness Schultz raised the issue of rate case expense in his initial testimony. Mr. Schultz voiced two concerns: the level of legal services and the amortization period for the expenses. With regard to the legal services, Mr. Schultz noted the amount by which legal services exceeded the same payment in Gulf's last rate case.

Composite exhibit 43; Schedule C-13 shows that the actual legal expense in Gulf's last rate case was $188,953. For this case Gulf originally estimated an expense of $603,000 but later revised it down to $550,000 (see late filed exhibit 55).

Gulf has not given adequate explanation for this level of increase in legal expenses. Accordingly, Mr. Schultz adjusted to a level that can be tied back to the last rate case. Mr. Schultz multiplied the $188,953 by the compound multiplier used by Gulf. Mr. Schultz then added 30% as a generous addition for increased billable hours to arrive at $449,777 as an allowable amount.

Mr. Schultz' estimate is liberal on two counts. First, the compound multiplier includes a customer growth factor, which actually should not affect the legal fees. Secondly, it could be argued that the rate case in 1989 was at least as complex as the current case, so a 30% addition for legal fees is generous.

In addition to legal services, late filed exhibit 55 raises an additional concern. Gulf is increasing its "Outside Consultants" estimate from $200,000 to $240,000. Gulf has not offered any

justification for this 20% increase. It should be noted that the testimony of Mr. Silva and Mr. Twery was stipulated without cross-examination. Further, OPC offered Gulf the same stipulation for cost of capital, so the decision to bring Mr. Benore to the hearing was unilateral on Gulf's part. Because of the foregoing, OPC believes the outside consultant expense should not be increased above the original estimate of $200,000.

Finally, OPC objects to the four-year amortization period. Because of its unique nature, the amortization of rate case expense merits special consideration. Rate case expense arises only when there is a rate case. This means that the customers are unfairly overcharged if the amortization is underestimated, but the utility is held harmless if the amortization period is overestimated. If the amortization is understated, the utility will continue charging customers for rate case expense long after it has fully collected the expenditure. On the other hand, if the amortization period is overstated, the utility merely adds the unamortized balance into its new rate case. It is extremely important, therefore, that the Commission not underestimate the amortization period.

History has shown that a four year amortization is far too short in the current environment. It has been twelve years since Gulf's last rate case. To apply a four-year amortization period almost certainly would mean the customers will be overcharged in the annual expense for this rate case. OPC recommends the Commission use an amortization period of six years.

Based on the foregoing arguments and based on Gulf's late filed exhibit 55, OPC recommends: outside consultants fee of $200,000; legal services fee of $449,777; meals and travel charges of $55,000; paid overtime of $40,000 (unless actual documentation is available to justify the increase); and other expenses of $418,000. The total rate case expense of $1,162,777 should be amortized over a period of not less than six years.

ISSUE 62: Should an adjustment be made to Production Expenses for the May 2003 projected test year?

OPC: Yes. Because Production O&M has increased so markedly from the historic trend, it should be adjusted to reflect levels that reflect normal operations. Production O&M should be reduced by $10,251,700.

DISCUSSION:

OPC is concerned that this is an area greatly affected by the "test year phenomenon." Because the test year period is being used to establish future rates, there is a temptation to be more liberal with approving projects that have discretionary time frames than the utility would otherwise be when the expense directly reduces the utility's profits.

To operate an immense operation like the production of electricity, Gulf must constantly be undertaking and completing a vast array of projects. While these projects all may be necessary, often the timing of when to begin and when to complete the projects are subject to considerable discretion. The exercise of this discretion is necessary and proper, and calls for a high level of expertise.

Because there is so much discretion and judgment involved, it is difficult to identify any one particular project and claims that it could have been delayed or accelerated by three or four months. When a multitude of such projects are aggregated, they can have a significant impact on the total amount of O&M expense that will be necessary in any particular time frame. The aggregation of each decision on the timing of projects, therefore, can have a major impact on the results of any given fiscal period. The area of electric production is the area where this phenomenon perhaps has the greatest effect. The Commission must be acutely aware of this factor when comparing Gulf's projected production O&M expense with its historic norm.

Gulf separates its Production O&M expense into three major categories: (1) Baseline, (2) Planned Outage, and (3) Special Projects. As shown on exhibit 43; HWS-6, the Baseline went from $38.5 M in 1996 to $41 M in 2000, but Gulf is projecting $50.6 M for the test year. Planned Outage went from $9.5 M in 1996 to $10.9 M in 2000, but Gulf is projecting $14 M for the test year. Special Projects went from $0.9 M to $1.4 M, but Gulf is projecting $2.7 M for the test year. Total Production O&M went from $48.9 M in 1996 to $53.4 M in 2000, but Gulf is projecting $67.3 M for the test year. These increases do not appear to be justified.

If the 2000 amount is adjusted by Gulf's own compound multiplier, the test year result would be $56.2 M. The Citizens recommend the midpoint between $56.2 M and the test year benchmark of $65.1 M for a total of $60.6 M. This would reduce Gulf's projected test year by $10,251,700.

ISSUE 64: Should an adjustment be made to cable inspection expense?

OPC: Yes. The $166,099 for silicone injection should be capitalized because it is being expanded to extend the life of a capital asset.

DISCUSSION:

Before 1990, Gulf installed over 600 trench miles of underground cable. Gulf is now undertaking a program to inject a silicone fluid into the cable to remove water and to fill voids. [T-810]. The effect of these efforts is to extend the life of the underground cable.

Costs for projects designed to extend the life of capital assets are normally capitalized. [T-810]. There is no reason for the silicone injection costs to be expensed. It appears at this point that Gulf witness Labrato is not opposed to capitalizing these costs. [T-1115].

The Commission should capitalize the $166,099 of costs associated with the silicone/cable injection project.

ISSUE 65: Should an adjustment be made to substation maintenance expense?

OPC: Yes. Gulf's projection of $1,647,000 should be reduced by $391,316 to reflect an amount more in line with the historical trend.

DISCUSSION:

This issue involves another example of the "test year phenomenon" discussed in OPC's discussion of Issue 62. Because the timing of substation maintenance projects is to a large extent within the discretion of the company, the Commission must be very attuned to all test year projections that represent significant departures from historic trends.

The projected substation maintenance expense reflects a significant departure from historical trends. The actual amount in 2000 was $893,320 (inflation adjusted), as compared to Gulf's test year projection of $1,647,000. As Mr. Schultz stated:

> This significant projected increase in spending raises a concern as to whether the sudden request for an additional $815,000 is rate case related. If the need for these expenditure exists, then one would think that the Company's actual historic costs would be closer to the 1999 benchmark of $1,196,666 instead of the $861,904 that was expended. The same applies to 2000 when the benchmark was $1,263,056 and only $817,256 was expended.

As a result of his concern, Mr. Schultz has recommended that the most recent 5-year average (1996-2000) be used, after adjusting each year's amount to reflect comparable test year dollars. [T-812]. This approach would normalize any anomalously low years (as 1999 and 2000 may be), and reflect Gulf's actual operations when rate setting is not in the balance. This method results in a maintenance expense of $1,255,684, or a reduction of $391,316 below Gulf's request.

ISSUE 66: Should adjustments be made to tree trimming expense?

OPC: Yes. The inflation indexed five-year average is $2,743,625 and the indexed year 2000 actual amount was $1,787,080. Gulf's test year projection is $4,122,705. The inflation indexed five-year average is a more reasonable indicator of Gulf's ongoing future needs. Tree trimming should be reduced by $1,379,080.

DISCUSSION:

The Citizens are aware of Gulf's testimony stating that it intends to move to a more proactive approach to curb vegetation-related outages. OPC, however, is concerned with whether allotted funds will actually be spent.

Mr. Schultz points out that for the year 2000, Gulf had budgeted $3,010,997 for tree trimming, but only spent $1,634,914. [T-813]. In addition, Mr. Fisher testified that immediately following its last rate case Gulf was spending substantially more funds for tree trimming, but after five years the company began to use the money elsewhere. [T-1034].

This raises great concern. It appears that tree trimming is a program that Gulf is willing to shortchange when desirable. Gulf had a more aggressive program before, but abandoned it later when earnings might suffer. There is no assurance that Gulf will not do the same thing in this case, after the Commission grants higher rates to cover the more comprehensive trimming policy. Why should customers be charged higher rates to cover a comprehensive trimming policy, only to see Gulf drop the program once it gets rates?

In the past "non-test year" years, Gulf was willing to squeeze down their efforts in this area. In other words, when the expense dollars were reducing Gulf's profit, the company chose to cut back on this service. OPC believes that until Gulf demonstrates a corporate policy that is dedicated to

keeping up the level of tree-trimming it now promises, the Commission should not grant the additional amounts.

ISSUE 67: Should an adjustment be made to pole line inspection expense?

OPC: Yes. Gulf did not expend any funds for this activity in either 1999 or 2000, and its five-year inflation adjusted average is $207,274. Gulf's test year projection of $734,000 is not a credible reflection of its year-to-year future needs. Gulf's projection should be reduced by $526,726.

DISCUSSION:

This is another issue involving an ongoing program in which Gulf intends to take a more aggressive (and more expensive) approach, just in time for the rate setting test year.

Mr. Fisher testified that this program began in 1991 [T-465]. For its first ten years, Mr. Fisher testified the program has addressed 48,000 poles [T-466], an average of 4,800 poles per year. Now, however, Gulf sees the need to accelerate the program to cover 12,000 poles per year, well over double what was previously considered adequate.

Once again, OPC cannot scientifically prove that Gulf's new aggressive policy is invalid. OPC can only point out that for ten years, Gulf itself apparently believed that 4,800 poles/year was adequate. Now, however, with the rate setting test year on the horizon, Gulf has discovered that its previous wisdom was inadequate by more than two-fold.

In light of the foregoing, OPC recommends the Commission use the most recent five year historical average 1996-2000, and inflate the dollars to their 2002 value. This would result in a reduction of $526,726 to this expense [T-814, 815].

ISSUE 68: Should an adjustment be made to street and outdoor light maintenance expense?

OPC: Yes. The five-year average historical cost is $880,370 and in 2000 the actual amount was $967,403. Gulf has projected $1,438,000 for the test year. Based on historic activity, a reduction of $320,143 should be made to reflect a more realistic expectation.

DISCUSSION:

Gulf's test year projection is such a departure from the historic trend that it does not appear to be a realistic estimate of its ongoing future needs. Once again, this is an ongoing program of considerable longevity, so its historical levels should reflect an experienced, deliberative norm. Accordingly, the Citizens recommend an amount that recognizes what Gulf found to be a reasonable level of activity in the past.

ISSUE 71A: Should an adjustment be made to Customer Accounts-Postage Expense for the May 2003 projected test year?

OPC: Gulf apparently agrees with OPC that the utility's initial amount for postage was excessive. Gulf's willingness to correct its $489,000 error removes the Citizens concern in this area.

ISSUE 71B: Should an adjustment be made to Customer Records Expense for the May 2003 projected test year?

OPC: The Citizens accept Gulf's explanation that a change in the company's accounting mechanics was the cause for the apparent excess in this account.

ISSUE 72: If the deferral of the return on the third floor of the corporate offices is allowed in rate base, what amortization period should be used?

OPC: If the Commission requires current and future to pay for historic returns that were deferred because the third floor office space was not in use, it should spread that deferral over the remaining useful life of the building.

DISCUSSION:

If the deferred earnings are allowed to be collected, they should be collected over the remaining life of the building. To establish a three-year amortization period for rate setting would compound the unfairness of requiring future customers to pay for past earnings. As is discussed under the rate case expense issue, Gulf is not likely to return for another rate case within three years. To allow a short recovery period will, in essence, allow Gulf to collect more for these earnings than they had to forego by having it removed from rate base.

Since the Commission removed the third floor on a used and useful basis, the deferral (if it is allowed) should be treated like either property held for future use or CWIP. In both of those cases, the deferred earnings are simply added to the capitalized costs when the asset is put into the rate base. As such, those costs are collected over the depreciable life of the asset. There is no reason for Gulf to receive more favorable treatment on the third floor than they would have received for CWIP or property held for future use.

ISSUE 79: Should an adjustment be made to Taxes Other Than Income Taxes for the May 2003 projected test year?

OPC: Yes, property taxes should be reduced by $1,251,000 to reflect the tax exemption that Gulf has received on Smith Unit 3.

DISCUSSION:

Gulf is currently involved in a controversy over a property tax exemption applicable to Smith 3. At this point, however, Gulf has prevailed in obtaining the exemption from the Bay County Board of Commissioners [T-589]. Gulf will retain that exemption unless the Bay County Property Appraiser can succeed in overturning the Commission decision on appeal. [T-597].

Gulf has filed this rate case, however, on the assumption that it did not obtain the exemption. Gulf apparently filed this way based on the possible chance that it might lose the appeal. This assumption is exactly opposite what it ought to be. It should be assumed that Gulf has the exemption, which it does. Gulf's property taxes should be reduced by $1,251,000 [T-590].

ISSUE 81: Should an adjustment be made to Income Tax expense for the May 2003 projected test year?

OPC: Yes. Adjustments need to be made to reflect Commission decisions on related issues.

ISSUE 82: Is Gulf's projected Net Operating Income in the amount of $61,378,000 ($61,658,000 system) for the May 2003 projected test year appropriate?

OPC: No. Adjustments need to be made to reflect Commission decisions on related issues.

ISSUE 84: Is Gulf's requested annual operating revenue increase of $69,867,000 for the May 2003 projected test year appropriate?

OPC: No. The increase is overstated. It should be adjusted in accordance with Commission decisions on related issues.

Respectfully submitted,

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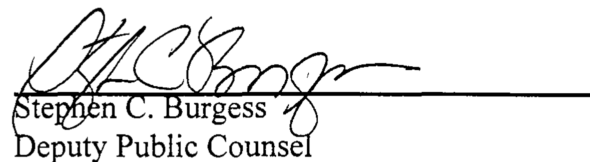

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CERTIFICATE OF SERVICE
DOCKET NO. 010949-EI

I HEREBY CERTIFY that a true and correct copy of the foregoing Citizens' Statement of Issues and Positions and Brief has been furnished by hand-delivery(*) or U.S. Mail to the following parties on this 20th day of March, 2002.

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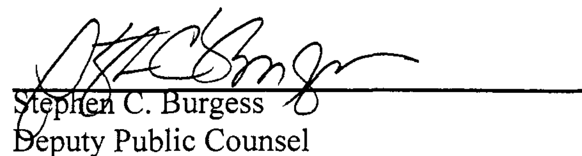

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