State of Florida

Public Service Commission

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-M-E-M-O-R-A-N-D-U-M-

DATE: APRIL 15, 2002

TO: DIRECTOR, DIVISION OF THE COMMISSION CLERK & ADMINISTRATIVE SERVICES (BAYÓ)

FROM: DIVISION OF ECONOMIC REGULATION (L. ROMIG, SLEMKEWICZ, HAFF, D. DRAPER, HUDSON, KAPROTH, BOHRMANN, E. DRAPER, D. LEE, P. LEE, LESTER, MEEKS, MATLOCK, MERTA, STALLCUP, WHEELER, C. ROMIG)
OFFICE OF THE GENERAL COUNSEL (STERN, ELIAS, HARRIS, ESPINOZA, ECHTERNACHT)

RE: DOCKET NO. 010949-EI - REQUEST FOR RATE INCREASE BY GULF POWER COMPANY.

AGENDA: 04/26/02 - SPECIAL AGENDA - POST HEARING DECISION - PARTICIPATION IS LIMITED TO COMMISSIONERS AND STAFF

CRITICAL DATES: 8-MONTH EFFECTIVE DATE: MAY 10, 2002

SPECIAL INSTRUCTIONS: NONE

FILE NAME AND LOCATION: S:\PSC\ECR\WP\010949.RCM
R:\010949-1-5.123 - ATTACHMENTS 1 - 5
R:\010949-6.123 - ATTACHMENT 6
ATTACHMENT 7 IS NOT AVAILABLE

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CASE BACKGROUND

On September 10, 2001, Gulf Power Company (Gulf or Company) filed a petition for a permanent rate increase. Gulf requested an increase in its retail rates and charges designed to generate $69,867,000 in additional gross annual revenues which would allow the Company to earn an overall rate of return of 8.64% or a 13.00% return on equity (range of 12.00% to 14.00%). This request was based upon a projected June 2002 through May 2003 test year and a 13-month average jurisdictional rate base of $1,198,502,000. The Company filed new rate schedules reflecting the proposed increases. The most significant basis for the requested increase, according to Gulf, was the addition of Smith Unit 3, a 574 megawatt gas fired combined cycle generating unit along with the associated operation and maintenance (O&M) expenses. Other significant factors include the addition since the last rate case of 100,000 new customers; 1,400 miles of new distribution lines; and 90 miles of new transmission lines; the replacement and repair of an aging electrical infrastructure; and the increased O&M costs associated with aging generating plants.

Pursuant to Order No. PSC-99-2131-S-EI, issued October 28, 1999, in Docket Nos. 990250-EI and 990947-EI, the Commission approved a stipulation that established a revenue sharing plan. Included in the stipulation was a provision whereby Gulf could not request an increase in base rates before the earlier of the commercial in-service date for Smith Unit 3 or December 31, 2002, the expiration date of the Stipulation. Gulf did not request interim rate relief but specifically asked that all or a portion of the requested increase of $69,867,000 be granted beginning on the commercial in-service date of Smith Unit 3 pending a final decision on this petition.

Pursuant to Section 366.06, Florida Statutes, Order No. PSC-01-2300-PCO-EI, issued November 21, 2001, suspended Gulf's permanent rate schedules pending review.

The Federal Executive Agencies (FEA), Florida Cable Telecommunications Association, Inc. (FCTA) and the Florida Industrial Power Users Group, (FIPUG) were granted intervention status in this docket by Order Nos. PSC-01-1934-PCO-EI, PSC-01-1949-PCO-EI, and PSC-01-1703-PCO-EI respectively. The Office of

Public Counsel (OPC) is a party to this docket pursuant to Section 350.0611, Florida Statutes; Order No. PSC-01-2024-PCO-EI, acknowledged OPC's intervention. All parties except FCTA filed post-hearing briefs.

Customer service hearings were held in Pensacola and Panama City on January 16, 2002. The final hearing was held February 25-26, 2002.

STIPULATIONS

The stipulations listed below were approved at the hearing.

I. Depreciation Stipulation

The Stipulation for Settlement of Depreciation Related Issues between OPC, FEA, FIPUG, and Gulf filed on February 22, 2002, was accepted. The Stipulation reflects a compromise settlement between the parties regarding depreciation rates and dismantlement accrual levels. It is not construed as an admission by any party that these rates or dismantlement provisions are appropriate in any other proceeding.

The accepted settlement reflects the depreciation rates and dismantlement accruals initially proposed by Gulf in its May 29, 2001, filing in Docket No. 010789-EI. For Smith Unit 3, the agreement reflects the depreciation rate and dismantlement accrual proposed by Gulf in Docket No. 010949-EI, except the depreciable life for the unit is set at 25 years (instead of the 20 years initially proposed by Gulf). As a result, the May 2003, depreciation expense will be reduced $2,041,000 ($2,117,000 system); the level of accumulated depreciation will be reduced by $1,019,000 ($1,057,000 system).

The Depreciation Stipulation also provides that the depreciation rates and dismantlement provisions be effective on January 1, 2002, except for Smith Unit 3. The depreciation rate and dismantlement provision relating to Smith Unit 3 will be effective on the commercial in-service date of the unit. Finally, the Stipulation provided that the prefiled testimony of witnesses Majoros, Zaetz, and Roff would be inserted into the record as though read.

Accordingly, Issues 17, 73, and 74 are fully resolved. Although, with respect to depreciation rates and dismantlement accruals, the Depreciation Stipulation likewise resolves Issues 18 and 75, those issues remain open for the purpose of identifying adjustments to accumulated depreciation and depreciation expense that fallout from other issues.

In addition, on its own motion, the Commission voted that acceptance of the Depreciation Stipulation rendered moot the Commission's vote in Docket No. 010789-EI made at the February 19, 2002 Agenda Conference. That vote had not been issued as a Proposed Agency Action Order at the time this Stipulation was accepted (February 25, 2002). Accordingly, the Commission voted that Docket No. 010789-EI should be closed administratively.

II. Motion for Judicial Notice

A Motion for Judicial Notice was filed by the Federal Executive Agencies on February 22, 2002, which requested judicial notice for certain parts of the Electric Utility Cost Allocation Manual published by NARUC in 1992. The parts to be noticed were the cover pages, table of contents, preface, and Chapter Six. The parties agreed to stipulate the material into the record as an exhibit, which was accepted by the Commission and so the Motion was effectively withdrawn.

III. Stipulated Issues

The stipulations listed below were accepted by the Commission.

A. Category One Stipulations

Category One stipulations are those to which Gulf, Staff, FEA, FIPUG, and OPC agree and for which FCTA takes no position.

1. The testimony and exhibits of OPC's witness, Michael J. Majoros, including his deposition testimony, shall be stipulated into evidence without cross examination by any party.

B. Category Two Stipulations

Category Two stipulations are those to which Gulf and Staff agree, and for which FCTA, FEA, FIPUG, and OPC have no position.

2. Gulf shall be required to file, within 90 days after the date of the final order in this docket, a description of all entries or adjustments to its annual report, rate of return reports, and books and records which will be required as a result of the Commission's findings in this rate case. (Issue 124)

C. Category Three Stipulations

Category Three stipulations are those to which Gulf, FEA, OPC, and Staff agree and for which FIPUG and FCTA have no position.

3. The appropriate cost of short-term debt for the May 2003 projected test year is 4.61%. The short-term debt cost rate has been revised from 6.02% as originally filed based on the most recent forecast of short-term interest rates for the test year. (Issue 32)

4. The appropriate cost rate for long-term debt for the May 2003 projected test year is 6.44%. The long-term debt cost rate has been revised from 7.08% as originally filed to 6.44%. The Company has completed the issuance of all permanent financing impacting the May 2003 projected test year. Therefore, the long-term debt cost rate was revised to reflect the actual rates of senior notes issued. In addition, the cost rates for the Company's variable rate pollution control bonds were revised based on the most recent forecast of short-term interest rates for the test year. (Issue 33)

D. Category Four Stipulations

Category Four stipulations are those to which Gulf, FEA, FIPUG, and Staff agree, and for which FCTA and OPC have no position or no opposition.

5. Based upon the Stipulation approved in Order No. PSC-99-2131-S-EI, the rates approved in this docket will be effective for bills rendered on or after (i) the commercial in-service date of Smith Unit 3, or (ii) 30 days after the date of the Commission's vote in this docket, whichever is later. (Issue 123)

E. Category Five Stipulations

Category Five stipulations are those to which Gulf and Staff agree, and for which FEA, FCTA, FIPUG, and OPC have no position.

6. Gulf's forecasts of Customers, KWH, and KW by Rate Class, for the May 2003 projected test year are appropriate. (Issue 2)

7. No adjustments shall be made to Gulf's projected test year due to customer complaints. (Issue 4)

8. The quality of electric service provided by Gulf is adequate as evidenced by Gulf's complaint activity being low and its rankings across all service and reliability attributes in customer surveys being consistently among the best in the industry. (Issue 5)

9. No adjustment shall be made to Smith Unit 3. The $220,495,000 requested for the construction of Plant Smith Unit 3 is reasonable, prudent, and should be allowed. (Issue 10)

10. The company has removed from rate base all non-utility activities, including the investment, accumulated depreciation, and working capital amounts related to the Company's non-utility activities. (Issue 15)

11. The requested level of construction work in progress in the amount of $15,850,000 jurisdictional ($16,361,000 system) is appropriate for purposes of computing base rate revenue requirements. This amount properly reflects the construction expenditures and plant clearings that are expected in the May 2003 projected test year. (Issue 19)

12. No adjustment shall be made to Plant Held for Future Use for Gulf's inclusion of the Caryville site in rate base. While Gulf has allowed the Caryville site to be used for various non-utility activities in recent years, the site was certified by the Power Plant Siting Board in 1976 and continues to be viable for building coal-fired capacity in the future. It is anticipated that certifying new plant sites will become increasingly more difficult in the future. Caryville has been in Gulf's rate base as Plant Held for Future Use for well over 35 years. Inclusion of this site in rate base is still a prudent decision. (Issue 20)

13. The requested level of Property Held for Future Use in the amount of $3,065,000 ($3,164,000 system) is appropriate for purposes of computing base rate revenue requirements. (Issue 21)

14. No adjustment shall be made to prepaid pension expense. The projected balance of prepaid expense has been properly reflected in the calculation of working capital. (Issue 22)

15. No adjustment shall be made to rate base for unfunded Other Post-retirement Employee Benefit (OPEB) liability. The projected balance of Other Post-retirement Employee Benefits has been properly reflected in the calculation of working capital. (Issue 23)

16. Gulf's projected level of Total Operating Revenues in the amount of $372,714,000 ($379,009,000 system) for the May 2003 test year should be reduced by $1,652,000 to reflect the impact of the Commission approved change to the Purchased Power and Capacity Cost Recovery Clause calculation as discussed in Issue 45. Total Operating Revenues should also be reduced if the Commission chooses to remove gross receipts tax from revenues and expenses in the calculation of Net Operating Income, rather than removing gross receipts tax from total revenue requirements in the calculation of proposed base rates. (Issue 38)

17. The appropriate inflation factors are those shown on Gulf's response to Staff Interrogatory No. 192. This results in a $100,000 reduction to O&M expense. (Issue 39)

18. Gulf has made the appropriate test year adjustments to remove fuel revenues and fuel expenses recoverable through the Fuel Adjustment Clause. As shown on Mr. Labrato's direct testimony Exhibit RRL-1, Schedule 8 and Schedule 9, the Company has removed from NOI the fuel revenues and expenses recoverable through the Fuel Clause for purposes of determining base rate revenue requirements. (Issue 43)

19. Gulf has made the appropriate test year adjustments to remove conservation revenues and conservation expenses recoverable through the Conservation Cost Recovery Clause. As shown on Mr. Labrato's direct testimony Exhibit RRL-1, Schedule 8 and Schedule 10, the Company has removed from NOI the conservation revenues and expenses recoverable through the Energy Conservation Cost Recovery Clause for purposes of determining base rate revenue requirements. (Issue 44)

20. Gulf has not made the appropriate test year adjustments to remove capacity revenues and capacity expenses recoverable through the Capacity Cost Recovery Clause. Gulf made adjustments to remove capacity revenues and expenses from NOI currently recoverable through the Capacity Cost Recovery Clause. Included in the adjustments are $1,652,000 in revenues currently embedded in base rates. Pursuant to Order No. PSC-01-2516-FOF-EI in Docket No. 010001-EI an adjustment should be made in this docket to Gulf's new base rate request. Accordingly, revenues shall be reduced by $1,652,000 to ensure that new base rates and the clause factors are calculated on a consistent basis. (Issue 45)

21. Gulf has made the appropriate test year adjustments to remove environmental revenues and environmental expenses recoverable through the Environmental Cost Recovery Clause. As shown on Mr. Labrato's direct testimony Exhibit RRL-1, Schedule 8 and Schedule 12, the Company has removed from NOI the environmental revenues and expenses recoverable through the Environmental Cost Recovery Clause for purposes of determining base rate revenue requirements. (Issue 46)

22. Gulf has not made the appropriate adjustments to remove lobbying expenses from the May 2003 projected test year. As shown on Mr. Labrato's direct testimony Exhibit RRL-1, Schedule 8, page 3 of 3, adjustments 13 and 24 were made consistent with the Commission's direction in the last rate case to exclude lobbying expenses. However, an additional adjustment in the amount of $7,000 jurisdictional ($7,000 system) shall also be made to remove the industry association dues for Associated Industries of Florida, as noted in the Commission Staff's audit report Exception No. 2, since these dues relate to lobbying activities. (Issue 49)

23. The appropriate amount for other post employee benefits expense is included in the May 2003 projected test year, and no adjustment shall be made. (Issue 52)

24. No adjustment shall be made to pension expense for the May 2003 projected test year. (Issue 53)

25. No adjustment shall be made to the accrual for the Injuries and Damages reserve for the May 2003 projected test year. The appropriate amount for the injuries and damages reserve accrual of $1,144,000 jurisdictional ($1,200,000 system) is included in the May 2003 projected test year. (Issue 56)

26. No interest on tax deficiencies for the May 2003 projected test year shall be included above-the-line, and the net operating income for the May 2003 projected test year does not include any interest on tax deficiencies. (Issue 57)

27. No adjustment shall be made to Transmission Expenses for the May, 2003 projected test year. The total requested transmission O&M expenses of $7,922,000 jurisdictional ($8,210,000 system) for the May 2003 projected test year are under the benchmark and are reasonable, prudent, and necessary in order for Gulf to provide a high level of reliability to its growing number of customers. (Issue 63)

28. No adjustment shall be made to Bad Debt Expense for the May, 2003 projected test year. The amount of bad debt expense of $1,544,000 jurisdictional ($1,544,000 system) included in the May 2003 projected test year is appropriate for purposes of determining base rate revenue requirements. (Issue 70)

29. Gross receipts tax shall be removed from base rates and shown on customer bills as a separate line item. (Issue 78)

30. No adjustment shall be made to the consolidating tax adjustments for the May 2003 projected test year. (Issue 80)

31. The appropriate revenue expansion factor for Gulf is 60.3110 and the appropriate net operating income multiplier is 1.658072. These factors are different from the factors included in the Company's original filing. The numerator of the bad debt rate calculation, as shown on MFR Schedule C-58, was found to be in error. A revised calculation of the revenue expansion factor and NOI multiplier was provided in response to Staff's Interrogatory No. 75. These factors also include the gross receipts tax rate of 1.5%. The gross receipts tax was removed from total revenue requirements in the calculation of proposed base rates, since the Company is proposing to remove the gross receipts tax from base rates and show it as a separate line item on the bill.

If the Commission were to choose to remove gross receipts tax from revenues and expenses in the calculation of NOI, then the appropriate revenue expansion factor for Gulf is 61.2323 and the appropriate net operating income multiplier is 1.633125, and it would no longer be necessary to remove gross receipts tax from total revenue requirements in the calculation of proposed base rates. (Issue 83)

32. Gulf's proposed separation of costs and revenues between wholesale and retail jurisdictions is appropriate. Wholesale allocations are predominantly based upon the 12 MCP methodology with some revenues and expenses allocated upon the energy allocator. These methods are based upon cost causation. This is consistent with Gulf's prior rate case and was approved by this Commission. It also has traditionally been FERC's preferred methodology. (Issue 85)

33. Gulf has accurately applied the appropriate tariffs to the billing determinants projected for the May 2003 test year. The resulting estimated revenues from sales of electricity by rate class at present rates for the May 2003 test year as filed in this docket are appropriate. (Issue 86)

34. The method used by Gulf to develop its estimate by rate class of the 12 monthly coincident peak hour demands and the class non-coincident peak hour demands is appropriate. The method is reflected in the Cost of Service study attached to Mr. McGee's late-filed deposition exhibit no. 2. (Issue 87)

35. The appropriate service charges are listed below: (Issue 94)

Connection of Initial Service	$27.00
Connection of Existing Service	$27.00
Restoration of Service (after violation of rules)	$35.00
Restoration of Service After Hours (after violation of rules)	$55.00
Restoration of Service at Pole (after violation of rules)	$95.00
Premise Visit	$20.00
Connection of Temporary Service	$110.00
Investigation of Unauthorized Use	$75.00
Returned Item Charge $50	$25.00
Returned Item Charge > $50 and $300	$30.00
Returned Item Charge > $300	$40.00

36. The OS-I and OS-II energy charges shall be set to recover the total non-fuel energy, demand and customer-related costs allocated to the classes in the Commission-approved cost of service study. The maintenance charges shall be set to recover the total maintenance and associated A&G costs allocated to the classes in the Commission-approved cost of service study. The fixture, pole and other additional facilities charges shall be set to recover the remaining revenue requirement for the OS-I and OS-II classes. (Issue 95)

37. Gulf's time-of-use rates shall be designed using the Existing Time-of-Use Modification (ETM) method, as described in the response to Staff Interrogatory No. 21, for revising incumbent, or existing, commercial/industrial Time-of-Use Rates. (Issue 96)

38. The appropriate monthly charge under Gulf’s GoodCents Surge Protection (GCSP) rate schedule is $3.45? (Issue 100)

39. The distribution primary and transmission transformer ownership discounts shall be calculated in the same manner they were calculated in Gulf's last rate case, using the Commission-approved cost of service study. (Issue 101)

40. The minimum monthly bill demand charge under the PX rate shall be set using the methodology described in Gulf's response to Interrogatory No. 233, as adjusted to reflect the final rates established for the PX rate. (Issue 102)

41. The minimum monthly bill demand charge under the PXT rate should be set using the methodology described in Gulf's response to Interrogatory No. 234, as adjusted to reflect the final rates established for the PXT rate. (Issue 103)

42. Gulf Power's proposed rates are designed recognizing that customers may migrate, or move, to different rates for which they are eligible but are not currently on. This occurs when rate changes make alternative rates more economical. Recognition of this migration should be handled by allowing consideration of such migrations in the rate design process, as Gulf has done. (Issue 104)

43. Gulf's GST and RST rate schedules shall be eliminated because of the historically minimal participation in these optional rates. (Issue 105)

44. Gulf's Supplemental Energy Rate Rider shall be eliminated. Gulf's Commercial/Industrial customers have other options, including Time of Use rates and the Real Time Pricing rate, that allow them to change their consumption in response to price signals. Gulf currently has no customers on the SE Rider. (Issue 106)

45. The Optional Method of Meter Payment provision in Gulf's GSDT rate schedule shall be eliminated. The Optional Method of Meter Payment is not necessary since the proposed customer charge for rate GSDT is identical to that for rate GSD. These customer charges are the same because there is no longer additional cost to the Company associated with time-of-use metering for GSDT. (Issue 107)

46. Gulf shall eliminate its OS-IV rate schedule and transfer the customers served under the rate to an otherwise applicable rate no later than 24 months after the final order in this Docket, 010949-EI. (Issue 108)

47. Gulf has proposed to eliminate the SE Rider option available to SBS customers. Consistent with Gulf's proposed elimination of the SE Rider, the proposed changes to the SBS rate should be approved. (Issue 109)

48. The monthly fixed charge carrying rate to be applied to the installed cost of OS-I and OS-II additional lighting facilities shall be calculated based on the methodology shown in Gulf's response to Staff's Interrogatory No. 42, and shall reflect the Commission-approved rate of return including the Commission-approved rate setting point ROE. (Issue 110)

49. The proposed revisions to the estimated KWH consumption of Gulf's high pressure sodium and metal halide lighting fixtures are based on manufacturer's specifications for the equipment involved, and are appropriate. (Issue 111)

50. Gulf shall add a provision to its OS-I and OS-II lighting schedules that allows customers to change to different fixtures prior to the expiration of the initial contract lighting term. This change, requested by Gulf's customers, allows greater flexibility to customers in choosing lighting offerings during the term of their contracts. (Issue 112)

51. The Street Lighting (OS-I) and Outdoor Lighting (OS-II) subparts of Gulf's Outdoor Service rate schedule shall be merged. Merging the subparts of OS-I and OS-II serves to simplify the tariff and avoid unnecessary complication for customers and employees. (Issue 113)

52. The proposed methodology for determining the price of new street and outdoor lighting offerings shall be approved and shall be used to determine the monthly charges incorporating the Commission-approved rate of return including the rate setting point return on equity (ROE). (Issue 114)

53. Gulf's new FlatBill pilot program shall be approved provided that: 1) the fuel and other cost recovery clauses revenues associated with FlatBill customers are credited to the clauses at the then-current tariffed adjustment clause rates, and based on the customer's actual metered kWh usage; and 2) any shortfall in base rate revenues between the customer's bill at standard rates and the FlatBill revenues will be absorbed by the company. (Issue 115)

54. Gulf's new rate schedule, GSTOU, shall be approved. This is an additional option for the GSD/GSDT customers with a different structure since it does not contain a distinct demand charge. The rate is simpler for customers to understand and would allow customers to more effectively manage energy costs. (Issue 116)

55. Gulf's proposed reduction in the contract term required under its Real Time Pricing rate schedule from five years to one year is appropriate. (Issue 117)

56. Gulf's GoodCents Select Program incorporating the proposed changes to Gulf's Rate Schedule RSVP continues to be cost-effective. (Issue 118)

57. The RSVP rate schedule shall be designed so that the RSVP charges are compatible with the RS rate schedule, enhance the GoodCents Select program, and are designed consistent with the currently approved charges, as described in response to Staff's Interrogatory No. 271. (Issue 119)

58. Gulf's proposed change to the P2 and P3 pricing periods under the RSVP rate schedule is appropriate. This change removes a disincentive for participation, and does so without negatively affecting conservation benefits. (Issue 120)

59. Gulf's proposed changes to the Participation Charge and Reinstallation Fee charged under the RSVP rate schedule are appropriate. The proposed amounts represent updated costs of the equipment that is installed and maintained in participating households. (Issue 121)

60. The proposed addition of the RSVP, GSTOU, PX, PXT, and RTP rate schedules to the Budget Billing optional rider is appropriate. (Issue 122)

61. Gulf shall be required to file, within 90 days after the date of the final order in this docket, a description of all entries or adjustments to its annual report, rate of return reports, and books and records which will be required as a result of the Commission's findings in this rate case. (Issue 124)

F. Miscellaneous

62. Staff, Gulf and OPC agree that the wholesale related costs allocated to Gulf were properly allocated and support the sale and purchase of energy and capacity for the benefit of Gulf's retail customers. Therefore, no adjustment to NOI is needed to remove wholesale costs allocated to Gulf. FIPUG, FEA and FCTA take no position. (Issue 42)

TEST PERIOD

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

RECOMMENDATION: Yes. With the adjustments recommended by staff in the following issues, and reflected on Attachments 1-4, the May 2003 projected test year is appropriate. (L. Romig)

POSITION OF THE PARTIES

GULF: Yes. Gulf's new combined cycle unit at Plant Smith is expected to be in commercial operation on or before June 1, 2002. The chosen test year is representative of Gulf's expected future operations after Smith Unit 3 is in service and is the first full year that new rates will be in effect.

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: The purpose of the test year is to represent the financial operations of a company during the period in which the new rates will be in effect. The projected period June 1, 2002, through May 31, 2003, represents the test year on which Gulf has calculated its revenue deficiency in this case. Gulf has used this projected test period because it best represents future operations after Smith Unit 3 begins commercial operation. Smith Unit 3 is the major factor behind Gulf's need for rate relief. (TR 57) Of the $69.9 million request for rate relief, approximately $48 million is associated with Smith Unit 3. (TR 608-609) The test year used will more accurately reflect the operations of the Company during the first 12 months after the new rates go into effect than a historical test year that does not include this investment.

OPC concedes Gulf's need to cover the costs associated with Smith Unit 3. (BR 2) OPC stated in its position that 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.

OPC witness Schultz testified that the use of budgeted information provides significant difficulty in determining the appropriate level of future plant and cost operations. The budget must be in sufficient detail to determine whether the assumptions and cost budgeted by the Company are reasonable. (TR 82) In OPC's opinion Gulf did not supply sufficient detail necessary for the Commission to properly examine the assumptions. (BR 3)

Witness Schultz testified that he made a number of adjustments based upon a historical level of spending that was considered sufficient to provide the quality of service. In his opinion, the historical spending should be used when establishing rates, especially when considering the lack of detail in the Company's budget. (TR 822-823) Mr. Schultz further testified that the budget provided by the Company does not appear to support $201 million in costs. (TR 822)

There are primarily two options for evaluating Gulf's expected financial operations. The first option is to use a historical test year and make pro forma adjustments to the test year. The second is to use a projected test year. Both of these options have strengths and weaknesses.

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

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

The parties and the staff have conducted extensive discovery on Gulf's forecast. The Commission has held hearings to investigate issues raised by the parties and staff. In the following issues, the staff is recommending that certain adjustments be made to Gulf's forecast. With the inclusion of these adjustments, staff believes that the forecast of Gulf's financial operations for May 2003 is accurate enough to use as a basis for setting rates.

ISSUE 2: Are Gulf's forecasts of Customers, KWH, and KW by Rate Class, for the May 2003 projected test year appropriate? (Stallcup)
STIPULATED

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? (D. Lee, Matlock)

RECOMMENDATION: A properly balanced incentive mechanism cannot be established at this time. However, the Commission should consider establishing for Gulf a forward-looking performance based incentive mechanism which includes opportunities for rewards as well as penalties. Such a mechanism should provide Gulf incentives to deliver high future performance in efficiency and service reliability to customers. Consistent with the recommendation for Issue 125, the specificity of the performance based mechanism should be addressed in a separate docket. (D. Lee, Matlock)

POSITION OF THE PARTIES

GULF: No. Gulf has demonstrated its commitment to providing reliable electric service and superior customer service. Such a mechanism could result in an electric utility focusing on one very narrow component of reliability to the exclusion of other equally important components. In addition, the proposed mechanism is one-sided and acts more as a penalty mechanism than an incentive mechanism.

FEA: No position stated in Brief.

FIPUG: Yes, FIPUG supports the position of Staff's witness, Mr. Bremen, on this issue.

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

STAFF ANALYSIS: This issue and Issue 34 address performance based incentives. Incentive mechanisms to promote future performance are addressed in this issue, whereas incentive mechanisms to address past and current performance are addressed in Issue 34. Staff witness Breman provided testimony to address the need for an incentive mechanism that would provide for a payment or credit to retail customers if frequent outages occur. Based on witness Breman's testimony, the main reason that an incentive mechanism is needed is that this approach is proactive rather than reactive in dealing with service reliability issues. (TR 868, 876) In addition, Mr. Breman proposed a specific incentive mechanism based on the measurement of Customers Experiencing More than Five Interruptions ("CEMI5"). His proposed annual minimum performance standard for Gulf is a CEMI5 of 2 percent. The Company would fail this standard if more than 2 percent of its customers experienced more than 5 interruptions a year. Based on the proposed mechanism, Gulf would be required to make an annual refund to its retail customers when CEMI5 exceeds 2 percent in any consecutive 12 month period. This penalty for poor performance is capped at the equivalent of 10 basis points of ROE. (TR 871-873; EXH 46 at JEB-4)

Gulf argues that a penalty mechanism is unnecessary because the Company has demonstrated a record of good performance and a commitment to satisfying its customers. Gulf witness Fisher cites the results of customer surveys and distribution reliability indices to demonstrate its record of good performance in customer satisfaction and distribution reliability. (TR 1020-1022, 1027) In addition, witness Fisher argues that Gulf's commitment comes willingly. (TR 1021)

Staff believes Gulf's arguments are not sufficient to support its position. A company's past performance and stated commitment to customer satisfaction do not obviate the need for a minimum performance standard and incentives for a company to maintain such a standard. If willing commitment could be an argument against a penalty, it could also be an argument against a reward, which would contradict Gulf's position on the ROE adjustment issue (Issue 34).

Witness Fisher's testimony indicates that Gulf's test year budget contains a commitment to improving its tree-related outage performance and a higher level of reliability. (TR 435) Yet Gulf offers no clear goals and performance guarantees attached to its budget.

Although Gulf has proven its capability to achieve CEMI5 of 1 percent in 2001 (EXH 52 at Schedule 6), Gulf appears to believe that it could be penalized by the standard of 2 percent CEMI5.

Staff believes a performance guarantee would be a more concrete form of commitment.

The idea that a proactive incentive approach is more effective than a reactive intervention approach is unchallenged. (TR 876) The evidence suggests that Commission intervention in 1997, after several years of declines in distribution reliability, resulted in improved distribution reliability. Although the intervention was a reaction to poor performance by other companies, the collaborative efforts of the utilities and the Commission staff have improved the reliability performance statewide, including Gulf's. (EXH 46; TR 868, 877-878, 884-886, 1022) Similarly, staff believes a well designed proactive incentive mechanism will be effective whether a company has demonstrated poor performance or not.

Gulf's other arguments deal with the specifics of Staff witness Breman's proposed mechanism. Gulf's major concern is that witness Breman's proposed incentive mechanism offers no opportunity for a reward. (TR 881-882, 1024-1025, 1099)

At the hearing, Gulf witness Bowden proposed a performance based concept that would provide rewards and earnings sharing based on performance ratings and availability of earnings. (TR 73-105) Staff witness Breman is not opposed to rewards for future performance if there is a balanced "carrot and stick" approach with properly defined standards. (TR 890-892) Staff agrees that both penalty and reward provisions should be addressed in a performance based mechanism and such a mechanism should be based on future instead of past or current performance.

Gulf also expressed a number of other concerns about the specifics of staff witness Breman's proposed mechanism. First, Witness Fisher argues that to use a single indicator of reliability could cause Gulf's focus to shift away from other more measures which Gulf deems effective. (TR 1023, 1027) Second, Gulf suggests that a number of factors that might affect customer interruptions (CEMI5), such as weather and accidents, are outside the utility's control. (TR 1019, 1021, 882-883) Finally, Gulf suggests that the administrative costs for such a program could be substantial and these dollars could be better spent to correct the reliability problem. (TR 883, 1022)

First, staff agrees with Gulf that CEMI5 is to narrow a measure to assess performance adequately. Other meaningful measures of distribution reliability such as average minutes of interruption should also be considered. (TR 74; EXH 46 at JEB-1) As discussed in Issue 34, staff also believes combining price and service performance measures to form a composite customer value indicator is a good idea.

Second, staff agrees with Gulf that factors outside of its control should be considered. Such factors may act to Gulf's benefit or detriment. Extreme weather conditions such as named storms are currently excluded from distribution reliability performance calculations. As discussed in Issue 34, other factors not related to Gulf's efforts, such as its geographic location, may have contributed to its low rates. These factors should be considered when establishing performance based incentives.

Third, while staff believes the benefits of an incentive mechanism may outweigh its costs, staff agrees that administrative costs should be considered.

Gulf witness Bowden's proposal offers no clear solution. Indeed, the Gulf's arguments against witness Breman's proposal apply to Gulf's proposal as well. First, witness Bowden suggests using surveys in addition to other reliability measures. (TR 74) Gulf witness Fisher admits that the proprietary surveys Gulf relies on are inherently less accurate than other objective methods. (TR 475-476) Thus, performance incentives based on results of proprietary surveys as suggested by Gulf could cause Gulf's focus to shift away from other more accurate and recognized measures.

Second, Gulf's proposed concept does not consider factors outside of its control. As discussed earlier, these factors may benefit Gulf's performance thus may reward the Company for performance not solely due to its efforts.

Third, Gulf's proposal provides only upside earning opportunities for Gulf. (TR 882)

Finally, because Gulf's proposal relies on broader performance measures, the administrative costs of a plan based on Gulf's proposal may be higher than the costs associated with witness Breman's plan. Determining the proper levels of performance and the appropriate levels of incentives is highly technical in nature. If these issues are not fully addressed, parties may revisit them in the annual administration of the incentive mechanism, which may lead to controversies and may affect the cost and effectiveness of the incentive plan.

Based on the above discussion, staff believes Gulf's proposal requires extensive review and may have implementation problems. However, the current lack of a specific incentive mechanism does not mean a performance based plan should not be established. Gulf witness Bowden supports the concept of performance based mechanisms. (TR 89) The concerns about witness Breman's and Gulf's mechanisms should be addressed and resolved so a better mechanism can be established. Staff witness Breman is not opposed to modifying his proposed mechanism for a larger, more meaningful penalty provision corresponding to Gulf's proposed plan. (TR 881, 891-892) Because Gulf's proposed incentive mechanism appears to be based on broader performance measures than the one proposed by staff witness Breman, staff believes the proper penalty provision should be addressed within a comprehensive performance-based incentive plan.

In summary, Staff witness Breman has provided a simple incentive mechanism which clearly defines the performance measure and the performance standard. He has also demonstrated the need of a forward-looking performance based approach to address the frequent outage problem. Staff agrees that Gulf's concerns about witness Breman's proposal should be addressed. Gulf witness Bowden's proposal also has its strengths and weaknesses. Gulf's alternative proposal was not fully developed and reviewed in this proceeding. Gulf witness Bowden has recognized that its plan is not in the prefiled testimony. (TR 103) A performance based mechanism involves highly technical issues. Gulf's conceptual proposal needs to be carefully reviewed to avoid future implementation problems. Staff believes it is better to consider all factors in a one-time, extensive review to establish reasonable performance measures, performance rating standards, and incentives.

Based on these reasons, staff concludes that to provide incentives for high future performance in efficiency and service reliability, a forward-looking performance based incentive mechanism is needed. However, a properly balanced incentive mechanism cannot be established at this time. Consistent with the procedural considerations discussed in Issue 125, staff believes the performance based mechanism should be addressed in a separate docket.

ISSUE 4: Should adjustments be made to Gulf's projected test year due to customer complaints? (P. Lowery)
STIPULATED

ISSUE 5: Is the quality of electric service provided by Gulf adequate? (D. Lee, Matlock, Lowery)
STIPULATED

RATE BASE

ISSUE 6: Should an adjustment be made to production related additions included in Plant in Service? (Haff)

RECOMMENDATION: No. Staff recommends no adjustment to production-related additions included in Plant in Service. (Haff)

POSITION OF THE PARTIES

GULF: No. The Commission approved a stipulation to include Smith Unit 3 without adjustment. The other production related additions included in plant-in-service for Gulf's projected test year are reasonable, prudent, and necessary and should be allowed. These additions, which are detailed in Mr. Moore's testimony and exhibits, are necessary to effectively maintain Gulf's existing fleet of generating units such that Gulf can continue to provide low cost, reliable generation to its customers.

FEA: No position stated in Brief.

FIPUG: Agree with OPC.

OPC: No position stated in Brief.

STAFF ANALYSIS: Over the four-year period from January 1, 1997, to December 31, 2000, gross production additions to Gulf's Plant in Service averaged $15,294,572 per year. (EXH 6, Gulf Depreciation Study, Tab 10)

For the 17-month period from January 1, 2001, to May 31, 2002 (prior year), Gulf's production budget expenditures total $238,059,000. (EXH 32, Schedule 9) The vast majority of this total, $188,232,000, is associated with the construction of Smith Unit 3. Expenditures associated with the construction of Smith Unit 3 were subject to a stipulation which was approved by the Commission at the beginning of the hearing.

For the period from June 1, 2002, to May 31, 2003 (projected test year), production-related items are forecasted to be $13,008,999. Approximately $677,000 of this total is associated with the construction of Smith Unit 3. These Smith Unit 3 expenditures were subject to the same Commission-approved stipulation. (EXH 32, Schedules 9 and 10)

Staff believes that the record evidence provides considerable identification and description of Gulf's specific capital projects associated with budgeted production expenses. (TR 410-412, 981-982; EXH 30; EXH 32) Gulf provided detailed cost estimates for these capital projects. Staff agrees with Gulf witness Moore's testimony that these projects are necessary to improve the efficiency and availability of Gulf's generating units. (TR 410-411, 983) Further, even though budgeted production plant items for the projected test year ($13,008,999) include some dollars associated with Smith Unit 3, the budgeted amount is still less than the four-year average for the 1997-2000 period ($15,294,572).

Prior to hearing, OPC took the position that, "... A number of budgeted items for production related items appear to be overstated. OPC is awaiting further information from Gulf to explain the items more fully." OPC witness Schultz's prefiled testimony stated that, "Tentatively, I believe the production plant additions were overstated." (TR 791) FIPUG adopted OPC's position prior to hearing. However, at the hearing, witness Schultz did not identify any specific adjustments to production plant. OPC took no position on this issue in its post-hearing brief.

In summary, staff concludes that Gulf has provided substantial detail on its production-related additions. OPC offers no evidence or argument to refute Gulf's position and does not recommend any adjustments to production plant items. Staff believes that the documentation provided by Gulf is adequate support and justification for the reasonableness of budgeted production plant additions. Therefore, staff recommends that no adjustment be made.

<u>ISSUE 7</u>: Should an adjustment be made to transmission and distribution related additions included in Plant in Service? (Haff, D. Lee)

<u>RECOMMENDATION</u>: No. Staff recommends no adjustment to transmission or distribution-related additions included in Plant in Service. (Haff, D. Lee)

<u>POSITION OF THE PARTIES</u>

<u>GULF</u>: No. The transmission and distribution related additions included in plant-in-service for Gulf's projected test year are reasonable, prudent, necessary and should be allowed. These amounts, which are detailed in the testimony and exhibits of Mr. Howell and Mr. Fisher, are necessary to serve new customers, meet additional load growth from existing customers, and replace deteriorating facilities.

<u>FEA</u>: No position stated in Brief.

<u>FIPUG</u>: Adopts OPC's position.

<u>OPC</u>: Yes. The $162,822,000 of distribution, transmission and general plant additions should be removed.

<u>STAFF ANALYSIS</u>: Over the four-year period from January 1, 1997, to December 31, 2000, Gulf's transmission plant additions averaged $5,704,145 per year. (EXH 6, Gulf Depreciation Study, Tab 10) During the same four-year historic period, distribution plant additions averaged $31,126,711. (EXH 6, Gulf Depreciation Study, Tab 10)

For the 17-month period from January 1, 2001, to May 31, 2002 (prior year), Gulf's transmission plant budget totals $48,530,000, while the distribution plant budget totals $57,113,000. (EXH 30, Schedule 2; EXH 53)

For the period from June 1, 2002, to May 31, 2003 (projected test year), the transmission plant budget is estimated to be $7,505,000. (EXH 30, Schedule 2) For the same period, the distribution plant budget is estimated to be $38,305,000. (EXH 30, Schedule 2)

Staff believes that the record evidence provides considerable identification and description of specific capital projects associated with budgeted transmission expenses. (TR 514-516, 1063-1065; EXH 30, Schedule 2) Detailed cost estimates are given for these transmission capital projects. (EXH 53) Staff agrees with Gulf witness Howell's testimony that these projects are necessary "to serve new customers; to strengthen the transmission system to meet additional demand resulting from load growth; and to replace damaged, worn out, or obsolete facilities." (TR 1063) Likewise, staff believes that the record provides substantial identification and description of budgeted distribution expenses. (TR 440-442, 1010-1011; EXH 53) Detailed cost estimates are given for these distribution capital projects. (EXH 52, Schedules 2 through 5) Budgeted transmission and distribution Plant in Service items for the projected test year are comparable to the four-year average for the 1997-2000 period.

OPC witness Schultz testified that the Commission should disallow $162,822,000 of budgeted additions for distribution, transmission, and general plant because Gulf did not adequately justify their inclusion in rate base. (TR 790-793) The witness testified:

> 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. (TR 791)

Staff notes that Gulf provided a similar level of detail for budgeted transmission, distribution, and general plant additions as it did for production plant additions (Issue 6), for which OPC and FIPUG proffer no disagreement. At the hearing, witness Schultz did not identify any specific adjustments to the transmission or distribution budget.

In summary, staff concludes that Gulf has provided substantial detail on its transmission and distribution-related additions. OPC and FIPUG did not recommend any adjustments to these items. Staff believes that the documentation provided by Gulf is adequate support and justification for the reasonableness of its budgeted transmission and distribution plant additions. Therefore, staff recommends that no adjustment be made.

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

RECOMMENDATION: No. Staff recommends no adjustment to the general plant related additions included in Plant in Service. (Meeks)

POSITION OF THE PARTIES

GULF: No. The general plant additions included in plant-in-service for the projected test year are reasonable, prudent, and necessary and should be allowed. The majority of these expenditures, which are described in the testimony of Mr. Fisher and Mr. Saxon, are to provide for improvements to buildings and land, as well as the purchase of automotive equipment, including mechanized line and service trucks, as well as telecommunications, computer and other equipment.

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

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

STAFF ANALYSIS: Gulf provided its construction budget for the period January 1, 2001 - May 31, 2003 totaling $413,891,000 in capital expenditures. The amount relating to transmission, distribution, and general plant totals $162,822,000. The general plant budgeted additions total $11,400,000. (EXH 30, RMS-1, Schedule 2)

Gulf's witnesses Fisher and Saxon testify that $5,300,000 reflect budgeted additions for the January 2001 through May 2002 period and $6,113,000 relates to the test year budgeted additions. (EXH 30, RMS-1, Schedule 2; EXH 52, FMF-2, Schedule 4-5; EXH 49, RMS-2, Schedule 1) The majority of the additions budgeted for the test year relate to improvements to buildings and land, as well as purchases of automotive equipment including mechanized line and service trucks, telecommunications, computer, and other equipment. (Saxon TR 356; Fisher TR 441-442, 1010; EXH 49, RMS-2, Schedule 1)

Gulf's witness Saxon asserts that the budgeted general plant additions are well within the range of normal spending compared to the last three years and the period of January 2001 through May 2002. (TR 356) The witness notes that the total actual 2001 capital expenditures are 1.85 percent under the 2001 budget. (TR 965) Both witnesses Saxon and Fisher provided documentation regarding the general plant additions showing the specific project description, identification, and dollar amounts for the test year. (EXH 5; EXH 49; EXH 52)

OPC witness Schultz testifies that Gulf's $162,822,000 budgeted additions for distribution, transmission, and general plant should be disallowed on the basis of inadequate support being provided. (TR 790-793) The witness testified:

> 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. (TR 791)

Staff notes that the evidence submitted provides an identification and description of the specific projects associated with the budgeted general plant additions. (Saxon TR 966-967; EXH 5, pp. 38-49; EXH 49; EXH 52) Moreover, the evidence indicates that the $6.2 million in test year general plant additions is within the range of additions recorded during the 1998 - 2000 period for this function. (EXH 6, Depreciation Study, Tab 10)

Since OPC takes no exception to Gulf's supporting information for budgeted production plant additions (Issue 6), staff compared that documentation with the documentation provided for the transmission, distribution, and general plant additions. (OPC BR p. 6; EXH 5, pp. 38-49; EXH 49; EXH 52) Specific items included in the construction budget for general plant additions are detailed in much the same format and contain much of the same information as provided for the production plant additions. For example, the production budget information includes individual project numbers with descriptions and estimated expenditures. Likewise, general plant budgeted information also includes individual project numbers with descriptions and estimated expenditures. (EXH 5, pp. 38-49; EXH 49; EXH 52)

In conclusion, OPC argues that Gulf's budgeted additions for distribution, transmission, and general plant should be disallowed based on Gulf's failure to provide supporting identification or description of the additions. However, Gulf provides a similar level of detail for the production plant additions and OPC does not object to that documentation. The supporting detail identifies and describes specific projects relating to the budgeted general plant additions. OPC provides no other specific disagreement with Gulf's budgeted additions. Staff believes that the documentation provided by Gulf is adequate support and justification for the reasonableness of its budgeted general plant additions. Staff recommends no adjustment is necessary to Plant in Service.

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

RECOMMENDATION: Yes. The deferral of the return on the third floor should be allowed in rate base. The balance should be reduced $610,886 ($753,403 system) to reflect additional amortization booked during 2001 and a four year amortization period as discussed in issue 72. (L. Romig)

POSITION OF THE PARTIES

GULF: Yes. In Gulf's last rate case, the Commission allowed Gulf to earn a deferred return on the third floor investment in anticipation of future recovery. The third floor is fully utilized and the deferred return should be allowed in rate base. The deferred return balance as filed in the MFRs should be reduced by $693,000 jurisdictional to reflect the impact of the additional amortization that was booked during 2001 pursuant to the revenue sharing stipulation.

FEA: No position stated in Brief.

FIPUG: No. The third floor has never been used and useful and it is not used and useful now. Current and future ratepayers should not be required to pay earnings on the building from past years when it was not used and useful.

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.

STAFF ANALYSIS: The Commission removed the cost of the third floor or $3,840,000 from rate base in the Company's last rate case, Order No. 23573, issued October 3, 1990, in Docket No. 891345-EI. The Commission found that Gulf had adequate storage space and maintenance facilities at other locations and that the ratepayers would not benefit from the use of the third floor of the headquarters building for these purposes. The Commission, however allowed Gulf to earn a return on this plant investment equal to the allowance for funds used during construction (AFUDC).

The Commission issued, on October 28, 1999, Order No. PSC-99-2131-S-EI, in Docket No. 990947-EI approving a Stipulation and Settlement. This Order addressed, among other things, Gulf's regulatory assets including the accumulated balance of the deferred return on the third floor of the corporate offices. The starting date of the Settlement began October 1, 1999, and expires with the earlier of the day before the commercial in-service date of Smith Unit 3 or December 31, 2002. The agreement authorizes Gulf to record at its discretion, up to $1 million per year through the expiration date to reduce the accumulated balance of the deferred return.

Gulf amortized $1 million in each of the years 2000 and 2001. The MFR balance of the deferred return at the end of May 2002 is $3,470,595 system, which includes the $1 million in discretionary amortization in the year 2000 but does not reflect the additional amortization in 2001. The 2001 amortization was recorded after the MFRs were filed. Based on Witness Labrato's Exhibit 54, Schedule 1, the adjusted balance at May 2002 reflecting the 2001 amortization is $2,444,958.

Gulf is requesting that the deferred return be allowed in rate base and amortized over three years since 100% of the third floor is now being utilized for record retention, spare office furniture, miscellaneous supplies, and other storage for the print shop, safety and health, and power delivery functions. The amortization period is discussed in Issue 72. It also contains space for building maintenance. (TR 1097) Witness Labrato testified that in 1999 a FPSC auditor toured the third floor and found that over 90% of the space was being utilized. Also, based on Disclosure No. 2 in the staff audit report (Exhibit 47, attached to the testimony of staff witness Bass), the utilization of the space was confirmed by the audit staff. (TR 907)

OPC witness Schultz testified that the third floor was initially used for storage space which was originally intended as additional office space to accommodate Gulf's growth. Gulf's employee complement in 1989 was 1,626 and in the year 2000 was 1,319. OPC stated in its brief that the space was never converted to offices as expected. (BR 7)

OPC also expressed concern that current customers would be required to pay deferred earnings on something that is not providing service. Accordingly, working capital should be reduced $2,893,000 and amortization expenses should be reduced $1,157,000. (BR 7)

Gulf Witness Labrato testified that at the time of the last case, Gulf had adequate space for storage and maintenance functions at other locations. When the office was built, it was built with the additional floor, and that it was not needed for office space at that time. Also, it was anticipated that it would be utilized in the future, and that because of the deferred return, future recovery would be allowed. In addition, it was not anticipated that the period of time would go this long, which is why the amount is so big. (TR 656-656)

In response to questions from Commissioner Deason, the witness further testified that for surveillance purposes the investment was removed from rate base, the deferral was recorded as a regulatory asset, and the earnings were below-the-line so it did not impact the surveillance earnings. (TR 658-659) For financial accounting purposes it was accounted for the same way. The investors and the financial community realized the amount was deferred and anticipated future recovery. (TR 659)

Staff recommends that the deferral of the return on the third floor be included in rate base. Although the third floor is not being used as it was originally intended, it is being used. Also, it was intended that recovery of the deferred return would ultimately be allowed. Therefore, it would be appropriate to include $2,138,760 in rate base, which reflects the additional amortization booked during 2001, and a four year amortization period as discussed in Issue 72.

ISSUE 9B: Should the third floor of the corporate offices be allowed in rate base? (L. Romig, Meeks)

RECOMMENDATION: Yes. Since the third floor is currently used and useful, it would be appropriate to include the third floor investment in rate base. (L. Romig, Meeks)

POSITION OF THE PARTIES

GULF: Yes. In Gulf's last rate case, the Commission ordered the Company to remove the cost of the third floor from rate base, but allowed the Company to earn a deferred return on that investment in anticipation of future recovery. The third floor is fully utilized and the investment, as well as the deferred return, should be allowed in rate base.

FEA: No position stated in Brief.

FIPUG: No. This asset is not used and useful and it should not be placed in rate base. Plant and depreciation should be reduced to remove the third floor.

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

STAFF ANALYSIS: As stated in Issue 9A, the Commission removed the cost of the third floor in the Company's last rate case. Gulf's witness Labrato testified that the third floor is being utilized and that the investment should be allowed in rate base. The projected test year rate base includes the $3.8 million of plant-in-service and $338,000 in accumulated depreciation, which were removed in the last case. (TR 619)

During cross examination, witness Labrato stated that the space is less expensive than the rest of the building because the space is unfinished with no walls. (TR 645-646) The witness further testified that the investment has allowed for convenient, secure, and humidity-controlled space for items that are used in the corporate office. (TR 1097) In addition, if this space were not available, the Company would be required to build or lease additional space. (TR 1097)

OPC states in its brief that it accepts the conclusion by the FPSC staff audit that the third floor is currently being used for storage space and therefore provides some value to the public. (BR 8; EXH 47) However, two concerns were raised by OPC.

First, the space was not originally intended to be used for storage space, but for office space. Accordingly, the "storage rooms" occupy space in a near waterfront building. The space is more expensive than that normally associated with storage space.

Secondly, the third floor has not been depreciated in the 12 1/2 years since Order No. 23573 was issued in Docket No. 891345-EI. The depreciable life of the office building is approximately 25 years. (TR 644) Therefore, if the third floor is being depreciated over the remaining life of the building, then the current and future customers would be charged double the depreciation rate for a storage area. OPC is therefore recommending that the Commission allow half the investment in rate base and reduce depreciation by half. (BR 8)

The FPSC audit staff toured the third floor of the corporate office and indicated that over 90% of the space is utilized. (EXH 47) The third floor is primarily used for storage of records, spare office furniture, miscellaneous supplies for the kitchen, print shop, safety and health, and power delivery. It also contains a workshop for building maintenance. (EXH 47) Staff witness Bass concludes in Audit Disclosure No. 2 that the third floor of the corporate office is used and useful for utility operations. (EXH 47) OPC accepts staff witness Bass' conclusion. (BR 8)

The third floor investment of $3.8 million will be recorded in Account 390, Structures and Improvement, where the investment in the corporate office is recorded. The third floor investment of $3.8 million will be depreciated over the remaining life of Account 390 and not over the remaining life of the individual unit or building. The remaining life of Account 390 is 30 years; not 25 years. (TR 644; OPC BR 8; EXH 6, Depreciation Study, Tab 5) The inclusion of the third floor investment will naturally increase depreciation expense. However, the additional investment will not affect the remaining life nor the depreciation rate for Account

390. This is because the $3.8 million associated with the third floor represent only about 7% of the total account investment. Compositing the age of the third floor (15.5 years) with the 16.2 year age given for Account 390 will result in no change in the average remaining life. While OPC is correct that there will be an inherent reserve deficiency associated with the third floor due to its exclusion from rate base for 12 1/2 years, it has no affect on the 2.2% depreciation rate. Moreover, Account 390 has sufficient existing reserve surplus to correct the deficiency. According to the information provided in Gulf's depreciation study, Account 390 has a perceived reserve surplus which could be used to offset the reserve deficit due to the exclusion of third floor investment from rate base. (EXH 6, Depreciation Study, Tab 5)

Since the third floor is used and useful, staff believes that it is appropriate that the investment and reserve for the third floor of the corporate office be included in rate base and that the Company begin depreciating this investment using a 2.2% depreciation rate. (EXH 6, Depreciation Study, Tab 5)

ISSUE 10: Should an adjustment be made to Smith Unit 3? (Haff)
STIPULATED

ISSUE 11: DELETED. Number retained for continuity.

ISSUE 12: What are the appropriate adjustments, if any, that should be made to Gulf's test year rate base to account for the additional security measures implemented in response to the increased threat of terrorist attacks since September 11, 2001? (McNulty, Mills)

RECOMMENDATION: An increase of $683,000 ($714,000 system) should be made to rate base for the May 2003 projected test year for investments in additional security measures made in response to the increased threat of terrorist attacks since September 11, 2001. (McNulty, Mills)

POSITION OF THE PARTIES

GULF: A $683,000 adjustment ($714,000 system) should be made to increase rate base for the May 2003 projected test year to reflect the impact of investments in additional security measures implemented in response to the increased threat of terrorist attacks since September 11, 2001.

FEA: No position stated in Brief.

FIPUG: No position stated in Brief.

OPC: No position stated in Brief.

STAFF ANALYSIS: Gulf's MFRs and direct testimony were filed on September 10, 2001, and thus do not contain the impact of the increased threat of terrorist attacks since September 11, 2001, on test year rate base. Staff requested information pertaining to the impact of the increased terrorist threat on Gulf's costs in Staff's Seventh Set of Interrogatories Nos. 235-238. Gulf filed its response to these interrogatories under a request for confidential classification on February 4, 2002. Order No. PSC-02-0220-CFO-EI, issued February 22, 2002, granted confidential classification to the interrogatory responses. The confidential interrogatory responses were identified as Exhibit 7 at the hearing.

Staff has reviewed Exhibit 7 and believes the rate base information provided is reasonable and appropriate. (EXH 7, Item 238, p. 2 of 2) Thus, staff agrees with Gulf and recommends that a \$683,000 adjustment (\$714,000 system) should be made to increase rate base for the May 2003 projected test year for investments in additional security measures made in response to the increased threat of terrorist attacks since September 11, 2001.

ISSUE 13: Should the capitalized items currently approved for recovery through the Environmental Cost Recovery Clause (ECRC) be included in rate base for Gulf? (D. Lee)

RECOMMENDATION: No. The current practice of recovering the capital costs through the ECRC is consistent with the Florida Statutes. No benefit to customers has been shown by including such costs in base rates during this rate proceeding. Therefore, not including Gulf's currently capitalized ECRC items in rate base is reasonable and appropriate. (D. Lee)

POSITION OF THE PARTIES

GULF: No. The Company filed its case assuming that the capitalized items currently approved for recovery through the Environmental Cost Recovery Clause ("ECRC") would continue to be recovered through the ECRC. The ECRC factors approved by the Commission for 2002 were calculated consistent with this assumption. The impact on customers is essentially the same whether the costs are recovered through base rates or through the ECRC.

FEA: No position stated in Brief.

FIPUG: No. All capital items are much more appropriately recovered through base rates rather than a guaranteed cost recovery clause.

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.

STAFF ANALYSIS: This issue concerns whether the capitalized items currently recovered through the ECRC should be moved into rate base in this proceeding. OPC and FIPUG argue that Section 366.8255(5), Florida Statutes, suggests incorporating such items into base rates during a rate case.

Section 366.8255(5), Florida Statutes, provides in part that: "Recovery of environmental compliance costs under this section does not preclude inclusion of such costs in base rates in a subsequent rate proceeding, if that inclusion is necessary and appropriate; ..." This section grants the Commission some discretion to decide whether costs approved for recovery through the ECRC should be moved into base rates.

In this case, staff agrees with Gulf that the impact on customers is essentially the same whether the costs are recovered through base rates or through the ECRC. There is no testimony in the record that indicates customers may benefit by including any of these capital costs in base rates, and that it is either necessary or appropriate to do so. According to Order No. PSC-94-0044-FOF-EI, issued January 12, 1994, in Docket No. 930613-EI, Gulf is allowed to earn its currently authorized ROE for capitalized items recovered through the ECRC. This fixed midpoint ROE policy is reaffirmed by Order No. PSC-99-2513-FOF-EI, issued December 22, 1999, in Docket No. 990007-EI. Because a company has an opportunity to earn a return higher than the midpoint ROE in base rates, including capitalized ECRC items in rate base may reward Gulf for the costs that are outside its control. For the reasons discussed above, staff concludes that not including Gulf's currently capitalized ECRC items in rate base is reasonable and appropriate.

ISSUE 14: DELETED. Number retained for continuity.

ISSUE 15: Has the Company removed all non-utility activities from rate base? (Meeks, L. Romig)
STIPULATED

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? (Meeks, Haff, L. Romig)

RECOMMENDATION: No. Based on the adjustments recommended below, Plant in Service should be increased $125,000 ($156,000 system). The appropriate amount of Plant in Service is $1,966,617,000 ($2,015,169,000 System) for the May 2003 projected test year. (Attachment 1) (Meeks, Haff, L. Romig)

POSITION OF THE PARTIES

GULF: No. The requested level of plant-in-service should be adjusted by $926,000 to a new total of $1,967,418,000 on a jurisdictional basis (or by $961,000 to $2,015,974,000 on a system basis) to reflect the increased investment associated with additional security measures discussed in Issue 12 and the capitalization of underground cable injection costs discussed in Issue 64.

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

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

STAFF ANALYSIS: This issue is dependent on the resolution of Issues 12 and 64 as well as a recommended adjustment regarding an understatement of Gulf's budgeted retirements for house power panels, Account 369.3.

Gulf's policy is to retire house power panels in place; that is to say the panels are abandoned in place rather than physically removed. Gulf indicates that the rate case budget inadvertently understated the retirements having the effect of overstating the plant in service for this account. Therefore, plant in service, accumulated depreciation, and depreciation expense should be decreased $641,000, $698,000, and $49,000, respectively. (EXH 6, pp. 42, 50)

The cumulative effect of staff's recommended adjustments is an increase of $125,000 to test year Plant in Service as shown below:

Test Year Plant in Service Staff Recommended Adjustments		
Issues	Jurisdictional	System
Issue 12-Security Measures	$683,000	$714,000
Issue 64-Cable Injection	83,000	83,000
House Power Panels	(641,000)	(641,000)
Total Adjustment	$125,000	$156,000

<u>ISSUE 17</u>: What adjustments should be made to Accumulated Depreciation to reflect the Commission's decision in Docket No. 010789-EI? (Meeks)
STIPULATED

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? (Meeks, L. Romig)

RECOMMENDATION: No. Based on the adjustments recommended in previous issues, the test year accumulated depreciation should be decreased $1,716,000 ($1,754,000 System). The appropriate amount of accumulated depreciation for the May 2003 projected test year is $852,383,000 ($874,482,000 System). (Attachment 1) (Meeks, L. Romig)

POSITION OF THE PARTIES

GULF: No. The requested level of accumulated depreciation should be reduced by $926,000 ($960,000 system) to reflect the stipulation to a longer depreciable life for Smith Unit 3, the effect of Gulf's recommended adjustments related to additional security measures, and capitalization of cable injection costs.

FEA: No position stated in Brief.

FIPUG: No position stated in Brief.

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

STAFF ANALYSIS: The appropriate amount of accumulated depreciation is $852,383,000 for the projected test year. This is a calculation based on adjustments addressed in Issues 16, 64, and 74 as shown below:

Test Year Accumulated Depreciation Staff Recommended Adjustments		
Issues	Jurisdictional	System
Issue 64-Cable Injection	$ (1)	$ (1)
Issue 16-House Power Panels	698	698
Issue 74-Stipulated 25-year life for Smith Unit 3	1,019	1,057
Total Adjustment	$1,716	$1,754

ISSUE 19: Is Gulf's requested level of Construction Work in Progress in the amount of $15,850,000 ($16,361,000 system) for the May 2003 projected test year appropriate? (Haff, Meeks, Green, L. Romig)
STIPULATED

ISSUE 20: Should an adjustment be made to Plant Held for Future Use for Gulf's inclusion of the Caryville site in rate base? (Haff)
STIPULATED

ISSUE 21: Is Gulf's requested level of Property Held for Future Use in the amount of $3,065,000 ($3,164,000 system) for the May 2003 projected test year appropriate? (Haff, L. Romig)
STIPULATED

ISSUE 22: Should an adjustment be made to prepaid pension expense in its calculation of working capital? (Kaproth, Kyle)
STIPULATED

ISSUE 23: Should an adjustment be made to rate base for unfunded Other Post-retirement Employee Benefit (OPEB) liability? (Kaproth, Kyle)
STIPULATED

ISSUE 24: Should any adjustments be made to Gulf's fuel inventories? (Bohrmann, Matlock)

RECOMMENDATION: No. Gulf's fuel inventory levels are consistent with the guidelines the Commission established in Order No. 12645, issued November 3, 1983, in Docket No. 830001-EI. (Bohrmann, Matlock)

POSITION OF THE PARTIES

GULF: No. Gulf's requested fuel inventory is reasonable, prudent and in the best interest of Gulf's customers. Gulf's inventory management policy balances the cost of replacement fuel and/or energy against the carrying cost of inventory. Any reduction in the allowed inventory would result in higher fuel cost and could impair the reliability of Gulf's generation. The inventory requested in this case, including in-transit, is $3 million lower than the amount allowed in Gulf's last rate case.

FEA: FEA adopts the position of OPC.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: Gulf has requested a total fuel inventory of $42.6 million (13-month average) which is comprised of $29.4 million for fuel stored at its generating plants and $13.1 million for in-transit fuel.

By Order No. 12645, the Commission applies a 90 days projected burn plus base coal volumes as a "generic policy" for coal inventory if two conditions are present: 1) the utility fails to justify its fuel inventory levels; and 2) the Commission can not determine the optimum policy from the evidentiary record.

When calibrating the days supply of its fuel inventory, Gulf must balance two competing concerns. First, if Gulf has too little inventory, Gulf may incur additional costs to purchase fuel on the spot market to maintain reliable service. Second, if Gulf has too much inventory, Gulf will incur greater carrying costs associated with its fuel inventory. Gulf establishes its fuel inventory levels to optimize Gulf's total costs associated with its fuel inventory. (TR 412-413)

In its brief, OPC advocates that the Commission should set Gulf's coal inventory at the sum of the actual 2000 historical amount and Gulf's requested in-transit amount. OPC's witness Helmuth W. Schultz, III, testified that Gulf's historic costs are representative of what is necessary to provide the quality of electric service that Gulf has provided. According to witness Schultz, Gulf did not provide sufficient detailed information about its costs in the projected test year to provide much assurance about the accuracy of these projected costs. (TR 822-823)

Gulf has requested a coal inventory of 52 days supply (695,289 tons) in this docket compared with the 90 days supply of coal inventory that the Commission authorized in Gulf's last rate case. Despite a 37 percent increase in Gulf's electric generation needs since 1990 (TR 417), the value of Gulf's coal inventory is $10.2 million less than what the Commission authorized in the last rate case. (TR 414) Witness Schultz advocates that the Commission should adjust Gulf's coal inventory by 218,808 tons. (TR 794) With an average price of $38.463 per ton (MFR Schedule B-17a, p. 6), the Commission would adjust Gulf's working capital balance by approximately $8,416,000.

Robert G. Moore, Gulf's witness, testified on rebuttal that year 2000 was extraordinary and atypical for Gulf on a going forward basis. Gulf's coal inventory levels fell sharply during the last three months of 2000 as early and prolonged winter conditions increased the demand for coal-fired generation as natural gas-fired generation became more expensive. Also, the winter conditions negatively impacted coal production and delivery schedules. After the winter conditions subsided, Gulf steadily increased its coal inventory back to normal levels. (TR 984-987)

In summary, witness Moore stated that a smaller coal inventory amount would impact Gulf's ability to provide reliable electric service and may cause higher coal procurement costs on the spot market for Gulf's ratepayers. (TR 984-987)

Staff agrees with Gulf that year 2000 was atypical and unrepresentative of Gulf's coal inventory requirements on a going-forward basis. Based on the evidentiary record in this docket, staff believes that Gulf has justified the amount and value of its fuel inventory levels. No adjustment to Gulf's fuel inventories for the projected test year ending May 31, 2003, is necessary.

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? (Kaproth, L. Romig)

RECOMMENDATION: No. The appropriate amount of working capital for the May 2003 projected test year is $66,583,000 ($68,589,000 system). (Attachment 1) (Kaproth, L. Romig)

POSITION OF THE PARTIES

GULF: No. The requested level of working capital should be reduced by $693,000 to $66,501,000 on a jurisdictional basis (or by $855,000 to $68,487,000 on a system basis) to reflect a change in the balance of the deferred return on the third floor of the corporate office.

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

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

STAFF ANALYSIS: Based on staff's recommendation in Issue 9A (Amortization of Deferred Return on the Third Floor), working capital should be reduced by $611,000 ($753,403 system), for a total working capital of $66,583,000 ($68,589,000 system).

ISSUE 26: **DELETED.** Number retained for continuity.

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? (L. Romig)

RECOMMENDATION: No. The appropriate rate base for the May 2003 projected test year is $1,199,732,000. (Attachment 1) (L. Romig)

POSITION OF THE PARTIES

GULF: No. The requested rate base should be revised to $1,199,661,000 on a jurisdictional basis to reflect the impact of the: (a) adjustment to working capital from changes in the deferred return on the third floor of the corporate office; (b) adjustments to plant-in-service and accumulated depreciation due to additional security measures; (c) adjustment to accumulated depreciation resulting from the stipulation reducing depreciation for Smith Unit 3; and (d) capitalization of cable injection costs.

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

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

STAFF ANALYSIS: The parties' positions are shown on the following table and are discussed in the preceding issues.

2003 Jurisdictional Rate Base (000's)			
	Gulf	Staff	OPC
Utility Plant-in-Service	$1,967,418	$1,966,617	--
Accumulated Depreciation	(853,173)	(852,383)	--
Net Plant-in-Service	1,114,245	1,114,234	--
Construction Work in Progress	15,850	15,850	--
Property Held for Future Use	3,065	3,065	--
Net Utility Plant	1,133,160	1,133,149	--
Working Capital	66,501	66,583	--
Total Rate Base	$1,199,661	1,199,732	--

COST OF CAPITAL

ISSUE 28: **DELETED**. Number retained for continuity.

ISSUE 29: What is the appropriate amount of accumulated deferred taxes to include in the capital structure? (C. Romig, Kenny)

RECOMMENDATION: The appropriate amount of accumulated deferred taxes to include in the capital structure is $122,133,000 jurisdictional. (C. Romig, Kenny)

POSITION OF THE PARTIES

GULF: The appropriate amount of accumulated deferred taxes is $121,587,000 jurisdictional ($124,565,000 system) for purposes of calculating the weighted average cost of capital. This amount has been revised from the jurisdictional amount $121,471,000 as originally filed to reflect the revised reconciliation of rate base and capital structure discussed in Issue 31.

FEA: No position stated in Brief.

FIPUG: No position stated in Brief.

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.

STAFF ANALYSIS: Per MFR Schedule D-1, Page 2 of 6, the "Company Total per Books" deferred taxes for test year ending May 31, 2003, is $164,672,000. (EXH 37) To the $164,672,000, the Company made adjustments to remove $33,458,000 of deferred taxes specifically identified with unit power sales contracts and to remove $6,757,000 of deferred taxes for the appropriate portion of other rate base adjustments which were made on a pro rata basis over all sources of capital. The result is total system adjusted deferred taxes of $124,457,000. The Company then applied a jurisdictional factor of .9760026 to this amount, resulting in adjusted jurisdictional deferred taxes of $121,471,000. (EXH 37)

On January 18, 2002, the Company revised its projected capital structure as Exhibit 2 to Mr. Labrato's deposition. The revised capital structure also reflected jurisdictional deferred taxes of $121,471,000. (EXH 11)

Neither FEA or FIPUG took a position on this issue. The OPC did not take issue with the methodology or the amount of deferred taxes in rate base prior to Commission adjustments, but it did state that the actual dollar amount is dependent on the Commission's adjustments to rate base.

Staff agrees with OPC. In addition, staff has made a specific adjustment of $662,000 related to the Smith Unit 3 life addressed in the Depreciation Stipulation. The result is adjusted jurisdictional deferred taxes of $122,133,000.

Accordingly, staff recommends adjusted jurisdictional Accumulated Deferred Taxes of $122,133,000 for the May 31, 2003 projected test year.

ISSUE 30: What is the appropriate amount and cost rate of the unamortized investment tax credits to include in the capital structure? (C. Romig, Kenny)

RECOMMENDATION: The appropriate amount and cost rate of unamortized investment tax credits to include in the capital structure is $16,584,000 and 8.80%, respectively. (C. Romig, Kenny)

POSITION OF THE PARTIES

GULF: The appropriate amount of unamortized investment tax credits is $16,601,000 jurisdictional ($17,007,000 system) and the appropriate cost rate is 9.48% for purposes of calculating the weighted average cost of capital.

FEA: No position stated in Brief.

FIPUG: No position stated in Brief.

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.

STAFF ANALYSIS: Per MFR D-1, Page 2 of 6, the "Company Total per Books" weighted cost investment tax credits for the projected test year ending May 31, 2003 is $22,113,000 and the cost rate is 9.70%. (EXH 37) To the $22,113,000, the Company made adjustments to remove $4,201,000 of investment tax credits specifically identified with unit power sales contracts and to remove $920,000 of investment tax credits for the appropriate portion of other rate base adjustments which were made on a pro rata basis over all sources of capital. The result is total system adjusted investment tax credits of $16,992,000. The Company then applied a jurisdictional factor of .9760026 to this amount, resulting in adjusted jurisdictional investment tax credits of $16,584,000 with a cost rate of 9.70%. The cost rate is derived from long-term debt, preferred stock, and common equity. (EXH 37)

On January 18, 2002, the Company revised its projected capital structure as Exhibit 2 to Mr. Labrato's deposition. The revised capital structure also reflects jurisdictional investment tax credits of $16,584,000, but alters the cost rate from 9.70% to 9.48%. (EXH 11)

Neither FEA or FIPUG took a position on this issue. The OPC did not take issue with the methodology or the amount of investment tax credits in the capital structure prior to Commission adjustments, but it did state that the actual dollar amount is dependent on the Commission's adjustments to rate base and the cost rate is dependent upon the allowed return on equity.

Staff agrees with OPC, but does not believe that there are any staff rate base adjustments that would impact investment tax credits. The result is that no adjustment is necessary and the balance would therefore remain at $16,584,000.

Staff has also recalculated the investment tax credit cost rate based on other staff adjustments and staff's recommended return on equity, resulting in a 8.80% weighted average cost rate for the investment tax credits.

Accordingly, staff recommends adjusted jurisdictional investment tax credits of $16,584,000 with a weighted average cost of 8.80% for the May 31, 2003 projected test year.

ISSUE 31: Have rate base and capital structure been reconciled appropriately? (D. Draper, C. Romig)

RECOMMENDATION: Yes. However, in addition specific adjustments were made due to the Company filing a revised capital structure. Staff also made a pro rata adjustment to investor's sources to properly reconcile the capital structure to rate base. (D. Draper, C. Romig)

POSITION OF THE PARTIES

GULF: Yes. The reconciliation of rate base and capital structure for the current filing is presented in MFR Schedule D-12a, and the proposed adjustments to rate base discussed in other issues have been reconciled on a pro rata basis over all sources of capital to determine the appropriate jurisdictional capital structure for use in the calculation of the overall cost of capital [see Issue 36].

FEA: No position stated in Brief.

FIPUG: No position stated in Brief.

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.

STAFF ANALYSIS: The Company presented its reconciliation of rate base and capital structure on MFR Schedules D-12a and D-12b. (EXH 37) On January 18, 2002, the Company revised its projected capital structure as Exhibit 2 to Mr. Labrato's deposition. (EXH 11) The Company made a specific adjustment to remove non-utility investment from equity and made specific adjustments to remove the unit power sales capital structure amounts from the per books capital structure balances. The Company also properly removed dividends declared from its capital structure. The remaining rate base adjustments required to reconcile the rate base and capital structure were made on a pro rata basis over all sources of capital. Finally, the jurisdictional factors were applied to these balances, resulting in the reconciliation of rate base and capital structure.

As stated, the Company removed all other rate base adjustments on a pro rata basis from all sources of capital. It has been this Commission's practice to make specific adjustments where possible and to prorate other rate base adjustments over investor sources only. However, Gulf's per books capital structure includes deferred taxes and investment tax credits that are being considered, along with the related assets, in cost recovery clauses. Staff believes that it is appropriate for the Company in this case to make pro rata adjustments for the remaining rate base items over all sources. This will allow the Company to match the related deferred taxes and investment tax credits with the assets being recovered through these clauses. For this reason, even though not specifically identified, it is appropriate to recognize the recovery clause treatment so as not to penalize the Company through the double counting of lower cost capital items.

Neither FEA or FIPUG took a position on this issue. The OPC did not take issue with the methodology of reconciliation, but it did state that the actual reconciled amounts will depend on the rate base allowed. Staff agrees with the OPC and has also made a pro rata adjustment over all investor's sources of capital. Staff also agrees with the revised capital structure provided in Mr. Labrato's deposition Exhibit 2. Accordingly, staff believes that with the specific capital structure adjustments and its pro rata adjustment, capital structure, and rate base have been reconciled appropriately.

ISSUE 32: What is the appropriate cost rate for short-term debt for the May 2003 projected test year? (Lester)
STIPULATED

ISSUE 33: What is the appropriate cost rate for long-term debt for the May 2003 projected test year? (Lester)
STIPULATED

ISSUE 34: In setting Gulf's return on equity for use in establishing Gulf's revenue requirements and Gulf's authorized range, should the Commission make an adjustment to reflect Gulf's performance? (D. Lee, Matlock, Lester)

RECOMMENDATION: The Commission should not make an adjustment to Gulf's return on equity to reward or penalize Gulf based on its current and past performance because a performance based plan has not been established for Gulf prior to this docket. Consistent with the recommendation for Issue 3, the Commission should consider establishing for Gulf a forward looking performance based incentives mechanism to encourage high performance in the future. (D. Lee, Matlock, Lester)

POSITION OF THE PARTIES

GULF: Yes. In recognition of Gulf's past and continuing high level of performance in customer satisfaction, customer complaints, transmission and distribution reliability, and generating plant availability, the Commission should increase the return on equity for purposes of setting rates by a minimum of 50 to 100 basis points over the Company's cost of equity.

FEA: No position stated in Brief.

FIPUG: No. As part of its regulatory bargain, Gulf is expected to provide high quality service at cost effective rates. It should not be rewarded for doing what it is required to do.

OPC: No position stated in Brief.

STAFF ANALYSIS: Gulf argues that the Commission should make an upward adjustment to the utility's return on equity (ROE) to reward Gulf for its current and past performance and to promote superior performance in the future. (TR 84) Gulf suggests a ROE adjustment, or ROE adder, over its cost of equity based on the Gulf's price and service performance. (TR 612, 442, 1005)

In its Brief, Gulf states that Staff witness Breman supports rewarding the Company. However, staff believes that witness Breman's proposed penalty mechanism, per his testimony, is directed at future performance rather than a retroactive assessment of past performance. (TR 867, 874) Mr. Breman's support for rewards is conditioned upon a balanced "carrot and stick" approach with properly defined standards for future performance. (TR 890-892) Staff believes it would be unfair to the Company if penalties were assessed without first establishing performance standards and mechanisms for penalties. For the same reason, it would be unfair to the customers if rewards were given to the Company without first establishing performance standards and mechanisms for rewards.

In addition, Gulf appears to have misread the Commission orders cited by Gulf in its Brief to support its position for the ROE adder. Gulf stated that, in Order No. PSC-99-1047-PAA-EI, issued May 24, 1999, in Docket No. 990250-EI, the Commission proposed a midpoint ROE based, in part, on Gulf's superior performance. As noted in Gulf's Brief, Order No. PSC-99-1047-PAA-EI was later withdrawn as part of the stipulation approved in Order No. PSC-99-1970-PAA-EI. Gulf appears to argue that while Order No. PSC-99-1047-PAA-EI offers no legal precedence, it provides a precedent of policy considerations. Based on staff's reading of Order No. PSC-99-1047-PAA-EI, the order provides no policy considerations that support the ROE adder. The third paragraph on page 7 of the order states:

> We find that the appropriate ROE midpoint for Gulf is 11.5%. We believe this is reasonable for Gulf, given the recent 11.0% midpoint for FPL, which the Commission approved as part of a stipulation by Order No. PSC-99-0519-AS-EI, issued March 17, 1999.

It is common for different companies to have different costs of equity because of differences in risk and cost characteristics. Gulf's witness Benore suggested a risk premium based on its smaller size. (TR 143) This does not indicate a reward for Gulf's performance. In fact, the same order suggests that factors outside of Gulf's control may have contributed to its performance, therefore rewards may not be merited. Page 3 of the order states in part:

> ... In its original proposal, Gulf stated that it believes its ROE should be reviewed in light of its reliability and quality of service, its competitive rates, and its equity ratio.

Currently, Gulf has the lowest residential rates among the four largest investor-owned electric utilities in Florida. We believe this is caused by differences in cost conditions for Gulf and the other electric utilities, and efficiency could be part of these cost conditions.

The Commission does have broad ratemaking authority, including the adjustment of ROE outside of cost of equity considerations. The Commission has exercised this authority over Gulf only twice under extraordinary circumstances. In Docket 891345-EI, Order No. 23573, the Commission imposed a two year 50 basis point penalty on Gulf's ROE as a result of criminal and unethical conduct of one of its Vice Presidents, which was affirmed by the Florida Supreme Court. This was an extraordinary circumstance. The other instance occurred in the early 1980s in reaction to the energy crisis. (TR 87) The Commission was required to promote energy conservation and Gulf was clearly the leading innovator in that effort. The 10 basis point adjustment provided by Orders 10557-EI and 9628-EI was more about sending a message to promote conservation than a financial reward. Again, this was an extraordinary circumstance.

The normal Commission practice dealing with incentives has been to reward or penalize a company based on a previously established mechanism. For example, the Generation Performance Incentive Factor, or GPIF, was established in 1981 and is currently administered as part of the annual adjustment to investor-owned utilities' fuel factors. (TR 87) The Commission has also established incentives for wholesale energy sales following the same principle. This is also the practice of other state commissions that have established performance based plans. Gulf witness Bowden's testimony on Mississippi's experience appears to confirm this practice. The Mississippi Power Company has operated under an incentive plan for several years. (TR 80) In December 2001, a performance based ROE adder was awarded based on the previously established plan. (TR 80) This is different from proposing a plan and asking for a reward based on the plan at the same time. It is common sense that standards and mechanisms need to be in place and clearly understood before incentives can work.

Gulf has operated under the incentives that exist in the traditional earning based mechanism and a revenue sharing mechanism. Under the traditional earning based mechanism, one of the main incentives is that once base rates are set, cost savings can be translated into higher shareholder earnings, as long as the earnings are within the authorized range. (TR 888-889, 894) The revenue sharing mechanism offers an expanded ROE range, thus a greater incentive for the Company to improve efficiency. (TR 71-73) Because of the concern that a utility's incentive to reduce costs may lead to deterioration of service quality, the Commission has programs in place to monitor service quality and to intervene if necessary. (TR 868-869, 877) Therefore, under these mechanisms, the Company has an opportunity to improve efficiency and earnings in exchange for its obligation to serve and to maintain a service quality.

In its Brief, FIPUG argues that Gulf operates under the current regulatory bargain and should not be further rewarded. Staff agrees with FIPUG that Gulf has already benefitted under the current regulatory bargain, demonstrated by its respectable earned ROE. In addition, GPIF already provides Gulf with rewards for its generating unit performance. (TR 87) Additional financial rewards based on distribution service or cost performance are not part of the current regulatory bargain.

Regarding Gulf's argument for the need to recognize its performance, staff witness Breman has testified on Gulf's overall distribution reliability performance. His testimony indicates that the Commission does not have any performance rating standards to establish whether Gulf's performance level is superior. (TR 874) The fact that Gulf needs to propose a performance based plan to justify its proposed reward demonstrates that the Commission does not have such standards to establish Gulf's performance level, much less the 50 to 100 basis points ROE reward requested.

In its Brief, Gulf also uses survey results as support for its performance adjustment. Gulf witness Fisher admits that the proprietary surveys Gulf relies on are inherently less accurate than other objective methods. (TR 475-476) He also states that surveys are used to gauge customer perception, which may be influenced by a number of factors including rates and reliability. (TR 475) Further, he recognizes that survey results have correlated with other objective performance measurements. (TR 473) Therefore, staff believes survey results are not mutually independent of other performance measures and should not be used as independent criteria for performance incentives.

Gulf witness Labrato argues that the Commission should make an adjustment to reward Gulf based on the price and service performance. (TR 612, 647, 1100) As discussed earlier, Order No. PSC-99-1047-PAA-EI indicates that performance comparisons between utilities should first consider differences in conditions beyond the control of the utilities. For example, if a company's geographic location is a major factor in determining whether the Company has access to low cost power, then the Company should not be rewarded or penalized simply because of its location. Gulf has not demonstrated that its performance is solely due to its efforts.

Gulf argues that both service and price should be considered in measuring performance. (TR 85, 612, 647) Staff agrees with this concept. It may not be desirable for a higher level of service performance to be achieved solely by a higher level of expenditures. Similarly, it is undesirable if rates are reduced simply at the expense of service quality. Therefore, combining these two components form a composite customer value indicator. As Witness Labrato demonstrated, if one of the components remains constant, a higher service performance or a lower rate indicates a higher value to customers. (TR 647-648)

In summary, Gulf is seeking an ROE reward for its past and continuing performance, but the Commission has not yet established incentive mechanisms upon which rewards would be based. Staff recommends that the Commission not make an adjustment to Gulf's ROE to further reward Gulf for its current and past performance since a performance based mechanism has not yet been established. As discussed in Issue 3, staff supports the use of performance based incentives to promote high performance. Once a performance based incentive mechanism is established, then Gulf should have the opportunity for rewards based on its future performance under the incentive mechanism.

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

RECOMMENDATION: The appropriate ROE is 11.6%. Staff addresses the appropriate range for the ROE in Issue 37. (Lester)

POSITION OF THE PARTIES

GULF: The appropriate ROE to use in establishing Gulf's revenue requirements is 13.0%, plus an adjustment of 50 to 100 basis points to reflect Gulf's superior performance in terms of reliability, low prices, and customer satisfaction. This adjusted ROE should be used as the rate setting point, and as the center of the authorized range of ROE established in Issue 37.

FEA: In light of recent actual and projected inflation experience, returns currently paid on long term debt instruments, the relatively risk-free regulatory environment in which GP operates, as well as rates of return authorized by other state regulatory Commissions in recent months, GP's requested return on equity is unreasonably high.

FIPUG: The appropriate ROE is 10.0%, based on the testimony of witness Rothschild. There should be no "performance reward."

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

STAFF ANALYSIS: Two witnesses provided expert testimony on the appropriate return on equity (ROE) to be used in establishing Gulf's revenue requirement. Gulf sponsored Charles Benore, who recommends 13.0% as the appropriate ROE. (TR 117, 146; EXH 26, Schedule 1a; EXH 27, p. 2) OPC witness James Rothschild recommends 10.0% as the appropriate ROE. (TR 175; EXH 28, JAR-2)

Witness Benore based his ROE analysis on a group of 8 companies involved in the regulated electric utility business. He employed 9 risk measures to select this comparable risk group. These measures included a Value Line beta no greater than .60, a Value Line safety rank of at least 2, and a Standard and Poor's (S & P) bond rating of A- or higher. He also eliminated any company involved in a merger. (TR 137-138; EXH 26, Schedule 6, pp. 3-4) Witness Benore updated his analysis, which resulted in the exclusion of 1 of the 8 original companies. His recommended ROE remained at 13.0%. (TR 325-326; EXH 29, Schedule 21)

To estimate Gulf's ROE, Witness Benore relied upon the results of three market-based models: a discounted cash flow (DCF) model, an equity risk premium model, and a capital asset pricing model (CAPM). (TR 138; EXH 26, Schedules 7, 8 and 9) For his DCF model, Witness Benore used stock prices for his comparable risk companies from July 16, 2001, to August 14, 2001, and a growth rate of 6% based on earnings growth. He obtained DCF result of 11.7% without flotation costs and 11.9% with flotation costs. (TR 139; EXH 26, Schedule7, pp. 3, 7, 13-16)

Witness Benore calculated a 5.0% equity risk premium using actual, annual returns realized by investors for investments in the common stocks of Moody's Electric Power Companies and in long-term Treasury bonds. The premium was calculated for the period 1932 to 1993. Witness Benore stopped at 1993 because he believes this year marked the onset of structural changes in the industry from regulated monopoly to competition. He added the 5.0% equity risk premium to the 6.4% yield on long-term Treasury bonds. Witness Benore's estimate of the risk-free rate was normalized for the impact of the Treasury's planned buyback of long-term debt. The equity risk premium result is 11.4% before flotation costs. (TR 140-141; EXH 26, Schedule 8, pp. 2-7)

Witness Benore's CAPM model result is 11.4% before flotation costs. This is based on the average of a standard CAPM and an empirical CAPM, a model which adjusts for underestimation problems associated with low beta stocks. The inputs for the CAPM are a risk-free rate, a beta, and a market equity risk premium. The risk-free rate is the same 6.4% "normalized" Treasury yield discussed above and the average beta for his comparable risk companies is .51. Witness Benore used both historical and projected market equity risk premiums in his CAPM analysis. (TR 141; EXH 26, Schedule 9, pp. 5-9, 15)

In addition to the three market-based models, Witness Benore used a comparable earnings analysis. This method is based on the projected returns on book common equity, as reported by Value Line, for the comparable risk companies. The result of the comparable earnings method is 13.3%. (TR 141-142; EXH 26, Schedule 10, pp. 1-5)

Witness Benore notes that the proceeds to a company from the sale of common stock are reduced by issuance or flotation costs. Using flotation costs of 3% of proceeds, Witness Benore recommends the ROE be increased by 20 basis points. (TR 142; EXH 26, Schedule 10)

Throughout his direct and rebuttal testimony, Witness Benore emphasized that his DCF, risk premium, and CAPM results should be adjusted because the stock prices (market value) of his comparable risk group are above book value per share. He refers to this adjustment as "transformation." (TR 127, 130) Witness Benore believes that transformation, accomplished through an iterative process, determines the necessary, regulatory book return so that investors have an opportunity to earn their required market return. (TR 130) Using a mathematical example of transformation, Witness Benore believes that, when the market price of a utility stock exceeds it book value, the regulatory return based on a DCF model must be increased to maintain the market value of the stock. (TR 127-130; EXH 26, Schedule 1b; EXH 27, p. 5)

For the comparable risk companies, the market price per share currently exceeds book value per share. Thus, Witness Benore's transformation adjustment is an increase to the results of his models. (TR 127; EXH 26, Schedule 7, pp. 8, 10, 17, Schedule 8, p. 14, Schedule 9, p. 16) According to Witness Benore, the result of the comparable earnings analysis is a book-to-book test and no transformation adjustment is needed. (TR 141-142, EXH 26, Schedule 10, p. 5)

Witness Benore updated his DCF, equity risk premium, and CAPM results. The updated DCF result is 12.1%. The equity risk premium result is 11.2% and the updated CAPM result is 11.1%. The comparable earnings test is 13.5%. With the transformation adjustment, the DCF result is 14.2%, the equity risk premium result is 13.3%, and the CAPM result is 13.2%. All these results exclude flotation costs. (TR 325-326; EXH 29, Schedules 21, 27, 30, 33, 35, Witness Benore recommends 13.0% as the appropriate ROE for Gulf. He notes that flotation costs should be considered along with Gulf's lower risk compared to the comparable risk companies. Gulf's smaller size relative to the comparable risk companies also should be considered. (TR 143)

For his analysis, OPC Witness Rothschild used Witness Benore's comparable risk companies. Witness Rothschild used two DCF models and two risk premium/CAPM models. He also applied a DCF model to Southern Company. (TR 170)

Witness Rothschild's constant growth DCF model used stock prices as of November 30, 2001, and the average of the high and low stock price for the year ended November 30, 2001. He derived the growth rate using the retention growth method whereby the Company's retention rate - the percent of earnings not paid out as dividends - is multiplied by the future expected earned return on book equity. (TR 198-199) The results of the constant growth DCF model range from 8.86% to 9.64%. (EXH 28, JAR-2; EXH 14, Deposition Exhibit 1, p. 1) Using dividend information from Value Line and his analysis of long term growth trends, Witness Rothschild's multi-stage DCF model produced results ranging from 9.28% to 10.73%. (TR 205; EXH 28, JAR-2; EXH 14, Deposition Exhibit 1, p. 1)

For his inflation risk premium method, Witness Rothschild used historical returns on common stocks, net of inflation, ranging from 6.60% to 7.20%. With his expected inflation of 2.0%, the mid-point cost of equity for a company of average risk is 8.90%. Using a beta of .52 for electric companies, he calculated a risk premium applicable to electric companies of 6.23%. (TR 210-213; EXH 28, JAR-9) Witness Rothschild employed a debt risk premium method whereby he measured the equity risk premium over the yields on short-term treasury bills, long-term treasury bonds, and corporate bonds. The results of this method range from 8.94% to 10.62%. (TR 213-219; EXH 28, JAR-2)

Witness Rothschild believes that pending recession fears currently cause the DCF to overstate the cost of equity. He notes that his inflation premium method is difficult to interpret due to the "flight to quality" impact on Treasury bond yields. He recommends 10.0% as the appropriate ROE and notes that this is conservatively high given the results of his multistage DCF model. (TR 174-175; EXH 28, JAR-2)

Witness Rothschild disagrees with Witness Benore's transformation adjustment. He notes that the Federal Energy Regulatory Commission (FERC) and the Federal Communications Commission (FCC) have rejected the argument. Specifically, FERC found that, when the cost of capital and interest rates decline, market prices of utility stock rise above book value per share. This occurs because the utility earns a higher ROE than that required by investors. Regulators have traditionally viewed market-to-book ratios above 1.0 as a possible indicator that the Company's return is higher than the return required by investors. The FCC found that setting the revenue requirement at investors' required return might cause the stock price to decline but "the requirement that we balance ratepayer and investor interest does not allow us to insulate investors from a diminution in the value of their stock." (TR 176-179) Witness Rothschild believes Witness Benore's transformation adjustment is circular because it suggests, once excessive earnings have caused the utility's stock price to increase, regulators must keep earnings at that level to prevent a decline in the stock price. (TR 227-228, 239)

Regarding the specifics of Witness Benore's models, Witness Rothschild disagreed with Witness Benore's risk premium method noting that the arithmetic average for historical returns is upwardly biased and that the geometric average should be used. (TR 222) Witness Benore's CAPM result also has the problem of using arithmetic instead of geometric averages in calculating the market risk premium, according to Witness Rothschild. (TR 238) Witness Rothschild disagreed with Witness Benore's comparable earnings model because the earned return on book equity is a separate and distinct concept of investors' required return. (TR 254) Regarding flotation costs, Witness Rothschild notes that flotation costs, as allowed by FERC, are very small and similar to rounding error. (TR 257-258)

In rebuttal to Witness Rothschild's testimony, Witness Benore notes that Witness Rothschild's results need a transformation adjustment to produce the return that investors require. (TR 277)

Witness Benore found errors and inconsistencies with Witness Rothschild's models and results. (TR 284-285, 290-291)

In particular, Witness Benore noted that Witness Rothschild substituted his own judgement in using a ROE of 13.0% in developing the sustainable growth rate for his DCF model. The comparable rate reported by Value Line was 13.5%. (TR 287) Regarding Witness Rothschild's multi-stage DCF model, Witness Benore again noted that Witness Rothschild ignored the use of expected ROEs as reported by Value Line and Zacks in favor of his own judgement. (TR 291-292; EXH 29, Schedules 14-16)

Regarding Witness Rothschild's inflation risk premium/CAPM results, Witness Benore noted the results are untenable - ROEs below the current yield on "A" rated utility bonds. (TR 296-297) He also noted that Witness Rothschild mixed real and nominal rates in calculating his results. (TR 296) Regarding Witness Rothschild's debt risk premium/CAPM model, Witness Benore notes that the arithmetic average of historical risk premiums, instead of the geometric average, is appropriate to reflect investors' expected risk premium. (TR 299-302) Witness Benore also noted that certain empirical studies show that the standard CAPM underestimates investors' required returns for low beta stocks like utilities. (TR 303-304)

Using his recommended corrections, Witness Benore recalculated the results of Witness Rothschild's models. These results range from 11.5% to 12.4% for the DCF models and 10.6% to 11.6% for the risk premium/CAPM models. Witness Benore noted these results are before flotation costs and transformation. (TR 295, 307)

Regarding risk premium methods, Witnesses Rothschild and Benore disagree on the calculation of the historical risk premium, specifically on whether a geometric average or an arithmetic average should be used. (TR 241-248, 299-302) Staff believes prospective risk premium analyses are more appropriate because historical risk premiums rely on earned returns instead of investors' required returns. Historical, earned returns can and do vary significantly from current, required returns. Also, both calculations of historical risk premiums include periods when returns on debt exceeded returns on common stock, i.e., periods of negative risk premiums. (EXH 13, pp. 72-73; EXH 14, pp. 18-19) In his CAPM, witness Benore used both prospective and historical risk premiums. (EXH 26, Schedule 9, pp. 5-3)

Staff recommends that the Commission reject the transformation adjustment to ROE recommended by Gulf Witness Benore. Given current market conditions in which prices of utility stocks exceed the book value per share, the transformation adjustment is convenient for utility witnesses because it results in an increase beyond the results of ROE models. In the past, when prices of utility stocks were below book value per share, Witness Benore did not recommend the transformation adjustment. He apparently became aware of the supposed need for the adjustment when utility stock prices exceeded book value. (TR 231-232; EXH 13, pp. 45-46)

Though Witness Benore states that he would make the adjustment if utility stock prices fell below book value, one has to wonder if that situation will recur in the foreseeable future. The market price-to-book ratio of the comparable risk companies is approximately 1.38. At the same time, Witness Benore testified that utility stocks have underperformed the market. (EXH 13, pp. 45-46; EXH 26, Schedule 7, p. 10; TR 124)

In addition to these shortcomings, both the FCC and the FERC have rejected the transformation adjustment. These decisions note that a utility may earn a return higher than that required by investors, causing the stock price to exceed book value. Resetting the allowed return at the investors' required return may cause the stock price to decline but the required return is reasonable and balances the interests of ratepayers and investors. Further, the FCC decision suggested investors may have anticipated and discounted reductions in the utility's ROE so that the reduction would have no effect on the stock price. (TR 176-179)

Regulators may not be capable of maintaining a certain market price to book value ratio for a utility, even if they wanted to do this. (TR 179, 230-231) Staff notes that book value of utility stocks, and stocks in general, can be affected by one-time changes in accounting rules. (EXH 13, p. 43) The market price-to-book ratio may be substantially outside the influence of regulators. (EXH 13, p. 47)

Witness Rothschild disagreed with the growth rates that Witness Benore used in his DCF model. In particular, Witness Rothschild notes that the long-term growth rate is based on 5 year earnings per share forecasts by analysts. (TR 232) Witness Rothschild believes this results in projecting a continued increase in the cost of equity. (TR 234) Staff notes that dividend growth is less volatile than earnings growth. (EXH 13, pp. 70-71)

Staff agrees with Witness Benore that some of the results of Witness Rothschild's models are untenable. (TR 296-297) Staff also agrees that the standard or simple CAPM may underestimate the cost of equity for low beta stocks. (TR 303-304) Further, staff agrees with Witness Benore that Gulf has lower regulatory risk compared to the comparable companies and that Florida's adjustment clauses reduce risk. (TR 143; EXH 13, pp. 19-20)

Regarding flotation costs, staff agrees with Witness Benore that these costs should be included in the ROE. (TR 324) The Hope and Bluefield decisions mandate a return that can attract capital, and flotation costs are a necessary part of attracting capital. Staff believes Witness Benore's allowance of 20 basis points for flotation cost is reasonable. (TR 324)

Witness Benore bases part of his recommendation on his opinion that Gulf is a small company, a point with which Witness Rothschild disagrees. (TR 143; EXH 14, p. 29) Staff notes that Gulf has an "A+" bond rating by Standard and Poor's. (EXH 13, p. 28) Staff believes that companies that can issue rated debt should not be considered small even though Gulf is smaller than the comparable risk companies. Staff agrees with Witness Benore that the Commission should treat Gulf on a stand-alone basis for purposes of deciding the ROE issue. (EXH 13, p. 90; TR 340)

Staff notes that determination of the appropriate ROE is ultimately a subjective process. Considering Witness Benore's updated results without the transformation adjustment and Witness Benore's adjustments to Witness Rothschild's results, staff believes the appropriate range for Gulf's ROE is 10.8% to 11.8% including an allowance for flotation costs. Staff recommends 11.6% as the appropriate ROE for Gulf. Staff believes the Commission should use a ROE toward the top of this range because Gulf has a reasonable capital structure - an equity ratio of 47% - and has maintained an "A+" bond rating. (EXH 14, p. 22; Attachment 3, EXH 13, p. 28) In Issue 37, staff discusses the issue of the appropriate range surrounding the ROE midpoint.

ISSUE 36: What is the appropriate weighted average cost of capital including the proper components, amounts and cost rates associated with the projected capital structure? (D. Draper, C. Romig)

RECOMMENDATION: The appropriate weighted average cost of capital for the projected test year is 7.75%. (Attachment 2) (D. Draper, C. Romig)

POSITION OF THE PARTIES

GULF: Based on a 13.0% cost of equity (before any performance-based adjustment), the appropriate weighted average cost of capital is 8.35% for the test year. This weighted average cost of capital utilizes the stipulated cost of short-term and long-term debt approved by the Commission and revised rates for preferred stock and investment tax credits. This weighted average cost is based on the reconciliation of rate base and capital structure described in Gulf's position on Issue 31.

FEA: FEA adopts the position of OPC.

FIPUG: No position stated in Brief.

OPC: No position stated in Brief.

STAFF ANALYSIS: The appropriate weighted average cost of capital including the proper components, amounts and cost rates associated with the projected capital structure is 7.75%.

Based on the stipulations among all of the parties, the appropriate weighted average cost of long-term debt is 6.44% and the appropriate cost of short-term debt is 4.61%. The cost rate for preferred stock, based on witness Labrato's Exhibit 2, is 4.93%. Staff believes that the Company's cost rates for preferred stock, and for customer deposits of 5.89%, are reasonable. Staff agrees with the Company that the deferred taxes should have a zero-cost rate. As discussed in Issue 30, the Company's weighted average cost of ITCs is 8.80%. As discussed in Issue 35, staff recommends 11.60% as the appropriate cost rate for common equity.

The appropriate capital structure for Gulf's projected test year ending May 31, 2003, should be based on the relative percentages of investor capital. Gulf specifically identified the balances for ITCs, deferred income taxes, and customer deposits.

Using the Company's reconciled capital structure as discussed in Issue 31, staff made the following three adjustments to the Company's jurisdictional capital structure. First, as discussed in Issue 29, due to the change in depreciation, staff made a specific adjustment of $662,000 to deferred taxes. Next, staff made specific adjustments to reconcile investor sources with witness Labrato's Exhibit 2. Finally, staff made a pro-rata adjustment over investor sources to reconcile capital structure to rate base.

Based on the relative amounts of investor capital, ITCs, deferred income taxes, customer deposits and the respective cost rates discussed above, the resulting weighted average cost of capital is 7.75%. Attachment 2 shows the components, amounts, cost rates and weighted average cost of capital associated with the May 31, 2003, projected test year capital structure.

ISSUE 37: What is the appropriate authorized range on ROE to be used by Gulf for regulatory purposes on a prospective basis? (D. Draper, Lester)

RECOMMENDATION: The appropriate range is plus or minus 100 basis points surrounding the recommended 11.6% ROE mid-point. (D. Draper, Lester)

POSITION OF THE PARTIES

GULF: The appropriate authorized range on ROE should have a spread of 150 basis points or more above and below the return on equity used for the purpose of setting rates (authorized range of 300 basis points). This range is appropriate in recognition of the fact that Gulf has provided high quality service to its customers at low rates with excellent customer satisfaction ratings. The expanded range would help the Company remain in sound financial condition.

FEA: Adopts OPC's position.

FIPUG: The appropriate range is 9.5% to 10.5% based on the testimony of witness Rothschild.

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%.

STAFF ANALYSIS: Gulf Witness Bowden proposes that the Commission expand the range for ROE from the traditional 100 basis points on either side of the ROE mid-point to 150 basis points or more. (TR 69, 71, 77) Staff notes that the record for this issue is more qualitative than quantitative. Gulf witnesses Bowden and Labrato provide only general statements supporting a wider range. Two reasons they cite are: (1) an expanded range for Gulf, according to witness Bowden, would encourage the high level of service and (2) an expanded range would aid Gulf in retaining its credit rating. (TR 61, 71-72, 77, 1100) For these reasons, this issue is similar to Issue 34 regarding a ROE reward. In that issue, staff recommends no ROE reward. Further, staff notes that Gulf has an A+ bond rating. (EXH 28, p. 28) The record in this case does not contain specific evidence on how the expanded range would enhance this bond rating.

Witness Bowden provides a third reason for expanding the range. In his summary of his direct testimony, he states:

> As I mentioned earlier, regulatory commissions are considering incentive-based approaches. I think to recognize our superior performance and the importance of continuing that performance in the future, at the low rates that I mentioned on page 7 of my testimony, I suggest two thoughts for the Commission's consideration: One is to increase the return on equity by some 50 to 100 basis points. **The second one is to consider expanding the Commission's range that it uses from two hundred basis points to three hundred basis points.**
>
> **I believe these suggestions could be included in an incentive sharing plan, a plan that would be based on the performance measures that incent this company to provide highly reliable service at low rates with high levels of customer satisfaction.** (Emphasis added.) (TR 69)

In the New Issue in this case, staff recommends that the Commission reject Gulf's proposed incentive sharing plan because it is not supported by the hearing record. Staff notes that such a plan could be addressed in a separate proceeding. Staff believes it would be incorrect to recognize one issue at this time, such as expanding the range for the ROE, that could be part of a comprehensive incentive plan.

The Commission historically has allowed 100 basis points on either side of the ROE mid-point used to set rates. Gulf's current authorized ROE is 11.5% with a range of 10.5% to 12.5%. (Order No. PSC-99-1970-PAA-EI, issued October 8, 1999, in Docket No. 991487-EI) In recent gas rate cases, the Commission set the range at 100 basis points around the ROE mid-point. (Order No. PSC-00-2263-FOF-GU, issued November 28, 2000, in Docket No. 000108-GU, and Order No. PSC-01-0316-PAA-GU, issued February 5, 2001, in Docket No. 000768-GU)

Staff recommends that the Commission maintain the range of 100 basis points surrounding the ROE mid-point at which it sets rates. Staff notes that no witness has provided specific reasons for quantifying a specific range, either more or less than 100 basis points. The Commission might consider expanding the range in a future proceeding regarding incentive regulation, such as is recommended in the New Issue for this case.

NET OPERATING INCOME

ISSUE 38: Is Gulf's projected level of Total Operating Revenues in the amount of $372,714,000 ($379,009,000 system) for the May 2003 projected test year appropriate? (Wheeler, Stallcup, L. Romig)
STIPULATED

ISSUE 39: What are the appropriate inflation factors for use in forecasting the test year budget? (Stallcup, Lester, L. Romig)
STIPULATED

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

RECOMMENDATION: Yes. Gulf's modified zero based budget should be accepted as support for the requested increase with all the adjustments recommended by staff as shown in Attachments 1-4. (L. Romig)

POSITION OF THE PARTIES

GULF: Yes. The modified zero based budget methodology used by Gulf is a proven and accurate method of budgeting to meet its resource management needs. This methodology gives the planning units the ability to build their budget program by program each year. This methodology was used to develop the budget for the May 2003 projected test year, which reasonably reflects expected future operations during the period that new rates will be in effect.

FEA: No position stated in Brief.

FIPUG: No. Adopt OPC's position.

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.

STAFF ANALYSIS: Gulf Witness Saxon testified that the financial forecast is the basis for Gulf's projected data for the test year used in this rate case. The financial forecast is comprised of eight individual budgets: Construction, O&M, Interchange, Fuel, Revenue, Customer, Energy, and Peak Demand. Each of these budgets is reviewed and approved by the Company's Leadership Team, consisting of Gulf's executive officers. (TR 352)

The budget process begins with five major functional areas which are broken into 29 individual planning units. These planning units provide input into each of the eight individual budgets mentioned above. (EXH 1, pp. 25-26) Each individual planning unit uses a modified zero based budget which gives the planning unit the ability to build its budget program each year. (TR-354-355)

Staff witness Bass testified that each planning unit develops its budget by FERC Sub account. Each planning unit maintains supporting documentation for these developed amounts. If the planning unit is unable to develop budgeted amounts for a given expenditure, then inflation rates or customer growth rates may be used. (TR 910)

Corporate Planning reviews submittals for compliance with the Company guidelines and compiles the data for review by the CFO and leadership team. Any changes are documented and then the approved budget is sent to the planning units. Each planning unit monitors its budget to actual comparison, using the accounting on-line system referred to as Southern Financial Information Access System (SOFIA). Quarterly reports are required that explain any variance plus or minus 10 percent and the variance amount is greater than or equal to plus or minus $25,000. Year-end projections are also received from each planning unit. (TR 910-911)

OPC stated in its brief that Gulf's budgeting process has resulted in numerous illogical results (e.g., Issues 64, 65, 66, 67, 68, 71A). OPC observes that 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. OPC maintains that 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, it is OPC's position that 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. (BR 24)

Staff recommends that Gulf's modified zero based budget be accepted. Staff witness Bass introduced Exhibit 47, staff's audit report, and provided a disclosure on the budget process; no exceptions were taken. Also, staff did not encounter any major problems during the discovery phase of this case. Also, after making adjustments recommended by staff in other issues coupled with Gulf's budget, the projected test year resulting from the budget appears reasonable and appropriate.

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? (L. Romig)

RECOMMENDATION: No. The appropriate level of O&M Expenses for the May 2003 projected test year is $180,614,000. (Attachment 3) (L. Romig)

POSITION OF THE PARTIES

GULF: No. The O & M Expense for the May 2003 projected test year should be increased by $149,000 to $182,568,000 on a jurisdictional basis to reflect the net effect of changes to inflation factors, amortization of rate case expense, security expense, lobbying expense, hiring lag, and cable injection costs, and to correct the Company's operating expense adjustment related to industry association dues.

FEA: FEA adopts the position of OPC.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: This is a fallout calculation based on the decisions in preceding issues.

Gulf stated in its brief that O&M Expenses should be increased to correct the Company's adjustment to industry association dues. Gulf disallowed 5% of the dues for all organizations instead of the dues for area economic development organizations. This error was included in an economic development issue which was dropped early on in this proceeding at an issue identification meeting. Staff was not aware of the error when the issue was dropped. Accordingly, since the error was not addressed at the hearing, staff has not made an adjustment to increase expenses $13,000, as requested by Gulf. (BR 69) In addition, Gulf addressed other changes in its position which are reflected on Attachment 3 and discussed in Issues S-17, S-22, 47, 51, 58, and 64.

ISSUE 42: Should an adjustment to Net Operating Income be made to remove wholesale related costs allocated to Gulf? (Bohrmann)
STIPULATED

ISSUE 43: Has Gulf made the appropriate test year adjustments to remove fuel revenues and fuel expenses recoverable through the Fuel Adjustment Clause? (Bohrmann, L. Romig, C. Romig)
STIPULATED

ISSUE 44: Has Gulf made the appropriate test year adjustments to remove conservation revenues and conservation expenses recoverable through the Conservation Cost Recovery Clause? (Haff, L. Romig, C. Romig)
STIPULATED

ISSUE 45: Has Gulf made the appropriate test year adjustments to remove capacity revenues and capacity expenses recoverable through the Capacity Cost Recovery Clause? (D. Lee, L. Romig, C. Romig)
STIPULATED

ISSUE 46: Has Gulf made the appropriate test year adjustments to remove environmental revenues and environmental expenses recoverable through the Environmental Cost Recovery Clause? (D. Lee L. Romig, C. Romig)
STIPULATED

<u>ISSUE 47</u>: What are the appropriate adjustments, if any, to Gulf's test year operating expenses to account for the additional security measures implemented in response to the increased threat of terrorist attacks since September 11, 2001? (McNulty, Mills)

<u>RECOMMENDATION</u>: A jurisdictional adjustment (increase) of $845,000 ($901,000 system) should be made to test year operating expenses to reflect the cost of additional security measures implemented in response to the increased threat of terrorist attacks since September 11, 2001. This amount includes $578,000 ($623,000 system) due to an increase in Gulf's property insurance expenses, $101,000 ($105,000 system) due to an increase in depreciation expense, and $166,000 ($173,000 system) due to increases in other additional security expenses. (McNulty, Mills)

<u>POSITION OF THE PARTIES</u>

<u>GULF</u>: An adjustment of $845,000 ($901,000 system) should be made to test year operating expenses to reflect the cost of additional security measures implemented in response to the increased threat of terrorist attacks since September 11, 2001. This amount includes $578,000 ($623,000 system) due to an increase in Gulf's property insurance costs as a result of the terrorist events of September 11, 2001 and $101,000 ($105,000 system) of depreciation on the additional investment in security measures.

<u>FEA</u>: No position stated in Brief.

<u>FIPUG</u>: No position stated in Brief.

<u>OPC</u>: No position stated in Brief.

<u>STAFF ANALYSIS</u>: Gulf's MFRs and direct testimony were filed on September 10, 2001, and thus do not contain the impact of the increased threat of terrorist attacks since September 11, 2001 on test year operating expenses. Staff requested information pertaining to the impact of the increased terrorist threat on Gulf's costs in Staff's Seventh Set of Interrogatories. Gulf filed its response to Staff's Seventh Set of Interrogatories under a request for confidential treatment on February 4, 2002. Order No.

PSC-02-0220-CFO-EI, issued February 22, 2002, granted confidential classification to the interrogatories.

No other party has taken a position on this issue. Gulf Witness McMillan stated in his rebuttal testimony that premiums for the Company's all-risk property insurance policy, which covers both generating plants and general plant, increased by $380,000 (system) as a result of the terrorist events of September 11, 2001, and the deductible increased from $1 million to $10 million. In addition, Gulf elected to self-insure for property losses between $2 million and $10 million at an estimated cost of $243,000 per year (system). The sum of these property insurance expense adjustments is $623,000 (system) or $578,000 (jurisdictional). (TR 952)

The adjustment for depreciation expense related to the rate base security adjustments described in Issue 12 is $101,000 (jurisdictional), or $105,000 (system). In addition, staff believes the additional security-related operating expense amounts not otherwise specified above, but approved for confidential treatment, is reasonable and appropriate. (EXH 7, Item 238, p. 2 of 2 - **Confidential**) Those additional expenses are $166,000 ($173,000 system). The sum of the incremental property insurance expenses, depreciation expense, and other confidential expenses related to the increased terrorist threat for the test year is $845,000 (jurisdictional), or $901,000 (system). Thus, staff agrees with Gulf and recommends that a jurisdictional adjustment (increase) of $845,000 ($901,000 system) should be made to test year operating expenses to reflect the cost of additional security measures implemented in response to the increased threat of terrorist attacks since September 11, 2001.

ISSUE 48: Should an adjustment be made to advertising expenses for the May 2003 projected test year? (Kaproth, L. Romig)

RECOMMENDATION: Yes. Advertising expense should be reduced by $539,000 jurisdictional ($550,000 system) to remove image enhancing advertising expense. (Kaproth, L. Romig)

POSITION OF THE PARTIES:

GULF: No. Gulf depends on advertising as one of the primary methods of communicating with our customers. The ability to communicate effectively with our customers is essential and helps to build awareness regarding the various products and services Gulf provides. It establishes Gulf's credibility as an information source and encourages loyalty. Adjustments to the May 2003 projected test year advertising expenses would reduce the level of success of Gulf's demand side management and conservation programs.

FEA: FEA adopts the position of OPC.

FIPUG: Adopts OPC's position.

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

STAFF ANALYSIS: Gulf requests recovery of $1,145,000 in advertising expenses in the projected test year. Gulf seeks to recover $595,000 (system & jurisdictional) in advertising for Customer Service and Information Expense. Gulf also seeks to recover $550,000 ($539,000 jurisdictional) for Corporate Communications and Advertising. (EXH 37, p. 118)

Witness Neyman explains that the utility has a two-step advertising expense philosophy. The first step is to develop trust, loyalty, and confidence in the utility. Once the customer believes in the utility, then the second step is to advertise to affect the customers' behaviors. (TR 539)

Witness Neyman asserts that Gulf's advertising messages are to develop trust, and that credibility is critical in gaining public acceptance of the utility as a caring, well-managed institution. Witness Neyman believes that after trust is built the utility can educate the customers and then change their behavior so that they will use energy efficiently. (TR 539)

In its brief on page 24, OPC states that advertising expense for corporate image building has been disallowed because the ratepayers of any regulated utility are customers that are provided services in monopolistic environment. Consequently, these customers cannot exercise a choice as to whether or not to pay for such advertising expenses.

OPC notes that witness Dismukes pointed out that the requested advertising expense of $550,000 is purely image-enhancement in nature because the examples of ads do not inform the customers about products or services nor do they assist customers in any way. Witness Dismukes explained that these ads are the type that the Commission has disallowed.

Under cross-examination, Witness Neyman agreed that the ads that the utility was requesting recovery for did not promote the utility's products and services but supported the efforts of the utility in an indirect way. (EXH 22, Part C; TR 562-563) Then she explained that the ads in the historical year ended December 31, 2000, were the same type of advertisements disallowed in the last rate case and, would be the type of advertisement that would be used in the projected test year. (EXH 22, Part C) Further, Witness Neyman is asking the Commission to reconsider its past position on this type of advertising even though the actual ads for the projected test year have not been produced. (TR 562-565)

In direct testimony, OPC Witness Dismukes stated that the Commission, in Order No. 6465, issued January 17, 1975, disallowed advertising expense related to enhancing the Company's image and goodwill-type advertising. Witness Dismukes refers to the ads in "Part C" of Exhibit 22 and states that these ads have been disallowed by Order No. 6465.

Contrary to Witness Neyman's suggestion, Witness Dismukes notes that not one of the ads in Part C of Exhibit 22 informs the customer about products and services available to assist customers "in making their home and businesses more enjoyable, comfortable and safe and provide for operation which is more energy efficient and, therefore, cost efficient." Witness Dismukes further asserts that the ads do nothing to educate customers. The ads merely enhance Gulf's image with the customers. (EXH 41, pp. 12-13)

Witness Dismukes further notes that in Order No. PSC-96-1320-FOF-WS, the Commission disallowed advertising costs related to image enhancement. (EXH 41, p. 13) Consequently, Witness Dismukes recommends that $550,000 in advertising expenses be disallowed.

In direct testimony, Staff Witness Bass stated the utility removed $226,000 for image enhancing ads for the historical year, 2000, but did not remove $550,000 for image enhancing ads in the projected test year. (TR 903-904)

Witness Bass identifies two problems with Gulf's request to recover the cost of image enhancing ads in base rates. First, it runs afoul of Order No. 6465, issued January 17, 1975, in Docket No. 9046-EU. (TR 903-904) Docket No. 9046-EU was a general investigation into promotional practices of electric utilities. The order expressly disallows, for ratemaking purposes "[a]dvertising which has as its primary objective the enhancement of or preservation of the corporate image of the utility."

The Commission disallowed recovery of image enhancement expenses because:

> Most, if not all, of this advertising is merely designed to improve the image of the utility in the eyes of the public. It has not been proven, in our judgment, that such programs reduce operating costs or result in greater operating efficiency nor do we see any tangible benefits to the customers. (Order No. 6465)

The second problem Witness Bass identified with Gulf's request is that the cost of image enhancing advertising increased dramatically from the historical year, 2000, to the projected test year. Gulf spent $226,000 on image enhancing ads in 2000 but requests $550,000 for the projected test year. (EXH 37, p. 116-118)

Under cross examination, Witness Bass identified only one requirement that need be present in an ad in order to recover the full cost of the ad. The requirement is that the ad offer any information on conservation, safety or electric efficiency. (TR

920-925) Thus, even if the ad included image enhancement, the full cost of the ad could be recovered if it also included, for example, the GoodCents logo.

Under cross examination, Witness Bass explained if the ads contained information pertaining to conservation, safety, or customer information, the ad was allowed. (TR 920) Further, Witness Bass agreed that the customer should not have to pay for image enhancing ads because the customer does not have a choice of electric utilities and to change this policy would break precedent established in Order No. 6465. (TR 929)

Under cross-examination, Witness Neyman noted that Commission Order No. PSC-96-1320-FOF-WS stated:

> However, we recognize that the utility's conservation efforts need to gain support and trust from its customer in order to be successful.

Again, Witness Neyman explained that these ads are critical to the success of Gulf's conservation programs. (TR 1069-1072)

OPC argues on page 26 of its brief, that Witness Bass disagreed with Witness Neyman's premise about the need for the recovery of indirect advertising expense. OPC notes that Witness Bass did testify that Gulf could communicate the substance of its educational messages, without engaging in these image enhancement types of advertising. (TR 915)

Gulf argues that Witness Bass said that if the Commission should choose to change its policy that he would no longer have a concern with the Company's requested advertising expense being included in base rates. (BR 73) Gulf also argues that times have changed since Order No. 6465 because today's ads are focused on educating the consumer regarding product and services available to ensure the efficient use of energy.

Staff believes that the Commission's stated policy in Orders 6465 and PSC-96-1320-FOF-WS is that the cost of advertising that is purely image enhancing should not be recovered through base rates. Order No. PSC-96-1320-FOF-WS states:

> We agree with OPC that advertising expense only for image enhancement purposes should not be borne by the ratepayers.

However, in that Order the Commission clearly acknowledged that it may be impossible to distinguish between advertising expense for image enhancement and advertising expense for public education and conservation. See id at p. 171. Staff's interpretation of the Order is that the Commission allowed recovery of the advertising expense because it was not purely for image-enhancement. Rather, the advertisements were such that a single purpose for the ads could not be isolated. Thus, the Commission allowed recovery of $14,783 in advertising expenses for ads that included image enhancement.

Staff notes that under Order 6465, the cost of ads that are both image enhancing and educational in some way can be allowed in rate base. It is only ads that are purely image enhancing that are not allowed in rate base. The Orders are not in conflict.

In staff's opinion, the ads in Part C of Exhibit 22 are purely image enhancing. Gulf does not refute this. For this reason staff believes the cost of the ads should not be included in base rates. Therefore, staff recommends that Gulf not be allowed to recover the advertising expense of $539,000 ($550,000 system).

Staff agrees that the utility should recover advertising expenses of $595,000, in Account 903, for Customer Service and Information Expense in the test year.

ISSUE 49: Has Gulf made the appropriate adjustments to remove lobbying expenses from the May 2003 projected test year? (L. Romig)

STIPULATED

ISSUE 50: Should an accrual for incentive compensation be allowed? (Kaproth, L. Romig)

RECOMMENDATION: Yes. An accrual for incentive compensation should be allowed. (Kaproth, L. Romig)

POSITION OF THE PARTIES

GULF: Yes. The full accrual for the projected test year should be allowed. Gulf's compensation philosophy links base and incentive compensation to provide base salaries at or near the median of an appropriate external comparator group and to provide incentive pay up to the top quartile for exceptional performance. Recent reviews of Gulf's total cash compensation (base plus incentive) indicates that Gulf Power is currently paying its employees "at market."

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

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).

STAFF ANALYSIS: In Direct Testimony, OPC Witness Schultz stated the gross payroll and fringe benefits on Schedule C-33 in the MFRs included all compensation and benefits. Witness Schultz further stated that the 2000 historical test year costs included an accrual of $10.8 million for bonuses and/or performance pay, which was an 83% increase over 1999. Witness Schultz also compared the accrual for the compensation plan with the total gross payroll and fringe benefits and stated that the compensation plan was material to the total gross payroll and fringe benefits. (EXH 43; TR 18-19) Witness Schultz recommended disallowing the accrual and reducing expenses by $4,917,000.

In rebuttal testimony, Gulf Witness Bell testified that Gulf's compensation philosophy is centered on the need to attract, retain, and motivate talented employees. In order to achieve these goals, Witness Bell stated that Gulf offers a compensation plan that consists of base salaries and incentive compensation. Witness Bell explained that base salaries are targeted at or near the median of a similar group of salaries. The additional incentive pay plan above the base pay allows the employees an opportunity to earn in the top quartile of the industry. (TR 942)

Witness Bell asserted that in order to keep the employees focused on their performance, the incentive compensation must be re-earned each year. Witness Bell explained that even though the incentive compensation portion for an individual employee may decline, the utility's total compensation expense will remain relatively constant over time because the base salaries rarely decline in amount. Therefore, the utility offers total pay that is market competitive. Lastly, only through performing well and meeting customers needs do employees have the opportunity to be paid at the top quartile of the industry. (TR 942)

Each year Gulf conducts an analysis of overall compensation using compensation surveys that are developed by independent consulting firms to perform these analyses. Current analysis of these approximately 40 surveys shows that the utility's pay for each position is both consistent with its compensation philosophy and current market. (TR 943)

In rebuttal testimony, Gulf Witnesses Silva and Twery stated that Witness Schultz's concerns were unfounded because the comparison of incentive compensation to gross payroll and fringe benefits is inappropriate. It is more appropriate to evaluate Gulf's total cash compensation against the market to insure competitiveness. The survey data (approximately 40 surveys) provides total cash compensation for various jobs in the relevant market. (TR 943, 947-948)

Witnesses Silva and Twery explained that to ensure Gulf's pay policy is competitive, Gulf produces a Market Position report on an annual basis. Organizations are considered to be "at market" if their pay policy falls between +/- 10% of the market. An analysis of Gulf's pay policy to the market was conducted in August of 2001. The report confirmed Gulf's total compensation pay policy was within +/-5% for all job groups, on average, to the actual (market) pay levels. (TR 947)

Gulf's philosophy is to pay employees at the 75th percentile. (TR 742) To only receive a base salary would mean Gulf employees would be compensated at a lower level than employees at other companies. Therefore, an incentive pay plan is necessary for Gulf salaries to be competitive in the market. Another benefit of the plan is that 25% of an individual employee's salary must be re-earned each year. Therefore, each employee must excel to achieve a higher salary. When the employees excel, staff believes that the customers benefit from a higher quality of service.

Staff further believes that OPC's adjustment to remove the increase in costs from 1999 to the 2000 historical test year is not justified. The utility did implement a new incentive compensation plan in 2000. Also, to compare the total incentive "cash" compensation to gross payroll is not a valid comparison. The total compensation plan should be compared to the market value for similar job groups.

Staff thinks that to analyze each individual's compensation for whether their base salary and incentive compensation, within each job group, is appropriate would be beyond the scope of the data collected from the individual utilities in the industry. Lastly, the utility is within +/-5% of the market values for their overall compensation policy. As a result, its employees will be paid based on market value and the customers will receive quality service and low rates.

Based on the above, staff recommends that no adjustment be made to the accrual for incentive compensation.

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

RECOMMENDATION: Yes. A reduction of $15,832 ($16,683 system) should be made in expenses associated with employee relocations. (L. Romig)

POSITION OF THE PARTIES

GULF: No. The amount of employee relocation expense of $461,754 jurisdictional ($486,580 system) included in the May 2003 test year is conservative. The amount is derived using a four year (1997-2000) average escalated for inflation. The test year budget is less than the 5-year historical (1997-2001) average for this expense and the actual relocation expenses incurred in 2000 and 2001.

FEA: No position stated in Brief.

FIPUG: Adopts Staff's position.

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.

STAFF ANALYSIS: Gulf's employee relocation plan covers a variety of costs involved in moving an employee and the employee's family. These costs include cost of living allowances, transportation, household goods moving and storage cost, closing costs, and other associated costs.

The Company included in projected test year expenses $461,754 for employee relocations. The Company stated on Staff's Exhibit 9 that it budgets relocation expenses are based on the previous four years actual relocation expenses escalated for inflation.

The Commission found in Gulf's last rate case, Order No. 23573, issued October 3, 1990, in Docket No. 891345-EI, that the $324,100 budgeted for relocations was too high and should be reduced to a more reasonable level. The Commission found that a reasonable approach was to use a four year average. Actual amounts were used in calculating the average and the average was not escalated for inflation. This approach was used because relocation expenses show wide variations from year to year and cannot be neatly extrapolated like salaries or plant maintenance expenses. For example, in this case the Company expensed $371,664 in 1997 to relocate nine employees or $43,516 each, compared with $335,664 in 1998 to relocate thirteen employees or only $27,179 each. (Staff EXH 9)

Based on the Commission's decision in the last rate case, staff recommends that relocation expenses be reduced $15,832 ($16,832 system) based on a four year average of expenses. This would reduce the Company's projected relocation expenses from $461,754 to $445,922.

ISSUE 51: Should an adjustment be made to Gulf's requested level of Salaries and Employee Benefits for the May 2003 projected test year? (Kaproth, L. Romig)

RECOMMENDATION: Yes. O&M expenses and payroll taxes should be reduced $323,635 (330,628 system) and $19,274 ($19,690 system) respectively to remove the hiring lag effect on the projected number of employees. (Kaproth, L. Romig)

POSITION OF THE PARTIES

GULF: Yes. An O & M adjustment of $324,000 ($331,000 system) should be made to reflect a hiring lag during the test year. No other adjustments are justified because the levels requested are necessary to maintain a competitive compensation and benefits package for Gulf employees. A competitive package is required to attract, retain, and motivate employees. The positions reflected during the test year represent the employees Gulf needs in the test year and beyond to accomplish its objectives.

FEA: Yes.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: In Direct Testimony, OPC witness Schultz, states that the projected test year had an increase of 48 employees and that he agrees with the 29 additional employees needed for Smith Unit 3. (EXH 43, p. 17) Witness Schultz further states that the remaining increase of 19 positions in the projected test year were not explained because in 1998 downsizing was the trend. In 1999, eight positions were added and in 2000 only five positions were added. Witness Schultz emphasized that the utility should not have incorporated a significant increase in employee complement without providing any justification for the increase. Lastly, Witness Schultz testified that an adjustment should be made to reduce payroll expense by $701,410, fringe benefits should be reduced by $131,177, and payroll tax expense should be reduced by $58,475 in order to remove the 19 positions from the projected test year. (EXH 43, p. 18)

In rebuttal testimony, Witness Saxon states that the projected test year expenses include additional expense for six cooperative educational students, 11 positions in Power Delivery for which employees are trained in an earned progression program, and two positions in the Company's Leadership Development program. Therefore, Witness Saxon states these 19 positions should not be removed from the projected test year. (TR 968-969)

Staff agrees that the 29 positions are needed for Smith Unit 3. Staff further believes that the utility should have positions in which the employees are trained in Power Delivery so that the qualified employees can fill vacant positions and that the power delivery is uninterrupted. Staff further agrees that a Leadership Program is essential for the development of qualified employees as well as a qualified management team. Based on the above, staff recommends that no positions be removed from the projected test year.

Gulf projected a test year complement of 1,367 employees. Mr. Saxon stated in his deposition, Exhibit 21 at page 7, that the Company did not take into account a hiring lag in projecting the 1,367 employee complement. A hiring lag is the length of time before an employee is hired to fill a vacant position. Witness Saxon further agreed that it would be appropriate to include a hiring lag adjustment that would reduce the projected payroll expenses. Witness Saxon filed a late-filed exhibit to his deposition that reflected a hiring lag equivalent to 34 employees and this hiring lag would reduce projected O&M expenses by $323,635, ($330,628 system) including fringe benefits and a payroll tax adjustment of $19,274 ($19,690 system). The hiring lag adjustment is consistent with a similar adjustment made in the Company's last rate case, Order No. 23573.

Based on the above, staff recommends that projected O&M expenses be reduced by $323,635 ($330,628 system) and payroll taxes be reduced by $19,274 ($19,690 system).

ISSUE 52: Should an adjustment be made to Other Post Employment Benefits Expense for the May 2003 projected test year? (Kyle, Kaproth, L. Romig)
STIPULATED

ISSUE 53: Should an adjustment be made to Pension Expense for the May 2003 projected test year? (Kyle, L. Romig)
STIPULATED

ISSUE 54: Should adjustments be made for the net operating income effects of transactions with affiliated companies for Gulf? (L. Romig, Merta)

RECOMMENDATION: No. Adjustments are not necessary for the net operating income effects of Gulf's transactions with affiliated companies. (Merta, L. Romig)

POSITION OF THE PARTIES

GULF: No. Gulf's test year O & M expenses related to affiliate transactions are conservative, and are less than the 1999 actual O & M charges. Based upon the 2002 Southern Company Services ("SCS") Budget, Gulf's test year O & M expenses are understated by $1.5 million.

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: Gulf Power Company is a wholly owned subsidiary of Southern Company, which is the parent company of five southeastern utilities and other direct and indirect subsidiaries. The Public Utility Holding Company Act (PUHCA) regulates Southern Company and its subsidiaries. With the exception of Southern LINC, all affiliates provide services and materials to Gulf at cost in accordance with PUHCA. Southern LINC provides telecommunications services to Gulf at market cost.

Contracts among the southeastern utilities related to jointly owned generating facilities, interconnecting transmission lines, and the exchange of electric power are regulated by the Federal Energy Regulatory Commission (FERC) or the Securities and Exchange Commission (SEC). Southern Company Services (SCS), the system service company, provides at cost specialized services to Southern Company and subsidiary companies. SCS services include general executive and advisory services, engineering, purchasing, accounting and auditing, finance, marketing and public relations, insurance, rate, employee relations, and, in the case of the operating utilities, power pool operations. All SCS costs are either directly charged or allocated to Southern affiliates through a work order system.

The SCS allocation methodology is approved and periodically audited by the SEC. All of the allocation methods are derived from system statistics which reflect the size of each company relative to the entire Southern Company. Percentages for these allocation methods are updated annually by Gulf. To derive the allocation factors, Gulf uses historical statistics based on a single year with a one-year lag; therefore, 2001 allocations were based on 1999 statistics.

The allocation factors applied by the Company in its MFRs were based upon 1999 data. (TR 762) OPC witness Kimberly Dismukes stated that because Gulf's allocation factors do not reflect the high growth of its non-regulated affiliates for the period 1999 to 2003, Gulf's customers will end up subsidizing non-regulated activities. (TR 758) Therefore, Ms. Dismukes modified the allocation factors to include additional allocations to Southern Power Company (SPC), a new subsidiary the Southern Company expects to grow at a rate of 15% per year. (TR 762) SPC will own, manage, and finance wholesale generating assets in the Southeast. (TR 760)

Ms. Dismukes modified data to reflect what could be expected for SPC in 2003. The fossil allocation factor, which is based upon the KW capacity of the various companies' plants, was modified to recognize the expected generation from SPC in 2003. There were several allocation factors where 2003 information was not readily available. For these factors, Ms. Dismukes adjusted the amounts for SPC by increasing them by a factor of seven based upon the relationship between the 2001 KW capacity of SPC compared to the KW capacity expected for SPC by 2003. (TR 765-766) For allocation factors where no information for SPC was available, e.g., for allocation factors that use employees as the allocation basis, Ms. Dismukes adjusted the factor for Gulf downward by the average of the change in all other allocation factors where data was available.

In addition, Ms. Dismukes removed the revenue component from two allocation factors which included revenue, expenses, and investment as components. She believes that including revenue in these two factors under allocates costs to new non-regulated companies because new companies in the start-up phase of operations produce little revenue relative to investment expenses. (TR 766) Allocation factors that used customers as the basis were not modified. Ms. Dismukes' factors did not reflect increases for growth in the other non-regulated companies. (TR 767) The above adjustments to the allocation factors resulted in Ms. Dismukes recommending a reduction in costs allocated to Gulf of $1.4 million. (EXH 41, Schedule 3, p. 5)

Gulf witness Richard McMillan stated that the amounts used to project O&M related to affiliate transactions were based upon the best information available at the time Gulf prepared the test year data for the original filing in this case. (TR 955) He believes that Ms. Dismukes' modification of the allocation factors using projected or estimated 2003 data for SPC is flawed by numerous errors and inappropriate assumptions.

Mr. McMillan stated that components of allocation factors reviewed and approved by the SEC can not be arbitrarily changed. (TR 955) Another criticism he had of Ms. Dismukes' testimony was that overall increases in total SCS allocated costs were ignored, as were changes in other affiliates' statistics; these allocations may offset the impact of adding SPC into the allocation. For example, while increasing capacity related allocations to include SPC, the increase in capacity related to Gulf's Smith Unit 3 and other Southern generating capacity additions were ignored. Staff's understanding of Mr. McMillan's position is that increasing the capacity factor for SPC and the other affiliates would reduce the amount allocated to Gulf while increasing the factor for Gulf would increase the allocation to Gulf. (TR 953)

In addition, Mr. McMillan stated that Ms. Dismukes assumed that all allocated costs were charged to O&M expense, when in fact, her proposed adjustment to O&M included capital and below-the-line charges. Mr. McMillan disagrees with Ms. Dismukes' use of a factor of seven to estimate some of SPC's statistics. He stated that there is no basis for using such a factor because there is no support for a correlation in the relationship between the increase in SPC's KW capacity and the statistics. A larger portion of SCS's costs were allocated to SPC by using this methodology. (TR 955)

Mr. McMillan further noted that the period of time selected by Ms. Dismukes, calendar year 2003, extends beyond the test year which ends in May of 2003, and she incorrectly assumes that SPC should receive allocations for all SCS activities except those based on customers. For example, she failed to exclude activities, such as transmission and distribution related activities, which are not related to generation, and therefore not applicable to SPC. (TR 955)

Mr. McMillan tested the reasonableness of the projected test year allocated amounts by looking at two scenarios. First, he updated the allocation factors to include year 2000 data, the most current historical data available, which reflect the inclusion of SPC. These factors were applied to the 2003 projected test year amounts used in preparing the MFRs. Next, he compared the test year SCS O&M amounts to the recently completed SCS 2002 budget. In both cases, the amount allocated to Gulf was more than the amount included in the projected test year. Therefore, Mr. McMillan concluded that the projected test year O&M expenses related to affiliated transactions are conservative, and are understated. (TR 953-954)

In the 2003 projected test year, $20,420,000 of SCS costs (capital, expense, and below-the-line charges) were allocated to Gulf. (EXH 41, Schedule 3, p. 5) OPC witness Dismukes made many assumptions, projections, and estimates in modifying the allocation factors she applied to the 2003 SCS costs. Staff agrees with Gulf witness McMillan's evaluation of Ms. Dismukes' modifications. Staff disagrees with the assumptions made by Ms. Dismukes and her reallocation of SCS costs.

In particular, staff is influenced by the fact that costs were allocated to SPC for all SCS activities when SPC should not have received allocations for transmission and distribution. SPC owns generation only, therefore costs related to transmission and distribution are not applicable to SPC. This would incorrectly reduce allocations to the other affiliates.

Staff also believes that the components of the SEC approved allocation factors should not be changed. When Gulf desires to change its allocation methodology, approval must be obtained from the SEC. By removing the revenue component, Ms. Dismukes' factors are no longer in compliance with SEC approved methodology.

In addition, staff believes that in order to calculate the appropriate allocations, statistics for all the affiliates should reflect the same time period in accordance with the matching principle. If factors are updated to reflect 2003 statistics for SPC, then the factors should be updated to reflect 2003 statistics for all the affiliates in order to create a level playing field and to fairly allocate costs. Total SCS costs will also be increased by updating to 2003 amounts and some affiliates will have increases while others will have decreases to their statistics as a result of changes in 2003. It is not appropriate to pick and choose which affiliates' statistics to update.

Further, it appears that Ms. Dismukes allocated costs that should have been capitalized or recorded below-the-line. This would incorrectly increase O&M expenses for all affiliates. Finally, staff believes that the use of a factor of seven to increase SPC amounts and adjusting some factors downward by the average of the change in all other allocation factors is arbitrary. Staff agrees with Gulf that there is no true correlation between these measures and the statistics to which Ms. Dismukes applies them.

Staff believes the level of allocated costs included in the 2003 test year is reasonable and representative of future costs. Therefore, staff recommends that no adjustments are necessary.

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

RECOMMENDATION: No. The Company should continue accruing $3,245,000 ($3,500,000 system). (L. Romig)

POSITION OF THE PARTIES

GULF: No. The appropriate amount for the property damage reserve accrual of $3,245,000 jurisdictional ($3,500,000 system) is included in the May 2003 projected test year. This is consistent with the Commission's decision in Order No. PSC-96-1334-FOF-EI approving a reserve target level of $25.1 million to $36 million based on a storm damage study filed as required by the Commission.

FEA: Adopts OPC's position.

FIPUG: Adopts OPC's position.

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

STAFF ANALYSIS: Gulf included in projected test year expenses, $3,245,000 ($3,500,000 system) for the accrual to the Accumulated Provision for Property Insurance (reserve). The accrual, which was approved by the Commission in Order No. PSC-96-1334-FOF-EI, issued November 5, 1996, in Docket No. 951433-EI, increased the reserve balance at the end of the projected test year to $16.5 million including projected charges to the reserve. In his rebuttal testimony, Gulf witness McMillan testified that the projected charges to the reserve were based on very conservative estimates, for example, no costs were projected for hurricane damages. (TR 952) Witness McMillan further testified that as a result of the terrorist events of September 11, 2001, property insurance costs increased. Premiums for its insurance policies covering its generating and general plant increased $380,000 or 60% while increasing uninsured deductibles $1 million. Mr. McMillan states that this increase in uninsured deductibles will increase future charges to the reserve. (TR 952-953)

OPC witness Schultz testified that the Company's authorized annual accrual of $3,500,000 since 1996, and average annual charges against the reserve of $1,536,000 since 1996, have resulted in an increase in the reserve balance to $8,731,000. Based on a continuation of the accrual the reserve balance will be $16,488,000 at May 31, 2003. (TR 816) The witness further testified that the annual accrual should be reduced to $1,679,616 resulting in a reduction of $1,680,384 to the projected test year expense. The reduced accrual is based on a five year average of annual charges to the reserve escalated by an inflation multiplier. In his opinion, the adjusted accrual is reasonable and would offset any charges and still maintain the current reserve balance. (TR 816)

Gulf had a balance of approximately $12 million in its reserve as of August 2, 1995. On August 3, 1995, Hurricane Erin caused $11 million in damages which were chargeable against the reserve. Two months later Hurricane Opal caused an additional $9 million in damages, also chargeable against the reserve. The damages from the two storms resulted in a negative balance in the reserve of approximately $9 million.

Based on the financial impact of the two storms, Gulf filed a petition requesting that it be allowed to increase its annual accrual to the reserve from $1.2 million to $3.5 million. The Commission stated in Order No. PSC-96-0023-FOF-EI, issued January 8, 1996, in Docket No. 951433-EI, that even increasing the accrual to $3.5 million, effective October 1, 1995, with additional charges, the reserve would have a negative balance until late 1997. "This obviously is not desirable since the Company is in a self-insurance position." (Order No. PSC-96-0023-FOF-EI) The Commission temporarily approved Gulf's request to increase its accrual and ordered the Company to file a storm damage study to determine the reasonableness of the proposed $3.5 million accrual.

Upon receipt and review of the study, the Commission allowed Gulf to continue the annual accrual of $3.5 million. In approving Gulf's request the Commission stated in the order that the primary concern is that the level of the accrual be sufficient to cover annual damages and promote growth in the reserve. The Commission also ordered that the appropriate target level for the reserve be between $25.1 and $36 million. The balance in the accumulated provision account was $8.7 million as of December 31, 2000, and the balance is projected to be $16.5 million at May 31, 2003. The projected balance is based on $297,000 in charges to the reserve in the year 2000, and $324,000 in each of the years ending May 2002 and 2003.

Staff recommends that Gulf continue its $3.5 million annual accrual until the target level ordered by the Commission is reached. The accrual and target levels should only be changed based on a review of an in depth storm damage study ordered by the Commission. In staff's opinion, OPC's proposal is not reasonable and would not allow Gulf to reach the target level approved by the Commission especially if Gulf were to sustain hurricane damage as in the past. If this were the case, Gulf could possibly have charges to the reserve which would put it in a negative reserve balance. This is contrary to the Commission's statement in the above referenced order that it would not be desirable to have a negative balance since the Company is in a self-insurance position.

<u>ISSUE 56</u>: Should an adjustment be made to the accrual for the Injuries & Damages reserve for the May 2003 projected test year? (L. Romig, Kaproth, Stern)
STIPULATED

<u>ISSUE 57</u>: Should interest on tax deficiencies for the May 2003 projected test year be included above-the-line? (C. Romig, Vendetti, McCaskill)
STIPULATED

ISSUE 58: Should an adjustment be made to Rate Case Expense for the May 2003 projected test year? (Kaproth, L. Romig)

RECOMMENDATION: Yes. The projected rate case expense of $1,383,500 should be reduced by $120,500 and amortized over four years for an annual rate case expense of $315,750. Therefore, O&M expenses should be reduced by $30,125. (Kaproth, L. Romig)

POSITION OF THE PARTIES

GULF: Yes. Based on the updated rate case expense estimate in Late-Filed Exhibit 55, total rate case expense should be reduced by $50,000 (to $1,333,000). This amount should be amortized over four years at the rate of $333,000 per year, which is consistent with the amortization period approved by the Commission in Gulf's last rate case. The change in the annual amortization of rate case expense results in a reduction to jurisdictional O & M expense of $13,000.

FEA: No position stated in Brief.

FIPUG: Yes. Adopts OPC's position.

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.

STAFF ANALYSIS: In Direct Testimony, Gulf witness Labrato requested $1,383,500 in rate case expense to be amortized over four years. Gulf explained that in its last case, the Commission approved a four year amortization period. As a result, the rate case expense would be $345,875 using a four year amortization period. (EXH 37, p. 112)

OPC witness Schultz testified that an adjustment is needed to the $603,000 in legal expense because in the prior rate case the legal expense was $188,953, and this requested increase would be a 219.13% increase. Witness Schultz reduced estimated legal fees by $153,223 for a total rate case expense of $1,230,277. Witness Schultz also used a six year amortization period for annual rate case expense of $205,046, and a recommended test year reduction of $140,829. (EXH 43, p. 34, Schedule C-13)

Because of the shortened hearing schedule Witness Labrato was requested to file a late-filed exhibit revising rate case expense reflecting the Company's most up to date estimate of rate case expense. Accordingly, Gulf filed late-filed Exhibit 55 showing the Company's revised expense compared to its original estimate. The table below shows the comparison as well as staff's recommended rate case expense.

Item	Per Filing	Gulf's Revised Rate Case Estimate	Recommended Rate Case Expense
Outside Consultants	$ 200,000	$ 240,000	$ 200,000
Legal Services	603,000	$ 550,000	$ 550,000
Meals and Travel	125,000	$ 55,000	$ 55,000
Paid Overtime	40,000	$ 70,000	$ 40,000
Other Expenses	415,500	$ 418,000	$ 418,000
Total	$1,383,500	$1,333,000	$1,263,000

In its brief, OPC argues that late-filed Exhibit 55 raises additional concerns because the "Outside Consultants" estimate increased from $200,000 to $240,000 and "Paid Overtime" also increased $30,000 without any additional justification from the utility. OPC recommends $200,000 for outside consultants, $449,777 for legal services, $55,000 for meals and travel, $40,000 for paid overtime, and $418,000 in Other Expenses for a total of $1,162,777 in rate case expense. With a six year amortization period, the annual amortized rate case expense would be $193,796.

Staff believes that the utility should not recover the additional $40,000 for Outside Consultants or the additional $30,000 for overtime costs without supplying documentation to justify the increase. A late-filed exhibit was required because the hearing lasted two days instead of five, an undisputed fact.

The increases in "Outside Consultants" and "Paid Overtime" are unsupported by the record.

Based on the above, the Company's per filing amount of rate case expense should be reduced by $120,500. Using a four year amortization period, the annual rate case expense is $315,750 for a test year reduction of $30,125 ($345,875 - $315,750) to O&M expenses.

ISSUE 59: Should an adjustment be made to marketing expenses for Gulf's marketing of high efficiency electric technologies for heating and water heating? (Haff)

RECOMMENDATION: Yes. Test year marketing expenses should be reduced by $116,695 ($116,695 system) to account for the removal of costs associated with Gulf's Water Heating Conversion Program. (Haff)

POSITION OF THE PARTIES

GULF: No. Gulf's marketing of high efficiency electric technologies for heating, water heating and other end uses is beneficial to the participating customer, the Company, and to the general body of customers. Gulf provides information on end-use technologies and efficiencies in all market segments so as to influence choices toward the most efficient and cost-effective technology. The Company's programs are designed and intended to reduce or control the growth in energy consumption and weather-sensitive peak demand.

FEA: No position stated in Brief.

FIPUG: Yes. These expenses should be removed. They are not permitted to be recovered through the conservation cost recovery clause and thus are not appropriate for base rate recovery.

OPC: No position stated in Brief.

STAFF ANALYSIS: Sections 366.80-366.85 and 403.519, Florida Statutes, comprise the "Florida Energy Efficiency and Conservation Act" (FEECA). The Legislative intent of FEECA states in part that FEECA is "to be liberally construed in order to meet the complex problems of reducing and controlling the growth rates of electric consumption and reducing the growth rates of weather-sensitive peak demand" Section 366.81, Florida Statutes.

Gulf's Water Heating Conversion Program (Program) allows customers to replace existing gas-fired water heaters with free, energy-efficient electric water heaters. (EXH 4; TR 565) As a result, the Program increases Gulf's winter peak demand by 0.25 KW per customer and annual energy consumption by 4,367 KWh per customer. (EXH 4; TR 567) Such increases clearly violate the Legislative intent of FEECA. Staff believes that Gulf's Program is not an energy conservation program, but, rather, an effort to promote use of electricity over natural gas.

Gulf Witness Neyman testified that Program costs are currently recovered through base rates rather than through the Energy Conservation Cost Recovery (ECCR) Clause because the Program does not reduce either peak demand or annual energy consumption. (TR 566-567) However, Program costs appear as base rate expenses in Gulf's surveillance reports to the Commission. Because the Program was started in 1997 (EXH 4), these costs were not approved by the Commission when it last set Gulf's base rates in 1989. (TR 57)

The Commission does not allow ECCR Clause cost recovery for electric conservation programs that do not advance the objectives of FEECA. (Order No. 22176, issued November 14, 1989, in Docket No. 890737-PU) Further, the Commission has a long-standing fuel neutrality policy in which ECCR Clause cost recovery is not approved for electric conservation programs used as a competitive tool against natural gas. (Reaffirmed most recently in Order No. PSC-00-0400-FOF-EG, issued February 24, 2000, in Docket No. 981591-EG.) Staff recommends that denial of ECCR Clause recovery for gas-electric competitive activities, such as Gulf's Program, can be extended to denial of cost recovery in base rates as well.

If Gulf wishes to continue offering the Water Heater Conversion Program to its customers, staff recommends that the Program's costs be borne by Gulf's stockholders rather than its ratepayers. For this reason, staff recommends that Gulf's test year marketing expenses be reduced by $116,695 ($116,695 system).

ISSUE 60: **DELETED**. Number retained for continuity.

ISSUE 61: **DELETED**. Number retained for continuity.

ISSUE 62: Should an adjustment be made to Production Expenses for the May 2003 projected test year? (Haff, Merta)

RECOMMENDATION: No. Staff recommends no adjustment to production expenses for the projected test year. (Haff, Merta)

POSITION OF THE PARTIES

GULF: No. Gulf's request of $74,522,000 jurisdictional ($77,202,000 system) is the reasonable and prudent amount necessary to effectively maintain and operate Gulf's generating fleet, and is less than the 5-year average projected for 2002-2006. This amount exceeds the benchmark due to a combination of factors including: the addition of Smith Unit 3; the increased generation demands being placed on an aging fleet; and a more proactive maintenance philosophy which has resulted in all-time high generation reliability.

FEA: FEA adopts the position of OPC.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: For the projected test year period from June, 2002, to May, 2003, Gulf estimates that production operating and maintenance (O&M) expense will be $77,202,000. (EXH 30, Schedule 3) This level exceeds the test year benchmark by approximately $10,714,000. (EXH 32, Schedule 7) Staff notes, however, that the baseline for benchmark comparisons was set twelve years ago in 1990, at Gulf's last rate case. Further, Gulf's requested test year production O&M expense is approximately $9.5 million less than the 5-year average projected for the 2002-2006 time period. (EXH 50, Schedule 4)

Gulf witness Moore identified and justified the reasons for the increase in production O&M. He cited three primary factors for the increase:

- The addition of new generating units. Witness Moore testified that the addition of Smith Unit 3 and the Pea Ridge cogeneration station, both combined cycle units, result in a benchmark variance of $3,840,000 in the "Production Steam" subcategory. (TR 408; EXH 32, Schedule 7)

- The increase in generation from an aging steam generation fleet, coupled with a more proactive maintenance philosophy. Witness Moore testified that substantially increased costs to maintain and operate Gulf's aging fleet of steam generating units have resulted in improved reliability and reductions in outages. (TR 406-407; EXH 32, Schedule 6) These factors, coupled with a 37% increase in generation, result in a benchmark variance of $5,786,000 in the "Production Other" subcategory. (TR 416; EXH 32, Schedule 7)

- The $1,088,000 benchmark variance for the "Production Other Power Supply" subcategory results from two items: (1) increased costs related to Gulf's share of operating the Southern Company's wholesale energy trading floor; and, (2) increased costs to operate the Power Coordination Center, whose responsibility is to carry out bulk power supply operations including those required by FERC Orders 888, 889, and 2000. (TR 408-409; EXH 32, Schedule 7)

OPC Witness Schultz recommends that production expenses be reduced by $10,251,700. However, he did not identify any specific items to be disallowed. In forming his opinion, witness Schultz relied on his prefiled testimony exhibit which appears to show that Gulf's production expenses in the test year are forecasted to exceed 2000 levels. (EXH 43) Gulf witness Moore testified that Mr. Schultz made an erroneous conclusion because his prefiled testimony exhibit does not include all dollars allocated to production expense. (TR 988, 992)

In summary, Gulf has provided sufficient identification and justification of its test-year production expenses. OPC did not identify any specific item in Gulf's testimony or exhibits on which it disagreed with Gulf's conclusions. Staff recommends that the documentation provided by Gulf is adequate support and justification for the reasonableness of its proposed production expenses. Therefore, staff recommends that no adjustment be made.

<u>ISSUE 63</u>: Should an adjustment be made to Transmission Expenses for the May 2003 projected test year? (Haff, Merta)
STIPULATED

<u>ISSUE 64</u>: Should an adjustment be made to cable inspection expense? (Matlock, D. Lee, Merta)

<u>RECOMMENDATION</u>: Yes. Cable injection expense should be removed from O&M Expense, capitalized in Account No. 367, Underground Conductors & Devices, and depreciated over the life of the associated cable. O&M expense should be reduced by $166,000 and Plant-in-Service, Accumulated Depreciation, and Depreciation Expense should be increased by $83,000, $865, and $2,490, respectively. (Matlock, D. Lee, Merta)

<u>POSITION OF THE PARTIES</u>

<u>GULF</u>: There should be no adjustment to the level of costs projected for this program. Injecting a selected group of cables will reduce the likelihood of outages caused by premature failures. The recent changes in the manufacturer's warranty improve the economics of this process and have resulted in Gulf reinstating cable injection. Gulf is willing to follow staff's recommendation and capitalize the costs of this program rather than charge them to expense.

<u>FEA</u>: FEA adopts the position of OPC.

<u>FIPUG</u>: Adopts OPC's position.

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

<u>STAFF ANALYSIS</u>: The Company budgeted $166,000 in the 2003 projected test year for a cable inspection and injection program.

(TR 1014) Before 1990, Gulf had over 600 trench miles of underground cable installed. Gulf is instituting a program to inject a silicone fluid into the cable to remove water and fill voids. This process has proven to retard the deterioration of the cable insulation and extend the life of the underground cable. (TR 436) A warranty by the manufacturer of the cable injection process carries an unconditional 20-year guaranty. (TR 1014) Through implementation of the program, Gulf believes the likelihood of future outages caused by the premature failure of the older cables can be reduced. (TR 437, 464) The Company has identified 28 miles of cable that will benefit from the injection process and anticipates injecting approximately four and a half miles per year. The project is anticipated to take about six years to complete. (TR 467-468)

Projects designed to extend the life of capital assets are normally capitalized. (TR 810) The cable injection process has been treated as a maintenance expense by Gulf because there was no installation or removal of a plant or property unit involved. (TR 1013-1014) Further, the cable injection did not qualify for a retirement unit code under the Company's capitalization guidelines, and Gulf believed its accounting treatment was consistent with that of other utilities. (TR 1112-1113) However, in Order No. PSC-94-1199-FOF-EI, issued September 30, 1994, in Docket No. 931231-EI, the Commission found that cable injection costs should be capitalized and recovered over the associated guarantee period. Cable injection costs will be recorded with underground cable costs in Account 367 which has a stipulated 20-year average remaining life and resulting 3.0% remaining life rate. (TR 464; EXH 6, Depreciation Study, Depreciation Stipulation) Since the guarantee period matches the remaining life of the account, staff recommends that the cable injection costs be capitalized and depreciated over the life of the associated cable. (EXH 56, EXH 6, Depreciation Study)

FEA, FIPUG, and OPC are in agreement that the cable injection costs should be capitalized. However, the parties have not proposed specific adjustments to rate base, maintenance expense, or depreciation expense. Although Gulf believes that it has properly classified the costs as an expense, it has no objection to capitalizing these costs.

In its brief, Gulf stated that if the cable injection program is capitalized, O&M expense should be reduced by $166,000 and Plant-in-Service, Accumulated Depreciation, and Depreciation Expense should be increased by $152,000, $2,000, and $4,000 respectively. It appears that Gulf has assumed that the project will go into plant in the first month of the projected test year. Staff can find no record basis for Gulf's adjustments to rate base and depreciation expense. No evidence was presented as to the date the project begins or the months in which the injections will take place. Based on prior Commission practice when project dates are unknown, staff has calculated its adjustments based on the assumption that the $166,000 project will go into plant evenly over the 2003 test year at one twelfth per month. Therefore, staff recommends that O&M Expense be reduced by $166,000 and Plant-in-Service, Accumulated Depreciation, and Depreciation Expense be increased by $83,000, $865, and $2,490, respectively.

ISSUE 65: Should an adjustment be made to substation maintenance expense? (Matlock, D. Lee, Merta)

RECOMMENDATION: No. Based on the additional substation maintenance activities planned for the test year, and Gulf's reasons for the expense decreases in the years 1999 and 2000, substation maintenance expense (Account 592) should not be adjusted. (Matlock, D. Lee, Merta)

POSITION OF THE PARTIES

GULF: No. To adhere to Gulf's substation maintenance program and to prevent failures of this aging equipment, the budgeted funds are needed to return six existing substation technicians that have been assigned to construction projects back to their normal maintenance activities.

FEA: FEA adopts the position of OPC.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: Gulf Witness Fisher presented direct testimony stating that test-year substation maintenance expense should be increased over the total for 2000 due to three factors: 1) an additional $555,000 to prevent failures of aging substation equipment; 2) $200,000 increased maintenance expenses for new substation transformer banks, breakers, and capacitor banks installed between 2001 and 2003; and 3) $60,000 additional annual expense to prevent insulator arching due to salt contamination at one distribution substation. (TR 434-435) These factors account for $815,000 of the total requested test-year increase in substation maintenance expense over the total for the year 2000 of $829,744. (TR 434-435) The total substation maintenance expense requested by Gulf is $1,647,000. (EXH 33) This requested amount exceeds its benchmark level by $266,000. (EXH 33)

OPC Witness Schultz presented testimony questioning the need for these proposed increases, noting that Gulf's actual substation maintenance expense in 1999 and 2000 and budgeted substation maintenance expense for 2001 were lower than the benchmark levels for those years, and that Gulf's requested increase was not reflected in its 2001 budgeted expenses. (TR 812)

Witness Schultz calculated an Indexed Five-Year Average of Gulf's substation maintenance expenses over the years 1996 through 2000. (EXH 43) Witness Schultz inflated each historic year's total annual expenses to make them comparable to test year expenses in terms of customers served and price levels and averaged the inflated expenses over the five years. (TR 849) Witness Schultz' Indexed Five-Year Average of Gulf's substation maintenance expense is $1,255,684. (TR 812; EXH 43) Witness Schultz offers this average as the reasonable level of substation maintenance expense, noting that this recommended expense level is $438,838 or 54% more than was actually expended in the year 2000. (TR 812) This recommended expense level represents an adjustment of $391,000. (TR 812)

In his rebuttal testimony, Witness Fisher explains that in the years 1999, 2000, and 2001, substation maintenance expense was lower than normal due to six substation electricians normally assigned to substation maintenance being temporarily assigned to substation plant construction. (TR 1015) These six substation electricians returned to their maintenance activities at the beginning of 2002. (TR 1015) Witness Fisher thus contends that Witness Schultz' Adjusted Five-Year Average is not representative of future periods. (TR 1015) Witness Fisher details the additional $555,000 over actual 2000 expense intended to prevent failures to aging substation equipment as consisting of $422,200 in additional salaries and $132,800 in additional material cost, and he details the $200,000 expense increase intended for maintenance of the new substation facilities as $141,000 in additional salaries and $59,000 in additional material cost. (EXH 5, Interrogatory 32) Witness Fisher explains the need for $60,000 additional annual expense to prevent insulator arching due to salt contamination at one distribution substation. (TR 434-435) This substation is located near the Escambia River. (EXH 12, p. 64) In periods of low rain, the salt content of the river water increases. (EXH 12, p.

64) This causes salt corrosion to build up on the substation's insulators. (EXH 12, p. 65) The $60,000 is requested to clean the insulators in this substation to prevent arching and outages. (TR 434-435)

Witness Schultz compares Gulf's 1999 and 2000 substation maintenance expenses with their respective benchmark levels which exceeded actual expenditures. (TR 812) Those years' actual expenses and benchmark expense levels appear in the following table along with the same data for 1996-1998. The benchmark levels for 1996-1998 are calculated using the $754,000 Commission approved expense level in 1990 (EXH 33) and the Inflation and Growth Compound Multipliers for those years (EXH 24, Schedule C-56, p. 1).

Actual and Benchmark Expense Levels
Substation Maintenance

Year	Actual Expense	Benchmark Level	Difference
1996	$1,059,337	$1,033,915	$ 25,422
1997	$ 938,694	$1,092,184	(153,490)
1998	$1,488,667	$1,148,478	$ 340,189
1999	$ 861,904	$1,196,666	(334,762)
2000	$ 817,256	$1,263,056	(445,800)

Sources: EXH 24, Schedule C-12, pp. 4,10, Actual Expenses
EXH 33, 1990 Approved Expense
EXH 24, Schedule C-56, p. 1, Escalation Factors

Staff notes that in the three years prior to the reassignment of the six substation electricians, Gulf's substation maintenance expenses exceeded the annual benchmark levels by an average of approximately $70,000 per year. Staff believes Gulf has accounted for the decreases in 1999 and 2000, and its expenses falling short of their benchmark expense levels in those years. (TR 1015)

With Gulf's explanation of its decreases in substation maintenance expense by the transfer of the substation electricians away from substation maintenance for 1999-2001 and their return in 2002, its additional substation maintenance activities planned for the test year, and its pre-1999 annual substation maintenance expenses, staff believes Gulf's requested test-year substation maintenance expense is a reasonable estimate of an appropriate level of test year expenses. Therefore, staff believes that Gulf demonstrated the need for the expense level it requested for the test year, and recommends that no adjustment be made to this category.

ISSUE 66: Should adjustments be made to tree trimming expense? (Matlock, D. Lee, Merta)

RECOMMENDATION: Yes. Staff believes that Gulf can at least maintain the quality of service it delivers to its customers, commensurate with customer expectations and historical expenses, with an annual tree-trimming expense of $3,193,000. This is a jurisdictional adjustment (reduction) of $930,000 to Account 593 - maintenance of overhead lines. (Matlock, D. Lee, Merta)

POSITION OF THE PARTIES

GULF: No. This requested level of tree trimming expense is necessary to allow Gulf to transition from the present spot trimming program to a more effective tree trim cycle and reduce tree related outages, which have escalated in recent years.

FEA: FEA adopts the position of OPC.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: Gulf Witness Fisher presented testimony requesting $4,123,000 for annual tree-trimming expense, $2,488,000 greater than the actual tree-trimming expense for the year 2000. (TR 435) Witness Fisher states that as a result of efforts to reduce costs, Gulf is presently relying on spot trimming. (TR 1034) He also notes that Gulf started to depend more on spot trimming beginning 5 years after the last rate case, and that as a result, tree related outages have risen. (TR 1034) The present level of tree trimming is estimated by the witness to be roughly a "seven year cycle that includes the use of spot trimming." (EXH 12, p. 40) Witness Fisher states that the increase in tree-trimming expense is intended to cover a three-year tree-trimming cycle, which would result in reduced outages. (EXH 12, p. 44) Witness Fisher does not believe that Gulf has achieved a three-year tree-trimming cycle since determining this to be the optimal cycle in 1981. (EXH 12, p. 40)

OPC Witness Schultz presented testimony questioning the need for the increase of $2,488,000. (TR 813) Witness Schultz notes that in the year 2000, Gulf budgeted $3,010,997 and expended only $1,634,914 for this activity, and for the year 2001, Gulf budgeted only $1,639,694. (TR 813) Mr. Schultz further questions the need for a more proactive position with regard to improving distribution reliability, since Gulf's customers site reliability as one the Company's strengths. (TR 813)

Witness Schultz calculated an Indexed Five-Year Average of Gulf's tree-trimming expenses over the years 1996 through 2000. (EXH 43) Witness Schultz inflated each historic year's total annual expenses to make them comparable to test year expenses in terms of customers served and price levels and averaged the inflated expenses over the five years. (TR 849) Witness Schultz' Indexed Five-Year Average of Gulf's tree-trimming expense is $2,743,625. (TR 813; EXH 43) Witness Schultz offers this average as the reasonable level of tree-trimming expense. (TR 813) This recommended expense level represents an adjustment of $1,379,000. (TR 813)

Witness Fisher states in his rebuttal testimony that the number of miles trimmed has declined from 889 miles in 1998 to 241 in 2000. (TR 1016) The expenses associated with these numbers of miles trimmed are $2,656,185 and $1,634,914, respectively. (EXH 43; EXH 5; Interrogatory 33) The numbers of minutes of interruption due to tree related outages increased from 1,557,000 minutes to 5,988,000 minutes over the same period. (EXH 52) The planned number of miles trimmed in the test year is 1,710 miles. (EXH 5, Interrogatory 35) This is the number of miles of tree-trimming activity for which the $4,123,000 test-year expense request is made. (EXH 5, Interrogatory 35)

Staff agrees with Witness Fisher that more tree-trimming activity is needed to counter the increased interruption minutes that have accompanied the reduced numbers of miles trimmed since 1998. Staff also agrees that Gulf's level of distribution reliability is presently at a satisfactory level, as pointed out by

Witness Fisher: "our complaint activity as reported by this Commission is low with no infractions in almost four years, and that during the customer service hearings in Pensacola and Panama City, not one customer had a negative comment about our electric service or our customer care." (TR 459) Witness Fisher states that while tree-related interruption minutes have increased, improvements have been made in other areas because of Gulf's other efforts to improve reliability. (EXH 12, pp. 42-43)

Due to the satisfactory performance by Gulf in spite of declining tree-trimming activity, staff does not believe that all of the additional expense requested is necessary. Nor does staff agree with Witness Schultz that including the 1999 and 2000 expenses in an Indexed Average is appropriate for test-year tree-trimming budgeting purposes, when tree-trimming activity during those years was significantly reduced from previous years' levels and those reductions were accompanied by increased numbers of tree-related interruption minutes.

Staff believes that the level of service that Gulf delivers to its customers in this area should return to, at a minimum, the level delivered in 1998. In that year, Gulf trimmed 889 miles of distribution line with associated expenses of $2,656,185. (EXH 5; Interrogatory 33) For purposes of calculating OPC's Adjusted Five-Year Average, Witness Schultz has inflated that level of expense to the test year, accounting for customer growth and price level increases. (TR 849) The inflated number of dollars is $3,193,000. (EXH 43) This expense level should be great enough to fund a level of activity comparable to the tree trimming carried out before Gulf switched to the less systematic program of spot trimming.

If history is any guide, tree trimming is an expense category wherein the budgeted amount should be closely tied to the benchmark, and the budgeted amount should be spent for the purpose intended in order to avoid significant increases in minutes of interruption. Staff believes the utility should be encouraged to budget and spend accordingly in this area. Staff believes the annual expense of $3,193,000 is sufficient for Gulf to perform a reasonable level of tree trimming and maintain its present level of distribution reliability. This represents a $930,000 (jurisdictional) reduction of the requested test-year expense for Account 593, maintenance of overhead lines.

ISSUE 67: Should an adjustment be made to pole line inspection expense? (Matlock, D. Lee, Merta)

RECOMMENDATION: No. Gulf has demonstrated the need for its proposed level of pole line inspection expenses and therefore staff recommends that no adjustment be made to pole line inspection expense (Account 593). (Matlock, D. Lee, Merta)

POSITION OF THE PARTIES

GULF: No. The level of expense budgeted for this program is necessary to maintain Gulf's aging pole plant to avoid more expensive repairs in the future.

FEA: FEA adopts the position of OPC.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: Gulf Witness Fisher filed direct testimony requesting $734,000 for Gulf's pole-line inspection program for the test year. (TR 433) This amount is a $734,000 increase over the pole-line expenses for the year 2000. (TR 434; EXH 5, Interrogatory 31) Witness Fisher described the pole-line inspection program as an effort to treat, repair, or replace 60,000 poles installed prior to 1980. (TR 433-434) Witness Fisher further explained that in the early 1980's, Gulf switched to using Chromium Copper Arsenate (CCA) treated wood poles with superior decay resistance. (TR 433) Plans for treating the 60,000 poles, over the next five years, are based on Gulf's experience so far in treating 48,000 such poles beginning in 1991. (TR 433-434)

OPC Witness Schultz calculated an Indexed Five-Year Average of Gulf's pole line inspection expenses over the years 1996 through 2000. (TR 814-815) Witness Schultz inflated each historic year's total annual expenses to make them comparable to test-year expenses in terms of customers served and price levels he then averaged the inflated expenses over the five years. (TR 849) Witness Schultz' Indexed Five-Year Average of Gulf's pole line inspection expense is $207,274. (EXH 43) Witness Schultz offers this average as the reasonable level of pole line inspection expense. (TR 814) This recommended expense level represents an adjustment of $527,000. (TR 815)

Witness Fisher's rebuttal testimony cites the age of the poles remaining to be treated - now all the poles are over 20 years old - as a factor to be considered in projecting expenses to the test year. (TR 1017) Witness Fisher described the process envisioned for the proposed pole line inspection program. (TR 465-472) Following its work with the remaining 60,000 line poles, Gulf will need to reinspect the original 48,000 line poles treated in the 1990's. (EXH 12, p. 38) Witness Fisher stated that in the future, Gulf will need to inspect the poles installed since 1980, which have superior wood decay properties compared to those installed prior to 1980. He notes that some of those poles are now twenty years old and their exact condition is not known. (EXH 12, p. 38) Witness Fisher stated that although the numbers of poles to be inspected should be smaller at the end of five years, the number of poles in service to be inspected and maintained will continue to grow, so Gulf will continue to incur expenses for this activity. (TR 469, 470)

Witness Schultz' claim that the requested $734,000 is excessive is based partly on the difference between the rate of replacement before the test year (48,000 poles in 10 years) and the rate proposed for the test year and beyond (60,000 poles in 5 years). (TR 814) Witness Schultz also questions Gulf's intentions to engage in this activity to the extent planned due to the absence of any expenses in 1999 or 2000, and no expenses budgeted for 2001. (TR 816) Witness Fisher points out that Gulf embarked on the pole line inspection program in the early 1990's and that its funding has had to come from existing programs. (TR 1032) Witness Fisher also notes that in the late 1990's, funding for this program and others was reduced due to Gulf's efforts to prepare for the transition to Y2K. (TR 1032)

Staff agrees with Witness Fisher that this inspection program enables Gulf to make repairs necessary to avoid more expensive repairs in the future. (TR 1017) Staff also agrees with Witness Fisher that Gulf's efforts to inspect and treat, reinforce, or replace the remaining 60,000 poles should be accelerated, as all of these poles are now over 20 years old. (EXH 12, p. 37) Therefore, staff recommends that no adjustment be made to pole line inspection expense.

ISSUE 68: Should an adjustment be made to street and outdoor light maintenance expense? (Matlock, D. Lee, Merta)

RECOMMENDATION: Yes. Street and outdoor lighting maintenance expense should be reduced by $320,000 to make the test year expense more reflective of actual annual expenses. (Matlock, D. Lee, Merta)

POSITION OF THE PARTIES

GULF: No. The amount requested is appropriate due to the increase in the number of lighting facilities and the group relamping program.

FEA: FEA adopts the position of OPC.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: Gulf Witness Fisher estimated the test-year street and outdoor light maintenance expense based on the growth in the number of street lights and the effects of group relamping in certain areas. (TR 438) Between 1990 and 2000, the number of lights maintained by Gulf increased by 263%. (TR 438) To account for increases in total maintenance expense, the number of dollars allowed in 1990 was escalated by that percentage to $1,328,000. (TR 438) To that amount, Witness Fisher added $110,000 to account for additional lights and planned group relamping. (TR 438) Thus, the test-year expense proposed by Witness Fisher is $1,438,000. (TR 438) This amount is proposed for two accounts, Account 585, street lighting and signal system expense, and Account 596, maintenance of street lighting and signal systems. (EXH 24, Schedule C-12, pp. 16-17)

OPC Witness Schultz testified that applying the growth rate since 1990 for the number of lights is not the appropriate method for projecting future expenses, as maintenance expense per light has declined since 1990. (TR 815) Witness Schultz calculated the Five-Year-Average of Gulf's street and outdoor light maintenance expenses over the years 1996 through 2000. (TR 815) This average was not adjusted for cost of living increases or for customer growth. (EXH 43) Witness Schultz' claim that maintenance expense per light has decreased since 1990 is supported by the fact that while the number of lights doubled during this period, expenses increased by only 63 percent. (EXH 5; Interrogatory 40)

Witness Schultz calculated the annual average expense per light and average of annual averages for 1996 - 2000. (EXH 43) The average of the five annual averages is $7.86. (EXH 43) Witness Schultz then multiplied the five-year average by his estimated number of lights in service for the test year, 142,255, to arrive at the estimated total street and outdoor light maintenance expense of $1,118,000, which he recommended as the total expense for this category. (EXH 43) Witness Schultz thus recommends a reduction of $320,000 in street and outdoor light maintenance expense. (TR 815; EXH 43)

In his rebuttal testimony, Witness Fisher represented the cost of group relamping in the test year as $425,600, or $38 per unit for the 11,200 lights expected to be replaced. (TR 1018, 1039-1048) Witness Fisher states in his direct testimony that the group relamping program reduces inefficiencies of individually relamping street lights as they fail. (TR 1018) However, he was not able to demonstrate how greater efficiency could be achieved by adding the expense of group relamping for a subset of Gulf's lights to the total cost of maintaining all lights. (TR 1039-1048)

Staff believes that Witness Schultz is correct in stating that expense maintenance per light has decreased since 1990. (EXH 5, Interrogatory 40) Staff also believes that the component of Gulf's proposed expense consisting of the total expense inflated by growth in the number of lights since 1990 would overstate the appropriate expenses for street and outdoor light maintenance. Therefore, staff believes that the additional expense proposed by Gulf for group relamping is not justified. Although staff does not believe that the additional expense for group relamping in the test year is justified, it is noted that Gulf performed some group relamping in 1998 and the expenses for that year are included in Witness Schultz' five-year average. (TR 1018; EXH 43) Staff agrees with Witness Schultz that the product of the Five-Year-Average of Gulf's street and outdoor light maintenance expense and the estimated number of lights in the test year represents a reasonable level for street and outdoor light maintenance expense ($1,118,000). Staff therefore recommends a jurisdictional adjustment (reduction) of $320,000 to Gulf's test-year street and outdoor light maintenance expense.

ISSUE 69: **DELETED.** Number retained for continuity.

ISSUE 70: Should an adjustment be made to Bad Debt Expense for the May 2003 projected test year? (L. Romig)
STIPULATED

ISSUE 71A: Should an adjustment be made to Customer Accounts-Postage Expense for the May 2003 projected test year? (L. Romig, Kaproth)

RECOMMENDATION: No. An adjustment should not be made to Customer Accounts-Postage Expense in the projected test year. The utility corrected an error which makes an adjustment unnecessary. (L. Romig, Kaproth)

POSITION OF THE PARTIES

GULF: No. An error was found in the breakdown of Customer Accounts Expense that did not affect the total Customer Accounts Expense in the test year. $489,000 that was budgeted in Postage should have been budgeted in Operations. The corrected May 2003 projected test year Postage amount of $1,157,000 compares favorably to the 2000 actual amount of $1,114,000.

FEA: Yes.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: In direct testimony, OPC Witness Schultz states that the postage expense was $1,114,054 in 2000 and $1,645,717 in the test year which was an increase of $531,663, or 48%. Witness Schultz states that the filing does not provide any explanation for such an increase and requested detail was not been provided. Consequently, Witness Schultz recommended a $427,975 decrease in postage expense. (EXH 43, Schedule C-11)

In rebuttal testimony, Witness Saxon testified that an error was found in the breakdown of expenses budgeted to Account 903-Postage and Account 903-Operations. The budgeted postage expense should have been reduced by $489,000, and, instead, budgeted in the operations account. If the correct amount were budgeted in the test year, the balance in Account 903-Postage Expense would have been $1,156,635, which compares favorably to the 2000 actual postage expense of $1,114,054. Even with the budgeted increase of $489,000 for Account 903-Operations, the test year amount would still be under the 2000 actual expenses for this account. (EXH 49; TR 969)

Staff recommends that no adjustment is necessary after the correction of the $489,000 error in the budgeted postage and operation accounts for the test year were made.

ISSUE 71B: Should an adjustment be made to Customer Records Expense for the May 2003 projected test year? (L. Romig, Kaproth)

RECOMMENDATION: No. An adjustment should not be made to Customer Records Expense for the test year because of Gulf's change in its allocation method. (L. Romig, Kaproth)

POSITION OF THE PARTIES

GULF: No. A change in the allocation of corporate and district facility operation and maintenance expenses was made in 2001 to more accurately assign the expenses to the various business functions. This increased the Customer Accounts Expense by $658,000 over 2000 actual. Prior to 2001, the facility operation and maintenance expenses were budgeted and charged to Administrative and General expense.

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

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.

STAFF ANALYSIS: In Direct Testimony, OPC Witness Shultz stated that the utility requested customer record expense of $3,102,769 for the projected test year is $743,942 higher than the 2000 actual expense of $2,338,827. (EXH 43, p. 33, Schedule C-12)

In rebuttal testimony, Witness Saxon explained that a change in the allocation of corporate and district facility operation and maintenance expenses was made in 2001 to more accurately assign the expenses to the various business functions. Witness Saxon testified that the customer expense accounts would then be $657,754 higher in the projected test year. Witness Saxon explained that an adjustment is not justified because of the change in the allocation method. (EXH 49; TR 370)

In its brief, OPC accepted Gulf's explanation that a change in the Company's accounting mechanics was the cause for the apparent excess in this account. Staff also accepts Gulf's explanation.

Based on the above, staff recommends that no adjustment be made to the Customer Accounts Expense because of the utility's change in its allocation method.

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? (L. Romig)

RECOMMENDATION: The deferred return should be amortized over four years. Amortization expense should be reduced $535,057 ($544,469 system) to reflect a four year amortization and the effect of the additional amortization booked during 2001. In addition, Gulf should be allowed to continue to have discretion to amortize up to an additional $1 million per year in accordance with the Commission-approved stipulation in Order No. PSC-99-2131-S-EI, issued October 28, 1999, in Docket No. 990250-EI. (L. Romig)

POSITION OF THE PARTIES

GULF: The accumulated balance of deferred return on the third floor should be amortized over three years. This treatment is consistent with the provision included in Gulf's revenue sharing plan, resulting from the Commission-approved stipulation in Order No. PSC-99-2131-S-EI, which allowed Gulf the discretion to amortize up to $1 million per year. The annual amortization as filed in the MFRs should be reduced by $336,000 (jurisdictional) to reflect the effect of additional amortization booked during 2001.

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

OPC: If the Commission requires current and future customers 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.

STAFF ANALYSIS: Gulf is requesting that the deferred return be amortized over three years. Gulf Witness Labrato testified that the requested level of amortization is consistent with the revenue sharing plan approved by the Commission in Order No. PSC-99-2131-S-EI, which permitted amortization of up to $1 million per year. (TR 620)

OPC Witness Schultz testified that Gulf based its three year amortization period on the above referenced order, but Gulf did not make the election in the time frame established by the revenue sharing agreement, to defer up to $1 million per year. (TR 795) The witness further testified that the deferral should not be included in rate base and that the requested amortization period was not appropriate. However, if the deferral is allowed in rate base then the deferral should be amortized over the life of the building. (TR 795)

Staff recommends that the deferral be amortized over four years, the same time period that staff is recommending for amortizing rate case expense. Also, Witness Schultz was in error when he testified that Gulf did not elect to write-off up to $1 million per year. It is clear that it was the intent of the parties to the revenue sharing agreement to allow the write-off of the deferral over a short period of time by authorizing Gulf to record at its discretion, up to $1 million per year to reduce the deferred return. In staff's opinion, the four year period is reasonable and would allow a fast write-off of the regulatory asset. In addition, the Company should be allowed to continue its discretion to write-off up to an additional $1 million per year. Therefore, expenses should be reduced $535,057 ($544,469 system).

ISSUE 73: What adjustments, if any, should be made to the depreciation expense and the fossil dismantlement accrual to reflect the Commission's decision in Docket No. 010789-EI? (Meeks)
STIPULATED

ISSUE 74: What is the appropriate depreciation rate and dismantlement provision for Smith Unit 3? (Meeks)
STIPULATED

ISSUE 75: Should an adjustment be made to Depreciation Expense for the May, 2003 projected test year? (Meeks)

RECOMMENDATION: Yes. Based on the adjustments recommended in previous issues, Depreciation and Amortization expense should be reduced by $2,522,000 ($2,603,000 System) for the May, 2003 projected test year. (Attachment 3) (Meeks)

POSITION OF THE PARTIES

GULF: Yes. Depreciation expense should be reduced by $2,272,000 ($2,350,000 system). This adjustment should be made to reflect the effect of the depreciation stipulation related to Smith Unit 3, the impact on depreciation expense of investment in additional security measures, a change in the balance of the deferred return on the third floor of the corporate office, and the effect of capitalizing cable injections costs.

FEA: FEA Adopts the position of OPC.

FIPUG: No position stated in Brief.

OPC: No position stated in Brief.

STAFF ANALYSIS: The appropriate jurisdictional depreciation and amortization expense is $75,042,000 for the projected test year. This is a calculation based on adjustments addressed in Issues 16, 47, 64, 72, and 74 as shown below:

Test Year Accumulated Depreciation Staff Recommended Adjustments		
Issues	Jurisdictional	System
Issue 16-House Power Panels	$ (49)	$ (49)
Issue 47-Security Measures	101	105
Issue 64-Cable Injection	2	2
Issue 72-3rd Floor Corp. Office-Amortization of Deferred Return	(535)	(544)
Issue 74-Stipulated 25-year life for Smith Unit 3	(2,041)	(2,117)
Total Adjustment	$(2,522)	$(2,603)

ISSUE 76: **DELETED.** Number retained for continuity.

ISSUE 77: **DELETED.** Number retained for continuity.

ISSUE 78: Should the total amount of Gross Receipts tax be removed from base rates and shown as a separate line item on the bill? (C. Romig, Kenny)
STIPULATED

ISSUE 79: Should an adjustment be made to Taxes Other Than Income Taxes for the May 2003 projected test year? (C. Romig, Kenny)

RECOMMENDATION: Yes. Taxes Other Than Income Taxes should be reduced by $12,380,000 from $36,969,000 to $24,589,000. (Attachment 3) (C. Romig, Kenny)

POSITION OF THE PARTIES

GULF: Taxes Other Than Income Taxes should be reduced by $11,110,000 ($11,110,000 system) to remove gross receipts tax from operating expenses in the calculation of Net Operating Income, rather than removing gross receipts tax from total revenue requirements in the calculation of proposed base rates. Taxes Other Than Income Taxes should also be reduced by $20,000 ($20,000 system) to reflect the adjustment to payroll taxes associated with the hiring lag discussed in Issue 51.

FEA: No position stated in Brief.

FIPUG: No position stated in Brief.

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

STAFF ANALYSIS: Per MFR Schedule C-38a, page 1 of 2, the adjusted jurisdictional May 31, 2003, projected Taxes Other Than Income Taxes is $36,969,000. (EXH 37) This amount includes taxes primarily related to revenues, property, and payroll. Gulf takes the position that Taxes Other Than Income Taxes should be reduced by $11,110,000 to reflect the unbundling of its gross receipts tax, and by $20,000 to reflect the adjustment to payroll taxes discussed in Issue 51. (TR 626; EXH 3, pp. 90-92) OPC takes the position that property taxes should be reduced by $1,251,000 to reflect the tax exemption that Gulf has received on Smith Unit 3. (TR 589-590)

Staff agrees that with the unbundling of the gross receipts taxes, it is appropriate to reduce this account by $11,110,000. Staff also agrees that it is appropriate to reduce this account for payroll-related taxes discussed in Issue 51. However, staff believes the adjustment should be rounded down to $19,000 rather than up to $20,000 to reflect the jurisdictional adjustment of $19,274 that is recommended in Issue 51.

Regarding property taxes, because only five months of property taxes for Smith Unit 3 were included in the test year, the Company made an annualization adjustment of $1,853,000. Per Witness McMillan, these estimated taxes do not reflect a county tax exemption for the Smith plant. Gulf requested and was granted a tax exemption by the Bay County Board of Commissioners. However, Witness McMillan states in his testimony that the Bay County Property Appraiser has taken the position that the exemption for Smith Unit 3 is unlawful. (TR 589) Further, in a lawsuit testing the legality of the exemption, Gulf received a Summary Judgement in its favor in circuit court. The decision was appealed by the Bay County Property Appraiser to the First District Court of Appeal, which affirmed. See Davis v. Gulf Power Corp. 799 So. 2d 298 (1st DCA 2001). Per Witness McMillan, the timing and final outcome related to this lawsuit cannot be determined at this time. However, if the Company prevails in court and the property appraiser is required to honor the tax exemption, the annual property taxes would be reduced by $1,251,000 based upon the 2000 millage rates. (TR 590)

In its brief, the OPC takes the position that property taxes should be reduced by the $1,251,000 to reflect the exemption that Gulf currently has. Gulf will retain that exemption unless the Bay County Property Appraiser can succeed in overturning the Commission decision on appeal. (TR 597) The OPC believes that Gulf should have filed this case on the existing status, rather than on the assumption that it would lose the appeal. (TR 590) No other party took a position on the Smith Unit 3 property taxes.

Staff believes that a $1,251,000 reduction to property taxes is appropriate. First Gulf has not actually paid the tax. Second, the decision of the First DCA has legal effect because that court has issued its mandate review by the Florida Supreme Court is discretionary, and the Property Appraiser sought no stay. See rule 9.310, Florida Rules of Appellate Procedure; Section 12.5, Florida Appellate Practice, 2001-2002 Edition. Therefore, Gulf has no legal obligation to pay at this time. Finally if the decision of the First DCA is reversed, and Gulf has to pay, Gulf may seek relief at that time. Given the above, staff believes the most conservative approach under the current circumstances is to reduce and property taxes by $1,251,000 for the May 31, 2003 test year.

Based on the above three adjustments, staff recommends reducing Taxes Other Than Income by $12,380,000 from $36,969,000 to $24,589,000.

ISSUE 80: Should an adjustment be made to the consolidating tax adjustments for the May 2003 projected test year? (C. Romig, Kenny)
STIPULATED

ISSUE 81: Should an adjustment be made to Income Tax expense for the May 2003 projected test year? (C. Romig, Kenny)

RECOMMENDATION: Yes. Income tax expense should be increased by $2,784,000 for the May 2003 projected test year. (Attachment 3) (C. Romig, Kenny)

POSITION OF THE PARTIES

GULF: Yes. The requested amount for income tax expense for the May 2003 projected test year should be increased by $1,475,000 ($1,530,000 system) to $17,321,000 ($16,892,000 system) to reflect the impact of the net increase to taxable income as a result of the revenue and expense adjustments proposed by the Company in other issues and to reflect the tax effect of the change in synchronized interest expense.

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

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

STAFF ANALYSIS: Per MFR Schedule C-2, page 3 of 3, jurisdictional adjusted income tax expense for the May 31, 2003 projected test year is $15,846,000. (EXH 37) Gulf, FIPUG, and OPC did not take issue with this amount and the FEA did not take a position on this issue. Further, staff believes this amount is reasonable, based on the other financial information provided in the Company's MFRs for the test year.

However Gulf, FIPUG, and OPC agree that adjustments are required for: 1) other revenue, expense and rate base adjustments that have been proposed by the Company and agreed to by staff; and 2) for other staff adjustments on related issues. Staff agrees that this is appropriate as well. To accomplish this, staff recommends increasing income tax expense by $1,523,000 for staff's recommended adjustments to revenues and expenses and increasing the interest synchronization adjustment by $1,261,000 for staff's recommended adjustments to rate base. The result is an income tax expense increase of $2,784,000, increasing income tax expense from $15,846,000 to $18,030,000 for the May 31, 2002 projected test year.

In summary, income tax expense should be increased by $2,784,000 for the May 2003 projected test year.

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? (L. Romig)

RECOMMENDATION: No. The projected net operating income for the May 2003 projected test year is $62,539,000. (Attachment 3) (L. Romig)

POSITION OF THE PARTIES

GULF: No. The projected jurisdictional Net Operating Income should be adjusted by $958,000 to $60,420,000 to reflect the impact of removing capacity revenues and expenses recoverable through the Purchased Power Capacity Cost Recovery Clause; to account for changes in O & M expense, depreciation and amortization expense, payroll taxes, and income tax expense; and to remove gross receipts tax revenues and expenses in the calculation of NOI.

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

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

STAFF ANALYSIS: This is a fallout calculation based on the decisions in preceding issues.

REVENUE REQUIREMENTS

ISSUE 83: What is the appropriate revenue expansion factor and the appropriate net operating income multiplier, including the appropriate elements and rates for Gulf? (C. Romig, L. Romig)
STIPULATED

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

RECOMMENDATION: No. The appropriate annual operating revenue increase for the May 2003 projected test year is $49,712,000. (Attachment 5) (L. Romig)

POSITION OF THE PARTIES

GULF: No. The requested increase should be reduced by $4,947,000 to a new total of $64,920,000 to reflect the impact of the adjustments proposed by the Company as discussed in the other issues. This amount is before the effect of any additional return on equity that the Commission allows as a result of Gulf's superior performance.

FEA: No position stated in Brief.

FIPUG: Adopts OPC's position.

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

STAFF ANALYSIS: This is a fallout calculation based on the decisions in preceding issues. The positions of the parties are reflected in the following schedule:

Calculation of Revenue Requirements (000's) May 31, 2003 Test Year			
	Company	Staff	OPC
Rate Base Rate of Return	$1,198,502 8.64%	$1,199,732 7.75%	--
Required NOI Adjusted Achieved NOI	$ 103,551 ($ 61,378)	$ 92,979 ($ 62,539)	--
NOI Deficiency Revenue Expansion Factor	$ 42,173 1.656666	$ 30,440 1.633125	--
Total Revenue Increase	$ 69,867	$ 49,712	--

COST OF SERVICE AND RATE DESIGN

ISSUE 85: Is Gulf's proposed separation of costs and revenues between the wholesale and retail jurisdictions appropriate? (Wheeler)
STIPULATED

ISSUE 86: Are Gulf's estimated revenues from sales of electricity by rate class at present rates for the projected 2003 test year appropriate? (E. Draper)
STIPULATED

ISSUE 87: Is the method used by Gulf to develop its estimates by rate class of the 12 monthly coincident peak hour demands and the class non-coincident peak hour demands appropriate? (Wheeler)
STIPULATED

ISSUE 88: What is the appropriate cost of service methodology to be used in designing Gulf's rates? (Wheeler)

RECOMMENDATION: The appropriate cost of service methodology utilizes the 12 Monthly Coincident Peak and 1/13 Average Demand method for the allocation of production plant, and classifies only the meter and service drop components of the distribution system as customer related. The appropriate study is contained in Hearing Exhibit 20, as Attachment 4B to Late-filed Deposition Exhibit 2 of Gulf Witness Robert L. McGee.

If the Commission decides in Issue No. 89 that the MDS method for the classification of distribution costs is appropriate for use in this case, the study contained in Hearing Exhibit 20, as Attachment 4A to Late-filed Deposition Exhibit 2 of Gulf Witness Robert L. McGee should be used to design Gulf's rates. (Wheeler)

POSITION OF THE PARTIES

GULF: The appropriate methodology for designing rates is reflected in Attachment A to MFR Schedule E-1 and in Exhibit 38. This cost of service methodology is the same as that approved by the Commission in Gulf's previous rate case except that the Minimum Distribution System ("MDS") was used in the cost of service study to determine customer and demand related cost. The MDS was used in order to adhere more closely to sound cost causative principles.

FEA: Minimum Distribution System Methodology (MDS) is the appropriate Cost of Service methodology for designing Gulf's rates. This is the only methodology sponsored by any witnesses on the record.

FIPUG: The Minimum Distribution System (MDS) methodology is the appropriate cost of service methodology to use in this case as it appropriately assigns costs to the cost causers.

OPC: No position stated in Brief.

STAFF ANALYSIS: In its MFR Schedule E-1, Gulf filed two Cost of Service (COS) studies. In Attachment B to Schedule E-1 (non-MDS study), Gulf filed a COS study utilizing a methodology identical to that approved by the Commission in Gulf's last rate case. In Gulf's last approved COS study, only the meter and service drop portions of the distribution system were classified as customer related. (EXH 24)

The COS study filed as Attachment A to MFR Schedule E-1 (MDS study) is supported by Gulf for use in this case. In this study, the Minimum Distribution System (MDS) methodology was used, which classifies a significant portion of the distribution system as customer related. (TR 683) Staff does not believe the MDS method should be adopted for use in this case, as fully discussed in Issue 88.

Both of the COS studies filed by Gulf in this case use the 12 Monthly Coincident Peak (MCP) and 1/13 Average Demand (AD) method for the allocation of production plant costs. No party has objected to the use of this method, which was approved for use in Gulf's last rate case. It was also approved in the most recent rate cases of Florida Power Corporation, Florida Power & Light Company, and Tampa Electric Company. (Order No. 23573, in Docket No. 891345-EI; Order No. PSC-92-1197-FOF-EI, in Docket No. 910890-EI; Order No. 13537, in Docket No. 830465-EI; and Order No. PSC-93-0165-FOF-EI, in Docket No. 920324) Staff believes this method is appropriate for Gulf in this proceeding.

Gulf Witness McGee provided two revised COS studies in a late-filed exhibit to his deposition in this case. (EXH 20, Attachments 4A and 4B to Late-Filed Deposition Exhibit 2) These studies are identical to the MDS and Non-MDS studies filed as Attachments A and B in MFR Schedule E-1, with three minor exceptions.

First, there was a change to the 12 CP demand allocators used for the Street (OS-I) and Outdoor (OS-II) rate classes. The initial filing developed these allocators using historical calendar year 1999 estimates of CP demand responsibility for these classes. The revised COS studies used a five-year (1996-2000) historical average. (EXH 2, Staff Interrogatory 2) Use of a five-year average avoids unusual circumstances that might occur when a single year is used. (TR 717; EXH 2) For the same reason, a similar adjustment was made to the 12 CP demand allocators for the Sports Fields (OS-IV) rate class. (TR 718) Finally, there was also an adjustment made to the Non-coincident (NCP) peak allocators for the OS-IV rate class to correct for errors made in the original filing. (TR 718)

In Issue 87 the Commission approved a stipulation reached by the parties that the proper estimates of 12 CP and NCP demand responsibility by rate class are reflected in the COS studies contained in Mr. McGee's Late-filed Deposition Exhibit No. 2. Gulf's rates should therefore be designed based on the revised non-MDS study contained in Attachment 4B to Late-filed Deposition Exhibit 2 of Gulf Witness Robert L. McGee. (EXH 20) If the Commission decides in Issue No. 89 that the MDS method for the classification of distribution costs is appropriate for use in this case, the MDS study contained in Attachment 4A should be used.

ISSUE 89: What is the appropriate treatment of distribution costs within the cost of service study? (Kummer)

RECOMMENDATION: The appropriate treatment of distribution costs should remain consistent with past Commission decisions which support that only Accounts 369 (Services) and 379 (Meters) should be classified as customer related. (Kummer)

POSITION OF THE PARTIES

GULF: Where possible, direct assignments are appropriate. For demand related distribution cost, allocation based on NCP is appropriate. For customer related cost, the customer allocator is appropriate. Where cost must be divided into demand and customer components, the Minimum Distribution System ("MDS") is appropriate in order to adhere more closely with sound cost causative principles.

FEA: The recommended MDS methodology classifies distribution costs as demand related, customer related or a combination of as stated by the National Association of Regulatory Utility Commissioners advocate in its official guide book Electric Utility Cost Allocation Manual, January 1992, page 89.

FIPUG: The Commission should use the Minimum Distribution System (MDS) methodology to correctly classify and assign distribution costs.

OPC: No position stated in Brief.

STAFF ANALYSIS: Two cost of service studies are under consideration in this case. Both methods are based on the same underlying cost allocation methodology. The significant difference is how Gulf's proposal allocates distribution costs to customer classes.

Description of methodologies

Previously approved methodology. The purpose of a cost of service methodology is to perform three activities. First, it functionalizes costs into production, transmission, distribution, customer and administrative/general categories. Second, these functionalized costs are separated into classifications based on the utility service being provided. There are three principal classifications of costs: (1) demand costs which are costs that vary with the KW demand imposed by the customer; (2) energy costs which are costs that vary with the energy or KWH used; and (3) customer costs which are costs that are directly related to the number of customers served. (EXH 18, pp. 18-20; TR 683) Under the methodology approved in Gulf's last rate case, only investment in two accounts, Account 369 (Service Drops) and 370 (Meters) were considered to be directly related to the number of customers served. The rationale as stated in all IOU rate cases since the 1980's is that only the line from the transformer to the meter and the meter itself are clearly customer related and, therefore should be the only accounts that are allocated on the basis of number of customers. All other distribution facilities are allocated on a demand allocator on the theory that load determines the size of these facilities, not the mere presence of the customer.

<u>Proposed MDS application.</u> Gulf's proposed cost study classifies certain distribution costs, other than those in Accounts 369 and 370, as 'customer' related. Specifically, Gulf's approach divides the distribution facilities from five additional accounts (Accounts 364-368) between demand and customer classification on the idea that a certain amount of poles, transformers, and conductors are necessary to extend service to a customer even if that customer never uses any energy. (TR 697) To arrive at this allocation requires the development of a hypothetical minimum distribution system to determine how much of each account is to be allocated on demand and how much on customers.

The MDS classification methodology uses a Zero Intercept (ZI) method to determine how much of the account should be allocated on a demand basis and how much is allocated on a customer basis by constructing the cost of investment at a zero load. The ZI approach uses a regression analysis to determine the zero capacity unit cost. (TR 680, 684, 699; EXH 38) This analysis plots the current replacement costs of the each type and size of equipment in each account against the various sizes of equipment (transformers, poles, conductors) and interpolates back to a 'zero,' or no-load, size. (EXH 38) This provides a theoretical replacement cost for the equipment with no load capability which the MDS then attributes as customer related.

Once the ZI cost is determined, that cost is multiplied by the number of units in inventory to arrive at a theoretical base cost of the distribution facilities designed to carry no load. Then, using the ZI ratio and the replacement costs for all equipment, the ratio of customer costs to demand costs is determined. This ratio is then multiplied times the actual booked costs to determine the actual dollars to be allocated on a customer and demand basis in the cost of service. This zero intercept analysis must be conducted for each piece of equipment in each distribution account which is deemed to have both a customer and demand component.

Evaluation of Cost of Service Studies

Gulf relies on four basic tenets to support the use of the MDS methodology. First, Gulf maintains that the NARUC Cost of Service Manual endorses the methodology. Second, Gulf contends that the complexity of the ZI methodology is necessary to accurately identify customer related costs. Third, Gulf argues that the Commission's reason for rejecting the MDS is that it increases customer related costs for the residential class. Fourth, Gulf maintains that the cost allocation methodology may or may not be used to set rates if the Commission believes the results are unacceptable for any reason.

NARUC Manual. In this filing, Gulf's COS witness Mr. O'Sheasy and other intervenors, rely heavily on a publication by the NARUC entitled, "Electric Utility Cost Allocation Manual" (Manual) to support the use of MDS. In particular, Mr. O'Sheasy cites language from Chapter 6 of this document in which the Manual describes the MDS methodology. He and other interveners (FEA and FIPUG), appear to place great importance on the fact that this publication includes the MDS. However, the Preface states three objectives of the Manual: (1) it should be simple enough to be used as a primer on the subject of cost allocation yet offer enough substance for experienced witnesses; (2) it must be comprehensive yet fit in one volume; and (3) the writing style should be non-judgmental; not advocating any one particular method, but trying to include all currently used methods with pros and cons. (EXH 23, p. ii) In other words, the Manual was designed to educate, not mandate any particular methodology.

The manual also notes that it discusses only major methodologies and recognizes that no single costing methodology will be superior to any other and the choice of the methodology will depend on the unique circumstances of each utility. (EXH 23, p. 22) During his deposition Mr. O'Sheasy was asked if the Commission was required to abide by the recommendations of the Manual, or if the Commission had ever formally adopted anything in the Manual as binding on its authority. Witness O'Sheasy's answer to both questions was no. (EXH 18, p. 36) During cross examination witness O'Sheasy again noted that the manual was developed as a guide, not a mandate. (TR 693) Gulf provided no evidence on the circumstances that made it choose the MDS methodology over the method approved in its last rate case.

Hypothetical system - ZI methodology. As described above, the MDS methodology requires construction of a hypothetical system consisting of equipment which is designed to carry zero load for each account identified as having both a customer and a demand component. Artificial no-load costs are created using replacement costs. Ratios of replacement cost are derived, which must then be translated in booked costs to determine the actual dollars to be allocated. (TR 680-681) According to witness O'Sheasy, that process must be applied to FERC Accounts 363-368. (TR 677) Each account may contain multiple sizes or types of items such as poles, transformers, and conductors. Replacement costs must be determined for each piece of equipment in each account.

This approach assumes that the cost relationships between items in an account remain constant over time. If they do not, it can skew the trend analysis. For example, replacement costs for older smaller equipment may be more expensive than newer products simply because there are fewer sources. In addition, if new technology allows a larger transformer to be sold at a cost comparable or less than a smaller transformer, due to economies of scale, the mathematical result of the zero intercept regression could conceivably show a cost at zero intercept for a no-load situation higher than the use of a larger transformer. Conversely, witness O'Sheasy and the NARUC Cost Manual agree that there is common agreement that Accounts 369 and 370 are fully customer related. (EXH 18, p. 22; EXH 23, p. 96)

The concept of a zero load cost is purely fictitious and has no grounding in the way the utility designs its systems or incurs costs because no utility builds to serve zero load. (TR 701-704) There is no real equipment which equates to the costs identified by the ZI methodology. (TR 703) The Commission has rejected MDS in the past for this very reason.

> The Company and staff have proposed the use of a theoretical minimum distribution cost as part of the customer cost... While we agree that sound regulatory practice should provide for a customer charge to defray otherwise fixed costs, as proposed by the Company and Staff, we do not agree that a theoretical cost of a minimum distribution system is appropriate... The installation of the distribution system is made in anticipation of a projected level of actual use. The system does not contain a basic theoretical minimum distribution system. Reliance on such a mechanism is speculative at best. Instead, we believe the appropriate customer charge should be based on the cost of the meter, service drop, meter reading and basic customer service costs (not including uncollectibles). (Commission Order 9599, p. 18)

Distinction between COS and rate design. Witness O'Sheasy repeatedly makes a distinction between the cost allocation methodology employed to determine costs, and rate design to set actual charges to customers. (TR 667, 684; EXH 18, pp. 12, 17, 19, 21, 26) However, he also states that the primary purpose of a cost study is to determine if rates need to be changed. (TR 667, 675, 676, 685) Indeed, the primary purpose of a cost of service is to determine the reasonableness of rates. "The cost principle applies not only to the overall level of rates, but to the rates set for individual services, classes of customers and segments of the utility's business." (EXH 23, p. 12)

Witness O'Sheasy agrees that the Commission can stray from the cost allocation results to mitigate the perceived impact of a particular cost allocation or level. (TR 684, 720) In fact, he notes in his deposition that Georgia employs the MDS cost methodology but that its customer charges were not set at the full cost of service. (EXH 18, p. 16) However, typically, the COS directs how any increase in revenue requirement is allocated across classes for the purpose of setting new rates. (TR 675)

To maintain that cost classification is no more than a theoretical exercise which does not have to affect rates is nonsensical. If a cost study were not used to design rates, there would be no purpose in performing the cost study. Although Mr. O'Sheasy states that it is his belief that the Commission rejected the MDS in previous rate cases because of the impact on residential customers (TR 684), the prior Commission orders show that it was the theoretical construct with which the Commission disagreed, not the end result.

The NARUC Cost Manual defines customer costs as "...the plant and expenses that are associated with providing the service drop and meter, meter reading, billing and collection and customer information and service." (EXH 23, p. 20) This is precisely the approach this Commission has taken in the past. Only the investment in the service drop and meters were allocated on a customer basis. Staff recommends that the Commission continue this policy.

Commission Precedent. Mr. O'Sheasy contends that staff opposes the MDS methodology because the Commission has consistently ruled against it. (TR 694) The Commission is not bound by any prior decision in this matter, if it deems that circumstances warrant a change. Similarly, the NARUC manual states that the choice of methodology will depend on the unique circumstances of the case. (EXH 23, p. 22) The problem is that Gulf has not offered any evidence to show how its circumstances have changed since the last rate case that would justify a change in cost methodology.

Internally inconsistent. Witness O'Sheasy describes MDS as identifying the costs of the facilities needed to simply hook-up a customer to the power system. (TR 679, 697) Yet, distribution lines must be connected to subtransmission and transmission lines and ultimately to the busbar at the power plant in order to be able to deliver a single kWh. To artificially separate distribution accounts on the basis that these facilities are necessary to make service available ignores the way the electric system works. MDS is internally inconsistent in that it separates out distribution facilities for different treatment than transmission lines. As cited in the order in Gulf's last rate case:

> There is a fundamental flaw in this proposal in that only part of the distribution (emphasis in original) system is classified as customer-related. None of the subtransmission and transmission system would be classified as customer-related. Hence, customers served at primary voltage through dedicated substations, and customer served at higher voltages would not pay for any of this network path.
>
> We believe this minimum distribution system approach should be rejected because it is inequitable and inconsistent to apply the concept to only those customers served at secondary voltage or at primary voltage through common substations when the network path must be there to serve each and every customers.
>
> In our opinion distribution facilities that function as service drops or dedicated tap lines should be directly assigned the classes whose members the facilities serve. No distribution costs other than service drops and meters should be classified as customer related. (Order 23573, Docket No. 891345-EI, p. 51)

Impact on residential customer. Gulf suggested that there was concern about the shifting of costs to the residential class. (TR 694) The Commission has consistently rejected the use of the Minimum Distribution System for the last twenty years. (Orders 9599, 9864, 10557, 11628, 11498, 23573) None of these Orders cite, as a reason for rejecting MDS, the impact on any particular class of customers. The criticisms have all addressed the merits of the methodology, not its eventual impact on rates. Specifically, as noted above, MDS has been rejected because of inconsistencies in the methodology and because it does not reflect the way a utility incurs costs.

Competitive pressure. Mr. O'Sheasy also cites as a reason for adopting the MDS in this case the fact that cross-subsidies are bigger issues now than they have ever been. (TR 699) He notes that commercial and industrial customers face greater competitive challenges in their own markets. (EXH 18, p. 33) However, the MDS has been proposed in rate cases for over 20 years. (See cited orders above) Staff is unwilling to accept as fact Mr. O'Sheasy's generalization that competitive pressures are greater now than at any time in the past 20 years. Gulf has provide no factual support for the generalization.

Further, staff questions Mr. O'Sheasy's qualifications to assess competitive trends in unregulated industries. In his background, Mr. O'Sheasy notes that he joined Southern Company in 1980 and has continued in various capacities in a regulated environment until his retirement in 2001. (TR 666) There is no evidence to indicate that he has any special knowledge as a competitive market analyst or an expert of competitive pressures in manufacturing or industrial applications. In fact, FIPUG, a trade association of large industrial customers in the state, presented no evidence that its members faced unusual or significantly changed competitive pressures. Every private enterprise desires to lower the costs of inputs to its production process in order to increase its income. This desire should not, however, drive a cost allocation.

Staff believes the simpler, more straight forward approach of allocating only service drops and meters on a customer basis adequately captures the distribution investment which is solely required to extend service to a new customer. Staff's recommended methodology is clear, generally accepted, and requires no series of hypothetical cost and system design calculations which do not reflect how the actual system is designed. Despite the statement in Mr. O'Sheasy's direct testimony that the electric industry is "very different from 12 1/2 years ago," he presented no evidence to support this statement. When asked during his deposition what had changed, he again refers to the competitive pressure on commercial and industrial groups and market pressures, and cross subsidies, but does not mention any changes to the electric industry itself which would justify a change in methodology. (EXH 18, p. 33-34) Changes in competitive markets should not drive the allocation of costs in a regulated electric cost study.

ISSUE 90: If a revenue increase is granted, how should it be allocated among the customer classes? (Wheeler)

RECOMMENDATION: The increase should be allocated to the rate classes in a manner that moves the class rate of return indices as close to parity as practicable based on the approved cost allocation methodology, subject to the following constraints: (1) no class should receive an increase greater than 1.5 times the system average percentage increase in total, and (2) No class should receive a decrease. Staff's proposed allocation of the increase is shown in Attachment 6. (Wheeler)

POSITION OF THE PARTIES

GULF: Based on Gulf's position on Issues 88 and 89, the increase should be allocated as shown in Gulf's MFR E-11. This allocates the requested increase to the rate classes in a manner that moves class rate of return indices as close to parity as reasonable, with the following constraints: (1) No class should receive an increase greater than 1.5 times the system average percentage increase in total; and, (2) No class should receive a decrease.

FEA: If a revenue increase is granted, it should be allocated based on the Company's MDS Methodology Cost of Service Study Results using the approach set forth by GP Rate Design witness James I. Thompson at Page 16, Lines 9-20.

FIPUG: Any increase should be spread as recommended by Gulf in its proposed cost of service study utilizing the Minimum Distribution System (MDS) methodology. Use of the cost of service study which Gulf has proffered results in an appropriate allocation of any increase. It also ensures that no class receives an increase greater than 1.5 times the system average percentage increase in total and no class receives a decrease.

OPC: No position stated in Brief.

STAFF ANALYSIS: The Commission has historically allocated revenue increases to the rate classes in a manner that moves the class rate of return indices as close to parity as practicable, based on the approved cost allocation methodology, subject to two constraints:

(1) no class should receive an increase greater than 1.5 times the system average percentage increase in total (including all adjustment clauses), and (2) No class should receive a revenue decrease. Gulf and FIPUG agree that any increase should be allocated subject to these constraints.

Gulf, FIPUG and FEA are supporting the allocation proposed in Gulf's original filing, as shown in MFR No. E-11. (EXH 20) The proposed allocation is based on a cost of service study that uses the MDS method for the classification of distribution expenses, as discussed in Issue 89.

Staff's recommended allocation of the increase in revenues by rate class is contained in Attachment 6, and is based on the staff-recommended cost of service study discussed in Issues 88 and 89. This study utilizes the 12 Monthly Coincident Peak and 1/13 Average Demand method for the allocation of production plant costs, and classifies only the meter and service drop portions of the distribution system as customer related.

The allocation of the staff-recommended $49.712 million increase in revenues shown in Attachment 6 moves each rate class closer to parity, and does not impose an increase on any rate class that exceeds 1.5 times the system average increase, including adjustment clause revenues. In addition, no class receives a rate decrease.

No increases are recommended for the General Service - Non-Demand (GS), Other Outdoor (OS-III), Standby (SBS), Real Time Pricing (RTP), and Large High Load Factor (PX/PXT) rate schedules because they are all significantly above parity. Although the Contract Service Agreement (CSA) customers are significantly below parity, the rates paid by these customers were negotiated pursuant to Gulf's Commercial/Industrial Service Rider, and thus are not subject to change.

ISSUE 91: What are the appropriate demand charges? (E. Draper, Wheeler)

RECOMMENDATION: This is a fallout issue and the Commission should address it at the May 8, 2002, Agenda Conference. (E. Draper, Wheeler)

POSITION OF THE PARTIES

GULF: The appropriate demand charges based on Gulf's original filing are listed in the table included as part of the discussion below. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.

Rate Schedule	Monthly Demand Charge
GSD	$5.23
LP	$8.66
PX	$8.20
GSDT	$2.81 (On-Peak) $2.49 (Maximum)
LPT	$6.95 (On-Peak) $1.75 (Maximum)
PXT	$7.61 (On-Peak) $0.68 (Maximum)

FEA: No position stated in Brief.

FIPUG: Demand charges should be based on the cost of service methodology prepared by Gulf, including use of the MDS methodology.

OPC: No position stated in Brief.

STAFF ANALYSIS: This is a fallout issue and the Commission should address it at the May 8, 2002, Agenda Conference.

ISSUE 92: What are the appropriate energy charges? (Wheeler)

RECOMMENDATION: This is a fallout issue and the Commission should address it at the May 8, 2002, Agenda Conference. (Wheeler)

POSITION OF THE PARTIES

GULF: The appropriate energy charges based on Gulf's original filing are listed in the table included as part of the discussion below. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.

Rate Schedule	Energy Charge
RS	4.124¢/kWh
GS	5.257¢/kWh
GSD	1.271¢/kWh
LP	0.543¢/kWh
PX	0.303¢/kWh
RSVP	1.800¢/kWh-P_1 3.021¢/kWh-P_2 7.798¢/kWh-P_3 29.000¢/kWh-P_4
GSTOU	15.963¢/kWh (Summer On-Peak) 5.660¢/kWh (Summer Intermediate) 2.076¢/kWh (Summer Off-Peak) 3.086¢/kWh (Winter All-Hours)
GSDT	1.271¢/kWh
LPT	0.543¢/kWh
PXT	0.300¢/kWh

FEA: No position stated in Brief.

FIPUG: No position stated in Brief.

OPC: No position stated in Brief.

STAFF ANALYSIS: This is a fallout issue and the Commission should address it at the May 8, 2002, Agenda Conference.

ISSUE 93: What are the appropriate customer charges? (Hudson)

RECOMMENDATION: Staff's recommended customer charges are shown below:

RATE CLASS	NON-MDS UNIT COST	MDS UNIT COST	CURRENT CHARGES	GULF PROPOSED	STAFF RECOMMENDED
RS, RSVP	$ 11.43	$ 20.90	$ 8.07	$ 12.00	$ 10.00
GS, OSIV	$ 17.50	$ 27.75	$ 10.09	$ 15.00	$ 13.00
GSD	$ 31.88	$ 42.47	$ 40.35	$ 40.00	$ 35.00
GSDT	$ 31.88	$ 42.47	$ 45.80	$ 40.00	$ 35.00
GSTOU	$ 31.88	$ 42.47	N/A	$ 40.00	$ 35.00
LP, LPT	$154.72	$160.39	$ 226.98	$ 226.00	$ 155.00
PX, PXT	$416.64	$416.64	$ 575.01	$ 566.38	$ 566.38
RTP	$452.37	$488.09	$1000.00	$1000.00	$1000.00

(Hudson)

POSITION OF THE PARTIES

GULF: The appropriate customer charges based on Gulf's original filing are shown in the table included as part of the discussion below. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.

Rate Schedule	Monthly Customer Charge
RS, RSVP	$12.00
GS, OSIV	$15.00
GSD, GSDT, GSTOU	$40.00
LP, LPT	$226.00
PX, PXT	$566.38
RTP	$1,000.00

FEA: No position stated in Brief.

<u>FIPUG</u>: No position stated in Brief.

<u>OPC</u>: No position stated in Brief.

<u>**STAFF ANALYSIS**</u>: Customer charges are flat monthly per-customer rates that do not vary with energy usage. They are designed to recover costs that typically vary with the number of customers served, rather than with kilowatt hour consumption. Customer costs include metering, billing, and customer service.

The two sets of customer unit costs shown above are contained in Gulf's response to Staff's Interrogatory 232, in Staff's Composite Exhibit 2 - Cost of Service. The interrogatory response contains two revised MFR Schedule E-8b's that show the customer unit costs by rate class under two 12 CP and 1/13 AD cost of service methodologies: a study that incorporates the Minimum Distribution System (MDS) Method for classifying distribution equipment, and a study that classifies only the meter and service drop portions of the distribution system as customer related (non-MDS). As discussed in Issues 88 and 89, staff is recommending that the non-MDS cost of service study be adopted for rate setting purposes in this case.

Staff believes that, to the extent practicable, the customer charges should be set to reflect the customer unit costs developed in the Commission-approved cost of service study. With the exception of the PX, PXT, and RTP rate schedules, staff's recommended customer charges meet this objective, regardless of whether or not the Commission adopts the use of the MDS method. The PX, PXT, and RTP customer charges are left at current levels because staff is not recommending an increase to these classes.

Staff is recommending that the RS and RSVP customer charges be increased from their current level of $8.07 to $10.00. While this is below the non-MDS unit cost of $11.43, staff believes that because the customer charge is a large portion of the customer bill for these classes, the increase in the customer charge should be limited in order to avoid an excessive increase to low-use customers. Similarly for the GS and OS-IV classes, staff is recommending that the customer charges be increased from their current level of $10.09 to $13.00, below the unit cost of $17.50.

ISSUE 94: What are the appropriate service charges? (Hudson)
STIPULATED

ISSUE 95: What are the appropriate Street (OS-I) and Outdoor (OS-II) lighting rate schedule charges? (Springer)
STIPULATED

ISSUE 96: How should Gulf's time-of-use rates be designed? (E. Draper)
STIPULATED

ISSUE 97: What are the appropriate charges under the Interruptible Standby Service (ISS) rate schedule? (E. Draper)

RECOMMENDATION: This is a fallout issue and the Commission should address it at the May 8, 2002, Agenda Conference. (E. Draper)

POSITION OF THE PARTIES

GULF: Gulf proposes no change to this rate since no revenue increase is allocated to the rate. Using either the MDS or the non-MDS cost of service methodology there is not a revenue increase to this rate.

FEA: No position stated in Brief.

FIPUG: No position stated in Brief.

OPC: No position stated in Brief.

STAFF ANALYSIS: This is a fallout issue and the Commission should address it at the May 8, 2002, Agenda Conference.

ISSUE 98: What are the appropriate charges under the Standby and Supplementary Service (SBS) rate schedule? (E. Draper)

RECOMMENDATION: This is a fallout issue and the Commission should address it at the May 8, 2002, Agenda Conference. (E. Draper)

POSITION OF THE PARTIES

GULF: Gulf has proposed changes to the Standby and Supplementary rate schedule which simplify the rate by removing the Supplemental Energy (SE) option. The appropriate charges are listed in the table included as part of the discussion below. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.

Contract Demand	100 to 499kw	500 to 7,499 kw	7,500kw and above
Customer Charge	$248.20	$248.20	$591.01
Demand Charge			
Local Facilities Charge	$1.66	$1.23	$0.51
On-Peak	$2.41	$7.16	$7.61
Reservation Charge	$0.99	$0.99	$0.98
Daily Demand Charge	$0.46	$0.46	$0.46
Energy Charge (per kWh)	1.177¢	0.311¢	0.300¢

FEA: No position stated in Brief.

FIPUG: No position stated in Brief.

OPC: No position stated in Brief.

STAFF ANALYSIS: This is a fallout issue and the Commission should address it at the May 8, 2002, Agenda Conference.

ISSUE 99: What is the appropriate rate design for Gulf's Real Time Pricing (RTP) rate schedule? (E. Draper, Wheeler)

RECOMMENDATION: This is a fallout issue and the Commission should address it at the May 8, 2002, Agenda Conference. (E. Draper, Wheeler)

POSITION OF THE PARTIES

GULF: The rate design utilized by Gulf in establishing the current RTP rate should be followed. Gulf proposes no change to this rate since no revenue increase is allocated to the rate. Using either the MDS or the non-MDS methodology in the cost of service study, there is no revenue increase to this rate.

FEA: No position stated in Brief.

FIPUG: No position stated in Brief.

OPC: No position stated in Brief.

STAFF ANALYSIS: This is a fallout issue and the Commission should address it at the May 8, 2002, Agenda Conference.

ISSUE 100: What is the appropriate monthly charge under Gulf's GoodCents Surge Protection (GCSP) rate schedule? (Hudson)
STIPULATED

ISSUE 101: What are the appropriate transformer ownership discounts? (Springer)
STIPULATED

ISSUE 102: What is the appropriate minimum monthly bill demand charge under the PX rate schedule? (Hudson)
STIPULATED

ISSUE 103: What is the appropriate minimum monthly bill demand charge under the PXT rate schedule? (Hudson)
STIPULATED

ISSUE 104: How should any revenue shortfall resulting from rate migrations following the rate design be recovered? (Wheeler)
STIPULATED

ISSUE 105: Should Gulf's GST and RST rate schedules be eliminated? (Hudson)
STIPULATED

ISSUE 106: Should Gulf's Supplemental Energy (SE) Rate Rider be eliminated? (E. Draper)
STIPULATED

ISSUE 107: Gulf proposes to eliminate the Optional Method of Meter Payment provision in its GSDT rate schedule that allows customers to make an initial payment as a contribution-in-aid-of-construction to offset a portion of the additional cost of time-of-use metering. Is this appropriate? (Hudson)
STIPULATED

ISSUE 108: Should Gulf eliminate its OS-IV rate schedule and transfer the customers served under the rate to their otherwise applicable rate schedules, as required by order No. 23573 in Docket No. 891345-EI? (Springer)
STIPULATED

ISSUE 109: Should the proposed changes to Gulf's Standby and Supplementary Service Rate (SBS) be approved? (E. Draper)
STIPULATED

ISSUE 110: What is the appropriate monthly fixed charge carrying rate to be applied to the installed cost of OS-I and OS-II additional lighting facilities for which there is no tariffed monthly charge? (E. Draper)
STIPULATED

<u>ISSUE 111</u>: Are the proposed revisions to the estimated kilowatt hour consumption of Gulf's high pressure sodium and metal halide lighting fixtures appropriate? (Springer)
STIPULATED

<u>ISSUE 112</u>: Gulf has proposed to add a provision to its OS-I and OS-II lighting schedules that allows customers to change to different fixtures prior to the expiration of the initial lighting contract term. Is this provision appropriate? (Springer)
STIPULATED

<u>ISSUE 113</u>: Should the Street Lighting (OS-I) and Outdoor Lighting (OS-II) subparts of Gulf's Outdoor Service rate schedule be merged? (Springer)
STIPULATED

<u>ISSUE 114</u>: Should Gulf's proposed methodology for determining the price of new street and outdoor lighting offerings be approved? (Springer)
STIPULATED

<u>ISSUE 115</u>: Should Gulf's proposed new FlatBill pilot program be approved? (Springer)
STIPULATED

<u>ISSUE 116</u>: Should Gulf's proposed new Rate Schedule GSTOU be approved? (E. Draper)
STIPULATED

<u>ISSUE 117</u>: Is Gulf's proposed reduction in the contract term required under its Real Time Pricing (RTP) rate schedule from five years to one year appropriate? (Wheeler)
STIPULATED

<u>ISSUE 118</u>: Is Gulf's GoodCents Select Program cost effective? (Haff)
STIPULATED

<u>ISSUE 119</u>: What is the appropriate design and level of charges for the Residential Service Variable Pricing (RSVP) rate schedule? (Wheeler)
STIPULATED

<u>ISSUE 120</u>: Are Gulf's proposed changes to the P2 and P3 pricing periods under its RSVP rate schedule appropriate? (Wheeler)
STIPULATED

ISSUE 121: Are Gulf's proposed changes to the Participation Charge and Reinstallation Fee charged under Rate RSVP appropriate? (Wheeler)
STIPULATED

ISSUE 122: Should Gulf's proposed changes to the applicability section of its Budget Billing optional rider be approved? (Wheeler)
STIPULATED

OTHER ISSUES

ISSUE 123: What impact does the Stipulation approved in Order No. PSC-99-2131-S-EI have on the effective date of the rates approved in this Docket? (L. Romig)
STIPULATED

ISSUE 124: Should Gulf be required to file, within 90 days after the date of the final order in this docket, a description of all entries or adjustments to its annual report, rate of return reports, and books and records which will be required as a result of the Commission's findings in this rate case? (L. Romig)
STIPULATED

ISSUE 125: Should Gulf's proposed Incentive Earnings Sharing Plan be approved? (Stern)

RECOMMENDATION: No. Gulf's proposed Incentive Earnings Sharing Plan should not be approved because it is not supported by the hearing record. Instead, Gulf's plan should be addressed in a separate evidentiary proceeding. (Stern)

STAFF ANALYSIS: At the hearing the Commission asked Gulf to file a late-filed exhibit describing an earnings sharing plan proposed by Mr. Bowden during his live testimony. The exhibit, identified at the hearing as Late-filed Exhibit 25, was also to include citations to the hearing record to show that the plan had evidentiary support. (TR 103-109) The parties' responses to the exhibit were to be filed two weeks after the exhibit. (TR 109)

Gulf filed the exhibit on March 14, 2002, and OPC filed its response on March 28, 2002. With its response OPC also filed a Request for Oral Argument. Gulf filed a response to OPC's response on April 5, 2002. No other parties filed a response to Gulf's exhibit.

OPC's Request for Oral Argument

OPC argues that oral argument should be allowed because Gulf cites to numerous areas of prefiled testimony in Late-filed exhibit 25 and the parties had no way of knowing, at the hearing, how Gulf would attempt to support its proposal.

Staff recommends the Request be granted. Neither the parties nor the Commission had the opportunity to evaluate the evidentiary support for the proposal at the hearing, because no one knew what it would contain. Oral argument would better inform the Commissioners as to the record support for Late-Filed Exhibit 25. Therefore, staff recommends that Oral argument be allowed in order to address whether Late-Filed Exhibit be admitted into the record. Staff suggests that each party be allowed ten minutes to make their arguments.

Gulf's Response to OPC's Response

Gulf's April 5, 2002 filing should not be considered in deciding this issue. First, the Commission did not grant the parties leave to file responses to responses. Second, such a filing is not contemplated by the Commission's rules or the Florida Rules of Civil Procedure.

Gulf's Proposal

Gulf titles its proposal "Incentive Earnings Sharing Plan." The plan is contained in Attachment 7 to this recommendation. Gulf proposes that its earnings be shared between customers and shareholders when those earnings lie between the top of its authorized range on ROE (the sharing point) and a higher point (the maximum sharing point) to be designated in the future. Earnings exceeding the maximum sharing point would be under the Commission's jurisdiction, and the disposition of those earnings would also be determined in the future.

The proposal identifies three measures that will be used to assess Gulf's performance: 1) price - the overall retail cents per kwh in the lowest quartile as compared to an appropriate peer group; 2) reliability - a fixed value on the System Average Interruption Duration Index (SAIDI) and the System Average Interruption Frequency Index (SAIFI); and, 3) customer satisfaction/value - the upper quartile among a peer group based on a customer value survey. The quantitative scores Gulf must receive on the reliability indices, number 2 above, will be set in the future.

The three performance measures will be used to develop an annual performance rating for Gulf. A Level 3 performance rating will be achieved if Gulf meets or exceeds all three performance measures. A Level 2 performance rating will be achieved if Gulf meets or exceeds two of the performance measures. A Level 1 performance rating will be achieved if Gulf meets or exceeds one of the performance measures. If Gulf does not meet any of its performance measures, the Commission will have jurisdiction over the earnings above the sharing point, and the disposition of those earnings will be determined in the future.

The division of earnings between the customers and shareholders for a year is based on the performance level Gulf achieves in that year. If Gulf achieves a Level 3 rating than the customers get 1/3 of the shared earnings and the shareholders get 2/3. If Gulf achieves a Level 2 rating than the customers get 1/2 of the shared earnings and the shareholders get 1/2. If Gulf achieves a Level 1 rating than the customers get 2/3 of the shared earnings and the shareholders get 1/3. If Gulf performs below a Level 1 rating than the sharable earnings will be under the jurisdiction of the Commission, and their disposition will be determined in the future.

Gulf proposes that the Incentive Earnings Sharing Plan be implemented in 2002 through 2005. The amount of earnings to be shared will be based on Gulf's surveillance reports. The proposal includes a schedule for determining the amount of earnings to be shared and distributing those earnings.

Finally, "to implement the proposed incentive plan in a timely manner that also recognizes the due process rights of the intervening parties, Gulf proposes the following procedure:

> "Simultaneous with the Commission's final vote on Gulf Power's request for rate relief, the Commission should vote to (1) approve the incentive plan concept as presented in th[e] Late-filed Exhibit (2) direct Gulf to file within thirty days after the Commission's vote proposed specific details for implementation and operation of the plan, and (3) schedule a 1 day hearing to allow parties to respond to the proposed plan."

Gulf suggests that the 1 day hearing be handled as a "second phase" proceeding in Docket No. 010949-EI.

OPC objects to the admission of Late-filed Exhibit 25 into the evidentiary record for three reasons. First, the Commission's jurisdiction to order refunds of historical overearnings is unclear and a decision cannot be made on Gulf's proposal until the legal issue is squarely addressed. Second, the procedural means by which the exhibit was introduced does not satisfy the requirements of due process. Finally, there is not evidentiary support for the proposal in the record.

OPC points out that Gulf's proposal assumes that the Commission has authority to order refunds of overearnings from a previous period whether or not there is a rate case. OPC notes that Mr. Bowden conceded the point during his live testimony.

OPC argues that if the Commission does in fact have continuing jurisdiction to order refunds of subsequent overearnings then the Commission should require Gulf to refund, at the close of each fiscal year, all earnings above the top of the range on ROE or whatever the Commission deems excessive. If the Commission does not have such jurisdiction, then it has no authority to approve Late-Filed Exhibit 25. OPC's position is that a decision on whether to approve the proposal cannot be made until this legal issue has been addressed, and Gulf has not addressed it.

OPC next argues that the proposal was not offered in a manner that satisfies the requirements of due process. Specifically, the proposal was not identified during the prehearing process so the parties had no opportunity for discovery. Because the proposal was filed late there was no opportunity for cross-examination or testimony to refute the proposal.

OPC argues that the evidentiary record does not provide support for the proposal. OPC notes that Mr. Bowden testified at the hearing that the concept was something he had thought about but not written down. OPC does not believe that the citations Gulf makes to the record support the proposal.

Staff does not agree with certain concepts put forth in the proposal, but more importantly believes the proposal is not supported by the record. The direction to Gulf was to prepare an exhibit that compiles, in one place, testimony from the record. (TR 105, 109) Approving Gulf's proposal would violate the parties' rights to due process because the proposal introduces concepts and criteria which are addressed no where in the record.

In its attempt to show that the evidentiary record supports the proposal, Gulf relies on the following: 1) Mr. Labrato's criticism of Mr. Breman's testimony; 2) Mr. Labrato's testimony that Gulf has low rates; 3)Mr. Bowden's testimony that Gulf has become more efficient and reduced its workforce through implementing new programs; 4) Mr. Fisher's testimony on Gulf's quality of service and customer satisfaction; 5) Mr. Fisher's testimony on Gulf's use of SAIDI; 6) Mr. Howell's testimony on the use of Integrated Resource Planning for transmission reliability; 7) Mr. Kilgore's testimony explaining that weather conditions during the past two years caused an increase in the number of consumer complaints to the Commission against Gulf; 8) Mr. Moore's testimony on programs that increase the system reliability and the efficiency of Gulf's generating units.

The record does not contain any reference to key elements of Gulf's proposal, including but not limited to: 1) the sharing point and maximum sharing point; 2) the combined use of the proposed performance measures to assess future performance; 3) the performance ratings; 4) the Commission's jurisdiction over earnings above the maximum sharing point; 5)the Commission's jurisdiction over earnings when Gulf fails to achieve a Level 1 performance or higher; and, 6) the percentages of earnings that would go to shareholders and customers. As OPC explains, there has been no opportunity to conduct discovery, file testimony, or conduct cross-examination on these and other components of Gulf's proposal. The lack of opportunity violates the parties' right to due process. For this reason staff recommends that Late-filed Exhibit 25 not be admitted into the evidentiary record.

Staff recommends that Gulf's proposal be addressed in a separate hearing. The hearing can be conducted as a "second phase" of this rate case, as Gulf proposed. If Gulf wishes to pursue its proposal, it should file a petition.

<u>ISSUE 126</u>: Should this docket be closed? (Stern, Kummer)

<u>RECOMMENDATION</u>: No. The docket should remain open to allow the Commission to vote on the final rates at a Special Agenda on May 8, 2002. (Stern, Kummer)

<u>STAFF ANALYSIS</u>: The Commission will determine final revenue requirements, cost of service and rate design issues at the Special Agenda on April 26. Staff will bring a recommendation on the final rates, based on the approved revenue requirements and rate design, for Commission approval at a Special Agenda on May 8, 2002.

JURISDICTIONAL
COMPARATIVE AVERAGE RATE BASES

GULF POWER COMPANY
DOCKET NO 010949-EI
PROJECTED TEST YEAR ENDING MAY 31, 2003
($000)

ISSUE NO		JURIS. PER BOOKS	COMPANY ADJS.	ADJUSTED COMPANY	STAFF ADJS.	ADJUSTED STAFF
	PLANT IN SERVICE	2,037,530				
C	Remove Appliance Sales		(289)			
C	Remove ECRC Amounts		(65,763)			
C	Remove ECCR Amounts		(4,986)			
12	Security Measures (Net)				683	
16	House Power Panels				(641)	
64	Cable Injection Expense				83	
	Total Plant In Service	2,037,530	(71,038)	1,966,492	125	1,966,617
	ACCUMULATED DEPRECIATION AND AMORTIZATION	(870,595)				
C	Remove Appliance Sales		115			
C	Depreciation Study Adjustment		(1,170)			
C	Smith CC Life Adjustment		(1,690)			
C	Remove ECRC Amounts		19,037			
C	Remove ECCR Amounts		204			
S	Smith Unit 3 - 25 Year Life				1,019	
16	House Power Panels				698	
64	Cable Injection Expense				(1)	
	Total Accumulated Derpreciation & Amort.	(870,595)	16,496	(854,099)	1,716	(852,383)
	NET PLANT IN SERVICE	1,166,935	(54,542)	1,112,393	1,841	1,114,234
	CONSTRUCTION WORK IN PROGRESS	27,081				
C	Remove CWIP Eligible for AFUDC		(8,734)			
C	Remove ECRC Amounts		(414)			
C	Remove ECCR Amounts		(2,083)			
S-11	Total Construction Work in Progress	27,081	(11,231)	15,850	0	15,850
S-13	**PLANT HELD FOR FUTURE USE**	3,065	0	3,065	0	3,065
	NET UTILITY PLANT	1,197,081	(65,773)	1,131,308	1,841	1,133,149
	WORKING CAPITAL	66,244				
C	Remove Non-Utility Investments		(55)			
C	Environmental Cost Recovery Clause		583			
C	Funded Property Insurance Reserve		(8,095)			
C	Employee Loans		(797)			
C	Interest and Dividends Receivable		(180)			
C	Loss on Railcars		522			
C	Non-Current Liabilities		8,973			
9A	Office Building - 3rd Floor				(611)	
	Total Working Capital	66,244	950	67,194	(611)	66,583
	TOTAL RATE BASE	1,263,325	(64,823)	1,198,502	1,230	1,199,732

JURISDICTIONAL
COMPARATIVE AVERAGE CAPITAL STRUCTURES

GULF POWER COMPANY
DOCKET NO 010949-EI
PROJECTED TEST YEAR ENDING MAY 31, 2003

GULF POWER COMPANY

	Amount ($000)	Ratio	Cost Rate	Weighted Cost Rate
Long-Term Debt	437.913	36.54%	7.08%	2.59%
Short-Term Debt	17.801	1.49%	6.02%	0.09%
Preferred Stock	99.565	8.31%	5.01%	0 42%
Common Equity	491.919	41 04%	13.00%	5.34%
Customer Deposits	13.249	1.11%	5.98%	0.07%
Deferred Taxes	121,471	10.14%	0.00%	0.00%
Investment Cr - Wt. Cost	16,584	1.38%	9.70%	0.13%
Total	1,198.502	100.00%		8.64%

STAFF
Capital Structure:

	Amount ($000)	Adjustments ($000) Specific	Pro Rata	Adjusted Total ($000)	Ratio	Cost Rate	Weighted Cost Rate
Long-Term Debt	437.913	(14,957)	229	423.185	35.27%	6.44%	2.27%
Short-Term Debt	17.801	15.895	18	33.714	2.81%	4.61%	0.13%
Preferred Stock	99.565	(938)	53	98.680	8.23%	4.93%	0.41%
Common Equity	491.919		267	492.186	41.02%	11.60%	4.76%
Customer Deposits	13.249		0	13.249	1.10%	5.98%	0.07%
Deferred Taxes	121.471	662	0	122.133	10.18%	0.00%	0.00%
Investment Cr. - Wt. Cost	16.584		0	16.584	1.38%	8.80%	0.12%
Total	1,198.502	662	568	1.199 732	100.00%		7.75%

Investment Credit Weighted Cost:

	Amount	Ratio	Cost Rate	Wtd Cost
Long Term Debt	$423.185	41.73%	6.44%	2.69%
Preferred Stock	98.680	9.73%	4 93%	0.48%
Common Equity	492.186	48.54%	11.60%	5.63%
Total	$1.014.052	100 00%		8.80%

Interest Synchronization:

	Adjustments	Cost Rate	Effect on Interest Exp.	Tax Rate	Effect on Income Taxes
Long Term Debt	($14.728)	6.44%	($948)	38 575%	$366
Short Term Debt	15.913	4.61%	734	38 575%	(283)
Customer Deposits	0	5.98%	0	38 575%	0
Total	$1 186		($215)		$83
Change in Cost Rates:					
Long Term Debt	$437 913	-0.64%	($2.803)	38 575%	$1.081
Short Term Debt	17.801	-1.41%	(251)	38 575%	97
Total	$455 714		($3.054)		$1.178
Total Interest Synchronization					$1.261

JURISDICTIONAL
COMPARATIVE NET OPERATING INCOME

GULF POWER COMPANY
DOCKET NO. 010949-EI
PROJECTED TEST YEAR ENDING MAY 31, 2003
($000)

ISSUE NO.		JURIS. PER BOOKS	COMPANY ADJS.	ADJUSTED COMPANY	STAFF ADJS.	ADJUSTED STAFF
	OPERATING REVENUES	633,347				
C	Remove Franchise Fee Revenues		(18,934)			
S-18	Remove Fuel Revenues		(221,901)			
S-19	Remove ECCR Revenues		(5,414)			
S-20	Remove PPCC Revenues		(3,455)			
S-20	Remove PPCC Revenues in Base Rates				(1,652)	
S-21	Remove ECRC Revenues		(10,929)			
78	Gross Receipts Tax				(11,110)	
	Total Operating Revenues	633,347	(260,633)	372,714	(12,762)	359,952
	OPERATING EXPENSES:					
	OPERATION & MAINTENANCE EXPENSE	411,649				
C	Remove Industry Association Dues		(15)			
C	Remove Economic Development Expenses		(53)			
C	Remove Management Tax Preparation Expenses		(4)			
C	Remove Tallahassee Liaison Office Expenses		(221)			
C	Remove Purchased Transmission Expenses		(135)			
C	Remove Marketing and Wholesale Expenses		(304)			
C	Depreciation Study Adjustment		547			
S-17	Inflation Factors				(100)	
S-18	Remove Fuel Expenses		(218,280)			
S-19	Remove ECCR Expenses		(4,312)			
S-20	Remove PPCC Expenses		(3,367)			
S-21	Remove ECRC Expenses		(3,086)			
S-22	Remove Lobbying Expenses				(7)	
47	Security Measures				744	
48	Advertising Expenses				(539)	
50A	Relocation Expense				(16)	
51	Hiring Lag				(324)	
58	Rate Case Expenses				(30)	
59	Marketing Expense				(117)	
64	Cable Injection Expense				(166)	
66	Tree Trimming Expenses				(930)	
68	Street & Outdoor Lighting Expenses				(320)	
	Total Operating & Maintenance Expense	411,649	(229,230)	182,419	(1,805)	180,614
	DEPRECIATION & AMORTIZATION EXP.	75,942				
C	Depreciation Study Adjustment		795			
C	Smith CC Life Adjustment		3,383			
S-19	Remove ECCR Expenses		(144)			
S-21	Remove ECRC Expenses		(2,412)			
S	Smith Unit 3 - 25 Year Life				(2,041)	
16	House Power Panels				(49)	
47	Security Measures				101	
64	Cable Injection Expense				2	
72	Office Building - 3rd Floor				(535)	
	Total Depreciation & Amortization Expense	75,942	1,622	77,564	(2,522)	75,042

JURISDICTIONAL
COMPARATIVE NET OPERATING INCOME

GULF POWER COMPANY
DOCKET NO 010949-EI
PROJECTED TEST YEAR ENDING MAY 31, 2003
(SC001)

ISSUE NO		JURIS PER BOOKS	COMPANY ADJS	ADJUSTED COMPANY	STAFF ADJS.	ADJUSTED STAFF
	TAXES OTHER THAN INCOME	58,498				
C	Remove Francnise Fee Expenses		(18,446)			
C	Smith CC Property Tax Annualization		1,787			
C	Remove Recovery Clause Revenue Taxes		(4,307)			
C	Remove Tallahasse Office Property Taxes		(10)			
S-19	Remove ECCR Expenses		(164)			
S-21	Remove ECRC Expenses		(389)			
51	Hiring Lag				(19)	
78	Gross Receipts Tax				(11,110)	
79	Smith Unit 3 Property Taxes				(1,251)	
	Total Taxes Other Than Income	58,498	(21,529)	36,969	(12,380)	24,589
	CURRENT/DEFERRED INCOME TAXES	16,599				
C	Effect of NOI Adjustments		(4,435)		1,523	
C	Interest Synchcronization		3,682		1,261	
	Total Current/Deferred Income Taxes	16,599	(753)	15,846	2,784	18,630
	INVESTMENT TAX CREDIT	(1,462)				
	Total Investment Tax Credit	(1,462)	0	(1,462)	0	(1,462)
	(GAIN)/LOSS ON SALE OF PROPERTY	0				
	Total (Gain)/Loss on Sale of Property	0	0	0	0	0
	TOTAL OPERATING EXPENSES	561,226	(249,890)	311,336	(13,923)	297,413
	NET OPERATING INCOME	72,121	(10,743)	61,378	1,161	62,539

COMPARATIVE NET OPERATING INCOME MULTIPLIERS

GULF POWER COMPANY
DOCKET NO. 010949-EI
PROJECTED TEST YEAR ENDING MAY 31, 2003

	Company As Filed	**Stipulation 30** W/O Gross Receipts Tax
Revenue Requirement	100.0000%	100.0000%
Gross Receipts Tax	-1.5000%	0.0000%
Regulatory Assessment Fee	-0.0720%	-0.0720%
Bad Debt Rate	-0.1583%	-0.2416%
Net Before Income Taxes	98.2697%	99.6864%
Income Taxes @ 38.575%	-37.9075%	-38.4540%
Revenue Expansion Factor	60.3622%	61.2323%
Net Operating Income Multiplier	1.656667	1.633125

COMPARATIVE REVENUE REQUIREMENTS

GULF POWER COMPANY
DOCKET NO. 010949-EI
PROJECTED TEST YEAR ENDING MAY 31, 2003

	Company As Filed ($000)	Staff As Adjusted ($000)
Jurisdictional Adjusted Rate Base	1,198.502	1,199,732
Required Rate of Return	8.64%	7.75%
Required Net Operating Income	103.551	92,979
Achieved Net Operating Income	(61.378)	(62,539)
Net Operating Income Deficiency/(Excess)	42.173	30.440
Net Operating Income Multiplier	1.656666	1.633125
Operating Revenue Increase/(Decrease)	69.867	49.712

DOCKET NO 010949-EI

DATE April 15, 2002

ATTACHMENT 6

GULF POWER COMPANY
DOCKET NO. 010949-EI
RECOMMENDED REVENUE INCREASE BY RATE CLASS
SUMMARY OF CLASS RATES OF RETURN AND PERCENTAGE INCREASES
($ 000s)

(1)	(2)	(3)	(4)		(5)	(6)	(7)	(8)	(9)		(10)	
											% INCREASE IN REVENUE FROM SALES OF ELECTRICITY	
RATE CLASS	RECOMM. RATE BASE	RECOMM. PRESENT NOI	PRESENT ROR	PRESENT INDEX	INCREASE FROM SERVICE CHARGES	INCREASE FROM SALES OF ELECTRICITY	TOTAL INCREASE IN REVENUE	REQUIRED NOI	RECOMMENDED ROR	RECOMMENDED INDEX	WITH ADJUSTMENT CLAUSES	BASE
RS/RSVP	$675,728	$31,914	4.72%	0.91	$1,808	$33,359	$35,167	$53,448	7.91%	1.02	11.0%	17.5%
GS	$46,505	$3,624	7.79%	1.50	$152	$0	$152	$3,718	7.99%	1.03	0.0%	0.0%
GSD/GSDT/GSTOU	$238,613	$13,901	5.83%	1.12	$80	$8,068	$8,148	$18,890	7.92%	1.02	6.8%	12.3%
LP/LPT	$148,389	$8,627	5.81%	1.12	$0	$4,991	$4,991	$11,683	7.87%	1.02	5.9%	12.3%
OS-I/II	$36,234	$1,349	3.72%	0.71	$0	$1,222	$1,222	$2,097	5.79%	0.75	11.9%	15.4%
OS-III	$2,452	$290	11.84%	2.27	$0	$0	$0	$290	11.84%	1.53	0.0%	0.0%
OS-IV	$771	$36	4.63%	0.89	$0	$32	$32	$55	7.17%	0.93	11.8%	18.3%
CSA	$20,504	($264)	-1.29%	-0.25	$0	$0	$0	($264)	-1.29%	-0.17	0.0%	0.0%
SBS, RTP, PX, PXT	$30,537	$3,061	10.02%	1.92	$0	$0	$0	$3,061	10.02%	1.29	0.0%	0.0%
TOTAL RETAIL	**$1,199,732**	**$62,539**	**5.21%**	**1.00**	**$2,040**	**$47,672**	**$49,712**	**$92,979**	**7.75%**	**1.00**	**8.2%**	**14.1%**

Florida Public Service Commission
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Incentive Earnings Sharing Plan

Florida Public Service Commission
Docket No. 010949-EI
GULF POWER COMPANY
Witness: T. J. Bowden
Late Filed Exhibit No. 25
Page 2 of 10

Incentive Earnings Sharing Plan
I. Proposal

(1) **Return on Equity / Sharing Points**
- **Cost of Equity (C)** to Gulf will be determined by the Commission as a part of Gulf's rate case proceeding
- ROE used for setting rates, **(M)** = **C + Performance Adder.** This becomes the **Midpoint (M)** of the ROE range.
- The **Authorized Range** will be determined by the Commission as a part of Gulf's rate case proceeding.
- Sharing of earnings between customers and shareholders begins at the top of the authorized range (the **Sharing Point)**
- Any earnings contributing to an ROE over a designated amount (the **Maximum Sharing Point**) will be under the jurisdiction of the Commission. The disposition of these earnings will be determined in the future.

(2) **Sharing**
- The amount of earnings contributing to an ROE above the Sharing Point up to the Maximum Sharing Point will be grossed up for taxes to determine the amount of **Shared Earnings.** This amount will be shared between customers and shareholders as follows:
  - If Gulf achieves a Level 3 rating on its Performance Measures (as described later in this document), the Shared Earnings will be split 1/3 to customers and 2/3 to shareholders.
  - If Gulf achieves a Level 2 rating (as defined below), the Shared Earnings will be split 1/2 to customers and 1/2 to shareholders.
  - If Gulf achieves a Level 1 rating (as defined below), the Shared Earnings will be split 2/3 to customers and 1/3 to shareholders.
  - If Gulf does not achieve a performance rating of Level 1 or above, the amount of any actual earnings contributing to an ROE above the Sharing Point will be under the jurisdiction of the Commission. The disposition of these earnings will be determined in the future.
  - Any actual earnings contributing to an ROE above the Maximum Sharing Point will be under the jurisdiction of the Commission. The disposition of these earnings will be determined in the future. Such earnings could be refunded to customers (added to the Shared Earnings determined above) or used to increase accruals or write-offs of regulatory assets.
- At the close of each calendar year, the total amount of Shared Earnings and the amount allocated to customers, as described above, will be

Incentive Earnings Sharing Plan
I. Proposal

determined based on actual financial results. The customers' portion of the Shared Earnings will be refunded in July of the following calendar year, beginning with the 1st billing cycle on or about July 1st. The credit to the customers will be calculated on a per kWh basis using projected kWh sales for the July billing cycle.

- The Company will report to the Commission the amount of Shared Earnings actually refunded. Any difference between the targeted refund amount and the actual refund amount will be considered in the fuel over/under recovery calculation.

(3) The Incentive Earnings Sharing Plan covers calendar years 2002, 2003, 2004 and 2005. The calculations of the actual jurisdictional ROE for these years will be on an "FPSC Adjusted Basis" using the adjustments and jurisdictional separation factors approved in Gulf Power's rate case. Docket No. 010949-EI. Except as noted in the preceding sentence, all actual reasonable and prudent expenses and investment related to Gulf's retail electric jurisdiction will be allowed in the calculation and no annualized or pro forma adjustments will be made. The calendar year surveillance reports for the years 2002 through 2005 on which the earnings sharing calculations will be based will continue to be filed no later than February 15 of the year following each plan year and will be subject to audit by the FPSC Staff and true-up. The Company will also submit a report to the Commission by June 15 regarding the results achieved on the Performance Measures defined below.

(4) Any amounts deferred pending Commission jurisdiction as to final disposition will accrue interest at the 30 day commercial paper rate as specified in Rule 25-6.109, FAC. Such deferred amounts will be assigned a cost rate in the determination of the cost of capital based on the rate used in the interest accrual for deferred balances.

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GULF POWER COMPANY
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Incentive Earnings Sharing Plan
I. Proposal

(5) **Performance Measures**
Gulf's operating performance will be assessed based on the following performance measures for the applicable plan year:

A. **Price**
- Overall retail cents per kwh in the lowest quartile as compared to an appropriate peer group

B. **Reliability**
- Achieve a certain performance level on the System Average Interruption Duration Index (SAIDI) and System Average Interruption Frequency Index (SAIFI) measurements

C. **Service (*Customer Satisfaction/Value*)**
- Be in the upper quartile among peer group based on Customer Value Survey

(6) **Performance Ratings**
- A **Level** 3 performance rating is achieved if Gulf meets or exceeds all three performance measures described above
- A **Level** 2 performance rating is achieved if Gulf meets or exceeds two of the performance measures described above
- A **Level** 1 performance rating is achieved if Gulf meets or exceeds one of the performance measures described above

Incentive Earnings Sharing Plan
II. References to Pre-filed Testimony of Gulf's Witnesses

<u>Labrato Rebuttal – Incentive Program with Reward for Quality Service</u>
<u>Page 6, lines 19 – 24 (RE: Part 1, 2, 5 and 6 of Proposal)</u>

- Regarding Mr. Breman's proposal to provide an incentive to Gulf to maintain reliable service, the Company agrees that it should be rewarded if it provides superior service.
- Mr. Breman's proposal actually penalizes the Company for not meeting one particular standard with no opportunity for reward.

<u>Page 7, lines 1 – 13 (RE: Part 1, 2, 5 and 6 of Proposal)</u>

- For a more appropriate way to establish an incentive program, the Commission should look at the overall quality of service rather than looking only at one particular standard.
- Gulf Power has demonstrated that is has provided high quality service to its customers at low rates with excellent customer satisfaction ratings through the testimony of several witnesses in this case, including customer testimony at Gulf's service hearings.
- Would be appropriate for the Commission to reward the Company for its high level of service by increasing the return on equity for purposes of setting rates and/or expanding the allowed return on equity range.

<u>Labrato Direct – Among Lowest Rates in Florida & Nation</u>
<u>Page 7, lines 8 – 20 (RE: Part 5 and 6 of Proposal)</u>

- As of July 2001, Gulf's residential rate for 1000 kWh compared to those of 53 other utilities across the nation and in the State of Florida was among the lowest, with only 4 other utilities having lower rates than Gulf. (See Schedule 1 of Exhibit RRL-1)
- Gulf's proposed residential rate for 1000 kWh will remain among the lowest - only 13 other utilities would have lower rates than Gulf.

<u>Bowden Direct– Overall Efficiencies through New Programs and Technologies</u>
<u>Page 5, lines 13 – 25 (RE: Part 5 and 6 of Proposal)</u>

- Company was able to reduce workforce through new programs and technologies – resulted in efficiencies and allowed improvement in service levels and customer satisfaction
- Distribution programs implemented: TCMS, Earned Progression, CSS, ARMS

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Incentive Earnings Sharing Plan
II. References to Pre-filed Testimony of Gulf's Witnesses

Page 6, lines 1-25 (RE: Part 5 and 6 of Proposal)

- Generation programs implemented: PRO, GADS, PREPS. Collectively, these programs automate the complex job of optimizing the impact of the Southern system's maintenance dollars and minimizing outages.
- Y2K effort, opportunities to apply new technology and increase efficiencies –
  1. Consolidated many company specific applications into Southern system-wide applications. For example, consolidation of purchasing/inventory applications.
  2. Replacement of 20-plus year old customer accounting system with CSS.

Page 7, lines 1 – 25 (RE: Part 5 and 6 of Proposal)

- Other economies and efficiencies:
  PC has had an impact on efficiency and has helped to reduce workforce
  Installation of 800 megahertz radio system
  Computers in line trucks to speed work orders and material deliveries to work sites
  Computer systems to track power outages to improve restoration times
  Digital cameras and intranet applications to do engineering work in the field
- References to low rates, National Customer Value Survey

Fisher Direct – Quality Service and Customer Satisfaction

Page 12, lines 14-25 (RE: Part 5 and 6 of Proposal)

- Corporate goal - to be an industry leader in service and customer satisfaction.
- Initiatives taken to understand & be responsive to customer's needs & expectations
- Customer service standards adopted to ensure consistent, reliable, high quality customer service
- Reduced customer complaints and avoided FPSC rules infractions

Page 13, lines 1-25 (RE: Part 5 and 6 of Proposal)

- Avoided FPSC rules infractions – In the past 3 years, Gulf has had 0 infractions.
- Low level of customer complaints
- Ranked #1 in overall satisfaction among major utilities last year in national customer value and satisfaction survey (Schedule 2 of Exhibit FMF-1)
- 2 annual surveys conducted by independent market research firms
- 1st survey is the "Customer Value Survey" – performance compared against peer utilities that are industry leaders
- Gulf ranked among the best in industry for residential, general business, and large business customers (Schedule 3 of Exhibit FMF-1)

Incentive Earnings Sharing Plan
II. References to Pre-filed Testimony of Gulf's Witnesses

- Use surveys to identify areas for process improvements as identified by customers
- 2nd survey is "The Public Confidence Survey" – measures customers' opinions on various facets of our business

<u>Page 14, lines 1-13 (RE: Part 5 and 6 of Proposal)</u>

- Recently Gulf received highest satisfaction ratings in more than 5 years
- 85% of customers surveyed in May and June 2001 had an overall positive opinion of Gulf
- Programs implemented to improve productivity and customers satisfaction: Trouble Call Management System (TCMS), Automated Resource Management (ARMS), and CSS

<u>Page 15, lines 12-17 (RE: Part 5 and 6 of Proposal)</u>

- TCMS – Residential segment of customer value surveys, Gulf ranks 2nd in handling emergencies and 3rd in responding quickly to problems. General business segment, Gulf ranks 3rd in restoring service quickly after an outage.

<u>Page 16, lines 13-16 (RE: Part 5 and 6 of Proposal)</u>

- ARMS – Customer value surveys – Gulf ranks 3rd among residential customers and 6th among general business customers in satisfaction with the way service requests are handled.

<u>Page 19, lines 3-8 (RE: Part 5 and 6 of Proposal)</u>

- CSS – Customer value surveys – Gulf ranked #1 by residential customers and 7th by general business customers on handling customer service requests right the first time. Gulf ranks 4th in the residential segment and 3rd in the general business segment on overall satisfaction with the billing statement and payment process.

<u>Page 20, lines 5-13 (RE: Part 5 and 6 of Proposal)</u>

- Centralization of Dispatch Center –
  Goal to be on time to appointments with our customers is 95%. As of July 2001, Gulf is making more than 99% of its appointments on time.
  Goal for completing lighting and service orders within their committed service dates is 95%. As of July 2001, Gulf is at 97% for service orders and 94% for lighting orders.

<u>Page 21, lines 13 – 21 (RE: Part 5 and 6 of Proposal)</u>

- Centralization of Customer Service Center –
  1. Customer value surveys –
     - Overall satisfaction with the knowledge and skills of our employees – Gulf ranks 1st in residential segment and 2nd in general business segment.

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Incentive Earnings Sharing Plan
II. References to Pre-filed Testimony of Gulf's Witnesses

- Ease in doing business – Gulf ranked 2nd in both residential and general business segments.
- Treating our customers with respect – Gulf ranked #1.

2. Consistently have achieved service level goal of at least 80% of all calls answered within 30 seconds or less.
3. Gulf has maintained an abandoned call rate of less than 3%.

Fisher Rebuttal - Reliability

Page 11, lines 11-16 (RE: Part 5 and 6 of Proposal)
- Gulf has used the System Average Interruption Duration Index (SAIDI), the Public Confidence Surveys and FPSC infractions results as indicators of providing reliable electric service.

Page 12, lines 4-9 (RE: Part 5 and 6 of Proposal)
- In 2001, SAIDI was reduced to 78.55 minutes, a 19% reduction from 2000.
- The Public Confidence Survey regarding "Providing Reliable Service" showed 93% favorable response
- No FPSC infractions

Page 13, lines 9-25 (RE: Part 5 and 6 of Proposal)
- Customers will experience variances in reliability over time – it is a function of many variables that are under various degrees of the utility's control
- References to page 15 of Fisher direct testimony

Page 14, lines 1-5 (RE: Part 5 and 6 of Proposal)
- References to page 15 of Fisher direct testimony
- Over 3 ½ years since we have had a reliability related infraction

Howell Direct – Transmission Reliability

Page 5, lines 4 – 10 (RE: Part 5 and 6 of Proposal)
- The Southern electric system (SES) Integrated Resource Planning (IRP) process has allowed for a least-cost, integrated demand-side and supply-side resource plan. IRP process results in an integrated plan that can meet the needs of our customers in a cost-effective and reliable manner.

Page 6, lines 1 – 6 (RE: Part 5 and 6 of Proposal)
- The SES transmission planning process – transmission system is studied to reveal any potential problems that could adversely impact Gulf's ability to maintain or restore lreliability, solutions are identified, and costs are evaluated to determine which solution is appropriate to correct the problem.

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Page 8, lines 17 – 20 (RE: Part 5 and 6 of Proposal)

- Through the SCS Power Coordination Center in Birmingham, Gulf and the other SES operating companies form a centralized power pool that provides electric service to their customers in the most reliable and economical manner.

Kilgore Rebuttal – Explanation of Customer Complaints
Page 3, lines 15 – 25 (RE: Part 5 and 6 of Proposal)

- Increase in complaints in last 2 years relate to circumstances beyond our control. Weather conditions explain the increase in complaint activity.

Page 4, lines 8 – 13 (RE: Part 5 and 6 of Proposal)

- We have gone over 3 ½ years without any apparent violations of FPSC rules or tariffs on complaints

Moore Direct –System Reliability and Efficiency of Generating Units
Page 8, lines 13 – 22 (RE: Part 5 and 6 of Proposal)

- Implementation of plant reliability optimization (PRO) program. PRO is a maintenance process to produce appropriate balance between corrective, preventive, and predictive maintenance. Goal to perform maintenance at the least cost while maximizing equipment reliability.

Page 15, lines 7 – 18 (RE: Part 5 and 6 of Proposal)

- Gulf monitors GADS data as part of the production capital analysis process and develops plans to address GADS events that continue to be problematic and makes decisions to repair or replace existing equipment.
- Gulf uses the Project Evaluation and Prioritization System (PREPS) model to determine the economic viability of a project. PREPS model assigns benefits in terms of dollars to heat rate improvements, reduced forced outage rates, or reduced station service expenses and compares those benefits to the project costs.

Moore Rebuttal –System Reliability and Efficiency of Generating Units
Page 16, lines 13 – 23 (RE: Part 5 and 6 of Proposal)

- Implementation of plant reliability optimization (PRO) program.

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Incentive Earnings Sharing Plan
III. Next Steps

In order to implement the proposed incentive plan in a timely manner that also recognizes the due process rights of the intervening parties, Gulf Power Company ("Gulf") proposes the following procedure:

Simultaneous with the Commission's final vote on Gulf Power's request for rate relief, the Commission should vote to (1) approve the incentive plan concept as presented in this Late-Filed Exhibit, (2) direct Gulf to file within thirty days after the Commission's vote proposed specific details for implementation and operation of the plan, and (3) schedule a 1 day hearing to allow parties to respond to the proposed plan. The order should include the specific goal of having an incentive plan finalized by no later than October 2002. For purposes of efficiency and convenience to all parties and the Commission, the plan could be handled as a "second phase" proceeding in Docket No. 010949-EI.