77,153

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

In The Matter of	DOCKET NO. 891345-EI
Application of GULF POWER COMPANY for an increase in rates and charges.	HEARING SECOND DAY MORNING SESSION

VOLUME - III

Pages 283 through 427

FPSC Hearing Room 106
Fletcher Building
101 E. Gaines Street
Tallahassee, Florida 32399

Tuesday, June 12, 1990

Met pursuant to adjournment at 9:00 a.m.

BEFORE: COMMISSIONER MICHAEL McK. WILSON, CHAIRMAN
COMMISSIONER GERALD L. GUNTER
COMMISSIONER THOMAS M. BEARD
COMMISSIONER BETTY EASLEY

APPEARANCES:

(As heretofore noted.)

REPORTED BY: JOY KELLY, CSR, RPR
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I N D E X

WITNESSES

Name:	Page No.
ARLAN SCARBROUGH	

P R O C E E D I N G S

(Hearing reconvened at 9:05 a.m.)

CHAIRMAN WILSON: Mr. Holland, you can call your next witness.

MR. HOLLAND: Call Mr. Scarbrough.

COMMISSIONER BEARD: Before you get started, there's been a munchkin or something working while I was not around, and I've got something marked Exhibit 36 and No. 298. Is that something that's just laid out today?

MR. STONE: Yes, Commissioner. We have handed out the exhibits listed under Mr. Scarbrough's name as miscellaneous exhibits, which I believe begin at Page 99 of your prehearing order.

COMMISSIONER BEARD: Why is it that I thought that I had already seen the audit report --

CHAIRMAN WILSON: Are you all talking about two different things?

MR. STONE: Those should be the audit --

CHAIRMAN WILSON: What Commissioner Beard is talking about is a very thick document.

COMMISSIONER BEARD: 881167, and I saw the 891, did I not? That's the difference.

MR. STONE: I've gotten the wrong one.

CHAIRMAN WILSON: Who put this on the bench?

MR. STONE: We put those on the bench and we've made an error, Commissioner. The one that's marked No. 36 and No. 298 is an error. We'll have to get that duplicated for you. That's the report and it should have been the Company's responses.

The other items, 20 through --

CHAIRMAN WILSON: The number designation is incorrect?

MR. STONE: No.

CHAIRMAN WILSON: The whole thing is incorrect? Do you want this back?

MR. STONE: That big document with the rubber band you can disregard. We can either have them back, but the other package which you received, which will be Exhibits 20 through 35, hopefully those are correct.

CHAIRMAN WILSON: All right.

(Pause)

MR. HOLLAND: Are we ready?

CHAIRMAN WILSON: Yes, go ahead.

ARLAN SCARBROUGH

was called as a witness on behalf of Gulf Power Company and, after being first duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. HOLLAND:

Q Mr. Scarbrough, would you state your name, business address and your position with Gulf Power Company?

A My name is Arlan Scarbrough, 500 Bay Front Parkway, Vice President, Finance.

Q And have you prefiled testimony in this docket entitled "The Direct Testimony of Arlan E. Scarbrough"?

A Yes.

Q Do you have any corrections to make to that testimony?

A Yes.

Q Would you please do so?

A Yes. If you go to Page 8 of my direct testimony, on Line 3, change 6.21 to 6.20. On Page 19, change the Line 15, change 5.7 to 5.1.

COMMISSIONER GUNTER: 5. what?

WITNESS SCARBROUGH: 1, yes, sir. Also on Page 19, Line 22, change 3.7 to 4.0. On Page 37 --

COMMISSIONER GUNTER: You don't have a change on Line 23?

WITNESS SCARBROUGH: Not on Page 19.

COMMISSIONER GUNTER: Okay.

WITNESS SCARBROUGH: Page 37, Line 23, change "exhibit" to "schedule."

On Page 38, Line 25, change \$1.3 million less to 912,000 more. On Page 39, Line 1, change "even though" to "because."

On Page 46, change Line 20, the \$1,120 to \$1,163.

Also on Page 46, Line 22, change the \$76.3 million to 85.4.

And those are all the changes in the narrative. On Schedule 9 --

COMMISSIONER BEARD: Would you go back to Page 19 for a minute, please.

WITNESS Yes. It's a nit, but since we're correcting things there --

WITNESS SCARBROUGH: Okay. I would just point out on Page 19, Line 22, the 3.7, that 4-point -- that was left blank in mine and I put in the zero, but it should be 4.2. I gave you 4.0. It should be 4.2.

COMMISSIONER EASLEY: Line 22.

WITNESS SCARBROUGH: On Line 22.

COMMISSIONER BEARD: Does that make Line 23, 9.3?

COMMISSIONER GUNTER: That was my question previously.

COMMISSIONER BEARD: Yeah, I know it was.

WITNESS SCARBROUGH: Hold it just a minute, sir. Let me look at that. (Pause)

Yes. It's because of rounding, but go ahead and change Line 23 to 9.3, so it adds.

COMMISSIONER GUNTER: That was the reason for my question previously, Mr. Scarbrough.

WITNESS SCARBROUGH: Yes, sir. Thank you.

CHAIRMAN WILSON: Mr. Holland, you have provided, or will provide the court reporter with corrected pages, right?

MR. HOLLAND: Yes, sir.

COMMISSIONER EASLEY: Schedule 9.

WITNESS SCARBROUGH: Schedule 9. On the "Customer Service and Information" line, under the column headed "1984 Allowed," on the "Customer Service and Information" line, strike the "3,514" and insert ",2522." And on that same line under the column headed "1990 Benchmark," change the "5,297" to "3,801."

Now, the next column which just says, "1990 Budget," change the "2,666" to "3,410." And on the column headed "Variance," change the "2,631" to "391."

COMMISSIONER EASLEY; Is that in brackets?

WITNESS SCARBROUCH: In brackets, yes, ma'am, 391 in brackets.

And on the "Sales" line, under the column headed "1990 Budget," change the "252" to "281," and also change the next column, the "Variance" line, from "252" to "281."

Then on the totals on the "1984 Allowed" column, change the "30,065" to "29,071." Then on the "1990 Benchmark" column, change the "42,437" to "40,941." The "1990 Budget," change the "41,080" to "41,853." And on the "Variance" column, change the "1,357" to a positive "912" number without brackets.

COMMISSIONER GUNTER: What was your '90 benchmark figure again?

WITNESS SCARBROUGH: 41,853. No, 40,941. 40,941.

COMMISSIONER GUNTER: All right.

WITNESS SCARBROUGH: And then delete the footnote that's on that schedule.

And those are all of the changes to my testimony.

Q (By Mr. Holland) Mr. Scarbrough, with those changes, if I were to ask you the questions today contained in your testimony, would your answers be the same?

A Yes.

MR. HOLLAND: Mr. Chairman, we ask that Mr. Scarbrough's testimony be inserted into the record as though read.

CHAIRMAN WILSON: His testimony will be so inserted into the record.

MR. HOLLAND: And Mr. Scarbrough's exhibits have been premarked and stipulated to and they are Exhibits 6 through 36, I believe.

(Exhibit Nos. 6 through 36 received into evidence).

GULF POWER COMPANY

Before the Florida Public Service Commission
Direct Testimony of
Arlan E. Scarbrough
In Support of Rate Relief
Docket No. 891345-EI
Date of Filing December 15, 1989

Q. **Please state your name, business address and occupation.**

A. My name is Arlan E. Scarbrough. My business address is 500 Bayfront Parkway, Pensacola, Florida 32501. I am Vice President - Finance of Gulf Power Company.

Q. **Please outline your educational background and business experience.**

A. I graduated from the University of Southern Mississippi in 1958 with a Bachelor of Science degree in Accounting. Following graduation from college, I attended Officer Candidate School and was commissioned in the United States Marine Corps. While serving in the Marine Corps, I graduated from East Carolina University in 1962 with a Master's degree in Business Administration.

Following my discharge from active duty in 1962, I was employed by Mississippi Power Company (an operating subsidiary of The Southern Company, as is Gulf Power Company) in the Accounting Department and held various positions in the department until June 1968, when I was elected Assistant Secretary and Assistant Treasurer of Mississippi Power Company. In this position, my primary function was responsibility for all accounting activities. I continued to serve in that capacity until October 1976, when I was elected Comptroller, with similar responsibilities. In October 1977, I accepted the position of Vice President and Comptroller and Chief Financial Officer of Gulf Power Company, and in April 1980, was appointed to the position of Vice President - Finance, with similar responsibilities.

Q. What professional license do you hold in the field of Accounting?

A. I am a licensed Certified Public Accountant and a member of the American Institute of Certified Public Accountants and Florida Institute of Certified Public Accountants.

Q. Will you briefly describe your duties as Vice President - Finance of Gulf Power Company?

A. I am the Chief Financial Officer with responsibility for all accounting, financial, corporate records, corporate planning, rates, and internal auditing and security activities of the Company. I also serve as Chairman of the Budget Committee.

Q. **What is the purpose of your testimony?**

A. The purpose of my testimony is to explain the need for immediate rate relief and to discuss the rate relief requested based on the 1990 test year approved by this Commission. I will describe my role in the budgeting process and the particular areas of the budget that I am supporting in these proceedings. I will discuss specific areas of the 1990 Operation and Maintenance expense (O & M) budget and provide justifications for variations from the benchmark in those areas.

Q. **Have you prepared an exhibit that contains information to which you will refer in your testimony?**

A. Yes.

Counsel: We ask that Mr. Scarbrough's Exhibit, comprised of 13 Schedules, be marked for identification as Exhibits 6-18 (AES-1).

Q. **Are you the sponsor of certain Minimum Filing**

Requirements (MFRs)?

A. Yes, these are listed on Schedule 13 at the end of my exhibit. To the best of my knowledge, the information in these MFRs is true and correct.

Q. Were all of the schedules in this exhibit prepared under your direction and supervision?

A. Yes.

Q. What is the source of the figures shown in these schedules?

A. The actual data presented on the schedules were prepared from the books and records of the Company. Gulf Power Company maintains its books and records in accordance with generally accepted accounting principles and the rules and regulations prescribed for public utilities in the Uniform System of Accounts published by the Federal Energy Regulatory Commission (FERC), and adopted by the Florida Public Service Commission (FPSC). Our books and records are audited by Arthur Andersen & Co., independent public accountants, and a copy of their latest audit opinion, for the year ending 1988, is included in the Company's 1988 Annual Report to Stockholders which is filed as MFR F-1 in this case.

Our books and records are also audited by the FERC and this Commission. In addition to the schedules presenting results of operations for 1989 (eight months actual and four months projected), I will also present certain budgeted data for 1990. Mr. D. P. Gilbert, Director of Corporate Planning, will testify about the budgeting process and methodology used in making the projections; Mr. Mark R. Bell of Arthur Andersen & Co. will testify to his review of the budget; and Mr. R. J. McMillan, Supervisor of Financial Planning will testify to the allocations to the Unit Power Sales customers and the calculations of the total retail revenue requirements.

Q. **Why is it necessary for the Company to seek rate relief at this time?**

A. Gulf last received an increase in retail rates in December 1984, five years ago. Gulf has made capital expenditures of over $385 million from January 1985 through August 1989 and is projected to make over $91 million of expenditures from September 1989 through December 1990. Thus the Company will have expended more than $476 million for plant facilities necessary to serve our customers since our last rate increase. Also, the Company has incurred significant increases in operating and maintenance expenses, primarily due to inflation and customer growth. Offsetting the impact of these increased capital expenditures and O & M expenses, to a significant degree, were benefits derived from extensive cost control efforts, increased Non-Territorial Sales (Unit Power Sales), a declining cost of money, and a decrease in the corporate federal income tax rate from 46 percent to 34 percent. All of these changing factors were concurrently reflected in the monthly surveillance reports that are filed by Gulf with the FPSC. These reports did not indicate a need for a significant adjustment in Gulf's retail rates until 1989.

The major factor triggering the Company's immediate need for rate relief is that all 515 megawatts of Gulf's portion of the Plant Daniel capacity and 63 megawatts (mw) of Gulf's ownership in the Plant Scherer capacity is now committed for territorial service. As shown in Mr. Parson's testimony and Schedule 9 of his exhibit, which I am jointly sponsoring, up until February 1989, the vast majority of this capacity was supported by our Unit Power Sales (non-territorial service) contracts. From June 30, 1988 to February 1, 1989, over 500 MW of generating capacity was returned to territorial service. The addition of this capacity, combined with the normal increases in capital expenditures and O & M expenses, created a significant 1989 retail revenue deficiency. This was not a surprise to Gulf Power Company. Since our last retail rate increase in 1984, our long-range financial forecasts have indicated a need for a substantial increase in retail revenues in 1989. Nevertheless, our Company has always placed great emphasis on attempting to find ways to avoid filing for rate relief. Despite these efforts, in order to maintain our high quality of service to our customers and a reasonable level of financial integrity, Gulf requested an increase in retail rates of $25.8 million on November 14, 1988. Even though the Company's financial condition continued to deteriorate as forecasted, Gulf withdrew its request for rate relief on June 9, 1989, because of the difficulties encountered in conducting a rate case during a Grand Jury investigation. At that time, the Company told the Commission we would file another case when the situation was resolved. As stated by Mr. McCrary, the investigation by the Grand Jury as it relates to Gulf Power was resolved on October 31, 1989. As anticipated, Gulf's earnings have continued to deteriorate to a seriously unreasonable level. Consequently, we are requesting a $26.3 million or a ~~6.21~~ 6.20 percent increase in our retail revenues.

Q. **Have you made a comparison of Gulf's retail cost to that of other companies?**

A. Yes. I have compared Gulf's annual average retail revenue per kilowatthour sold to those of 25 other southeastern electric utilities for 1988. My Schedule 11, page 1, shows Gulf in the lowest quartile of this comparison group, with only three companies that had lower costs than Gulf Power Company.

Q. **Would Gulf still have compared favorably if the $26.3 million rate relief requested in this case had been granted to Gulf in 1988?**

A. Yes. As shown on my Schedule 11, page 2, Gulf's retail revenue per kilowatthour sold would have remained in the lowest quartile of the comparison group.

Q. **Your projections indicate that in 1990 Gulf's earnings, without rate relief, will be less than its** annual common stock dividend requirement. What are the implications of this weak financial projection for the Company and its customers?

A. Common stockholders provide a significant portion of the capital needed to construct our generation, transmission and distribution facilities. In exchange, they expect, and they deserve, a fair return on their investment, and a large part of this return is in the form of dividends.

For an ongoing business, earnings are the ultimate source of dividend payments. On a short-term basis, the Company could meet its dividend obligation with cash flow from depreciation and other non-cash expenses, or from borrowings. But beyond the short term, a growing company like Gulf Power must earn at a level in excess of its dividend. It is not likely that additional equity capital would be available to a company earning only enough to cover its current dividend. Failure to meet the dividend obligation would adversely impact both the Company and its customers.

The evidence is clear with respect to the market's reaction to reduced or omitted dividends by utility companies. The immediate decline in stock price is only part of the overall reaction. The greater concern is the impact on the Company's ability to access the markets for additional common equity capital in the future. The inability of the Company to obtain additional equity capital on reasonable terms could restrict growth or result in increased leverage which would only exacerbate a deteriorating financial situation.

Gulf, as you know, obtains its equity from the Southern Company, but the above impact would be no less direct because Gulf is responsible for its share of Southern's dividend. Gulf's share is determined based on the amount of its equity as a percent of the total Southern system equity.

Q. **Without rate relief, would your security ratings be put in jeopardy?**

A. Yes. In a recent report on Gulf Power, Schedule 12 of my exhibit, the Standard & Poor's rating agency affirmed the single "A" rating of Gulf Power Company's First Mortgage Bonds and preferred stock. This report referenced Gulf's "aggressive" debt leverage and its need for rate relief. The report concluded with a "Negative outlook" that stated, "If needed rate relief is not forthcoming, financial protection measures could fall to levels below those commensurate with the current rating."

Therefore, we conclude that without rate relief our bond and preferred stock ratings would likely be downgraded. This, of course, would increase our cost of capital and possibly restrict, to some degree, our access to the capital markets.

Q. **Mr. Scarbrough, what are the projected earnings of Gulf Power Company for 1990 with present retail rates.**

A. With present rates, the adjusted jurisdictional return on average rate base is projected to be 6.60 percent for 1990. This provides a return on the average common equity (risk capital) component of 7.52 percent, which is significantly below the 13.00 percent determined by Dr. Morin to be appropriate for Gulf Power Company.

Q. **Mr. Scarbrough, what areas of the financial budget are you testifying to in these proceedings?**

A. As Vice President - Finance and as Budget Committee Chairman, I have overall responsibility for the entire budgeting process. In these proceedings, however, the budget areas I am supporting will be confined to the Customer Accounts function and the

Administrative and General area of Operation and Maintenance (O & M) expenses, and to taxes, interest rate assumptions, dividends, capital contributions from The Southern Company and other financings.

Q. Mr. Scarbrough, earlier you made reference to resolution of the Grand Jury investigation. I believe at least some of what occurred was as a result of the circumvention of internal controls by those involved. Have you made any changes to your Management Procedures that provide additional guidelines for internal controls?

A. Yes. Several accounting and purchasing Management Procedures have been revised. Because of the increased amount of transactions and the problems which were focused during the investigation primarily on the use of professional services throughout the Company, we decided to include them in the purchase requisition process to provide additional assurance that the Company was getting the best possible services for the best price.

In addition, other revisions included changes to approval levels for purchase requisitions, personal expense statements, and executive controlled expenses. Blanket purchase orders were capped for total annual spending limits.

Q. Will the tightening of the internal controls guarantee that the circumvention of controls will not occur in the future?

A. To my knowledge, no cost effective system of internal controls exists which can detect every instance of theft or fraud where collusion exists. I firmly believe that we have carefully reviewed our controls and made those changes reasonable to deter the reoccurrence of this type activity. The best internal controls are honest and ethical employees who recognize the importance of adherence to these controls. As indicated in Mr. McCrary's testimony, a number of other steps have been taken to emphasize the importance of such conduct.

Q. Mr. Scarbrough, has the Company made those adjustments necessary to remove from this rate case any impact of the losses associated with the Grand Jury and internal investigations.

A. Yes, we have. On specific instruction from me, the auditing and accounting personnel have attempted to identify those dollars associated with theft or otherwise involving the circumvention of controls.

Virtually all of these items relate to years prior to 1989 and do not impact the test year. A relatively small amount was capitalized and would, therefore, be included in the test year had they not been removed from rate base as detailed in Mr. McMillan's testimony. In addition, $615,000 budgeted for legal fees in connection with the investigation was removed from O & M expenses in this case.

Q. **Would you please explain your involvement in the O & M expense budget process?**

A. As Budget Committee Chairman, I administer the budget process and participate in the review and approval of the O & M budget.

Q. **What is the most appropriate comparison which can be made to determine the reasonableness of the 1990 O & M expense budget?**

A. Before I respond, let me first say that I am fully aware of the Commission's directive to present a "benchmark" comparison using the level of O & M expenses approved in the last case. In Gulf's case, the base amount is the level of O & M approved in our last completed rate case, Docket No. 840086-EI, Order No. 14030. We have done this and, I believe, have fully justified the variances between the 1984 base year and the 1990 test year.

However, you have asked me to address the most appropriate method of measuring the reasonableness of requested O & M expense levels. I feel very strongly that the most appropriate and most realistic method is to examine the reasonableness of the prior year expenditures. One can then compare the amount requested in the test year with the prior year.

In this case, the most appropriate test of the reasonableness of the 1990 O & M budget is to examine the reasonableness of 1989 O & M expenses and compare them with 1990 and review the explanations for the increase. In 1989, we have spent at the level necessary to provide adequate and reliable electric service to our customers. An examination of 1989 expenses and the comparison of 1989 to 1990 is the best measure of the reasonableness of our 1990 O & M budget.

Q. Have you made such a comparison?

A Yes, I have. I will present the 1990 O & M expenses, exclusive of fuel and purchased power, and summarize the explanations for the changes in O & M expenses from 1989 (8 months actual and 4 months projected) to

1990. Those explanations are provided on Schedule 1.

In addition, I am prepared to address the specific explanations for the variances related to Customer Accounting and Administrative and General expenses which are also shown on Schedule 1, page 2. Mr. Lee, Director of Power Generation, is responsible for O & M expenses related to Production. Mr. Howell, Manager of Transmission and System Control, is responsible for O & M expenses related to Transmission. Mr. Jordan, Director of Power Delivery, is responsible for O & M expenses related to Distribution. Mr. Bowers, Director of Marketing & Load Management, is responsible for O & M expenses related to Customer Service and Information and Sales.

In addition to the Schedule 1 analysis, Schedule 2 compares 1989 O & M expenses, escalated by inflation and customer growth (benchmark analysis) to the 1990 budgeted O & M expenses. The 1990 budgeted O & M expenses are $126.9 million, which is $5.9 million or 4.4 percent less than the escalated 1989 expenses.

Q. Mr. Scarbrough, earlier you indicated that you would present testimony relating to the benchmark comparison used by the Commission to measure the appropriateness of increases in O & M expenses. Do you believe use of the benchmark is an appropriate tool for testing the reasonableness of O & M expenses?

A. As long as it is truly used as an analytical tool as the Commission intended, use of the benchmark may be appropriate.

If the benchmark procedure requires that those expenses in excess of the benchmark undergo a more rigid analysis and justification by the Company before they are approved by the FPSC then I think the technique is appropriate. However, the benchmark methodology, as interpreted by some, assumes that customer growth (except for production) and inflation as measured by the Consumer Price Index (CPI), will adequately cover increases in O & M expenses from whatever baseline year is used to the test year. We know this is the exception rather than the rule. A multitude of O & M increases in the utility industry are totally unrelated to either customer growth or inflation. These may take the form of new programs or increases associated with conforming to newly adopted laws or regulations. Moreover the CPI is a measure of increases in the cost of a multitude of consumer items, only a few of which are directly related to the utility industry. The increases in utility related expenses may far exceed those associated with general increases in consumer products across the country.

The biggest fallacy which we see associated with use of the benchmark is the growing tendency of some to advocate its use as an absolute or, at the very least, a strong presumption that if a utility is over the benchmark, the overage should be disallowed. Arbitrary application and the absence of any clear guidelines for determining what constitutes a valid justification of an overage leaves the utilities in this state justifiably apprehensive over the use of the benchmark methodology. Finally, unless the baseline year is representative of O & M expenses required to be expended by the utility to maintain a high quality level of service to its customers, application of the benchmark methodology will render results which are unfairly skewed.

Q. In Gulf's 1984 rate case, Order No. 14030, issued January 25, 1985, the Commission approved 1984 adjusted O & M expenses (exclusive of fuel, purchased power, and ECCR) totaling $80.2 million. Was this amount representative of a normal level of O & M expense for 1984?

A. No. My testimony in the 1984 rate case indicated that the level of O & M expenses included in the original filing for that case was the level necessary for the Company to continue normal operations. I also stated that due to the poor return on average common equity which would result if the expenditures were made and inadequate rate relief was received, the Company had deferred certain expenditures such as turbine maintenance, travel, training, and the hiring of new and replacement employees.

We were chastised for deferring expenses in Order No. 14030, and as a result, the Commission reduced the requested level of O & M expenses by ~~$5.7~~ 5.1 million. This reduction was determined by annualizing the actual expenditures for 1984 through July which were under the level budgeted and needed for normal operations. The Commission also made several adjustments related to the benchmark justification which further reduced the allowed O & M below the level needed for normal operations by approximately ~~$3.7~~ 4.2 million. The total reduction of O & M expenses amounted to $9.~~4~~3 million.

Q. Have you prepared a comparison of 1990 O & M expenses, exclusive of fuel, purchased power, and ECCR, to a benchmark which uses the O & M allowed in Order No. 14030 as the base year?

A. Yes. The comparison of 1990 O & M expenses to the benchmark has been prepared and is included on Schedule 3. The 1990 O & M budget is $5.2 million over the 1990 benchmark.

As I stated earlier, while the benchmark can be a useful tool in performing an analysis of O & M expenses, the selection of the base year has a significant impact on the results obtained by using the benchmark methodology. The use of a base year that is well below the level of O & M expenses needed for normal operations will result in the need to provide extensive and additional justification for a disproportionately large amount of expenditures when analyzing a normal year.

As I have previously mentioned, the level of O & M expenses allowed in Order No. 14030 was $9.4 million below the level required for normal operations. The variance resulting from the application of the benchmark methodology to the 1984 allowed O & M expenses is larger than would have occurred had a normal level of O & M expenses been used as the base. Gulf does not believe that the use of the 1984 O & M expenses allowed in Order No. 14030 as the base is appropriate. Nevertheless, we have calculated the benchmark in compliance with the Commission's directive using the O & M expenses approved in Order No. 14030, with proper adjustments as I will discuss later in my testimony, as the base and provided the necessary justifications.

Q. **Would it be more appropriate to use a base other than the O & M expenses allowed for the 1984 test year in the calculation of the 1990 benchmark?**

A. Yes. Commission Order No. 11498, issued on January 11, 1983, allowed $84.4 million for adjusted O & M expenses (exclusive of fuel, purchased power and ECCR), which is $4.2 million higher than the $80.2 million of O & M expenses allowed for the 1984 test year. The use of the 1983 allowed O & M level as a base results in a benchmark of $130.4 million which is $3.5 million <u>greater</u> than the 1990 budgeted O & M expenses as shown on Schedule 4. The effect of the Commission's directive to use the 1984 allowed O & M as the base has required the Company to provide more detailed justification for a greater portion of our 1990 O & M expenditures than would have been necessary had a normal level of O & M been used as the base year, such as the O & M allowed in our 1983 Rate Case, Order No. 11498.

In Order No. 14030, the Commission stated that:

> Gulf's strategy of intentionally not spending what it professes to need has only served to complicate our examination of what its true and legitimate needs are. It is not a strategy that should be repeated or adopted by others.

In each year since 1984 the Company has heeded this Commission admonishment and Gulf has incurred the level of O & M expenses necessary to operate at a normal level. Applying the benchmark methodology to <u>any base year since 1984</u> yields a benchmark that is <u>greater</u> than the budgeted O & M expenses for 1990.

Q. **Was the application of the benchmark methodology in Gulf's 1984 rate case properly calculated regarding the jointly owned Plant Daniel generating facilities?**

A. No. In Order No. 14030, the benchmark methodology was improperly applied to make two significant adjustments to the O & M expenses related to Gulf's 50 percent ownership in Plant Daniel, which is jointly owned with and operated by Mississippi Power Company (MPC) as Gulf's agent. These adjustments were for transmission line rentals and Gulf's portion of MPC's Administrative and General (A & G) expenses which are incurred solely because of the jointly owned Plant Daniel production facility. The benchmark was calculated by applying the escalation factors to the 1979 base year, which contained O & M expenses for only Gulf owned and operated generating facilities. This benchmark was compared to the 1984 budgeted O & M expenses which included O & M expenses for Gulf operated facilities as well as O & M expenses for the jointly owned production facilities (Plant Daniel) which were operated by Gulf's agent, MPC.

The methodology as applied gave no consideration to the facts that (1) there were not any O & M expenses related to jointly owned facilities in the base year, (2) all O & M expenses for Plant Daniel are production, and (3) all production O & M expenses should be added to the benchmark when the plant is placed in service. The Commission inappropriately disallowed $2.0 million of Plant Daniel Production O & M expenses which Gulf is contractually obligated to pay in order to receive its 50 percent share of the electricity generated at Plant Daniel.

Q. You stated previously that the O & M expenses allowed in Order No. 14030, issued January 25, 1985, were used

as the base for calculating the 1990 benchmark. Have you made any adjustments to the allowed O & M in calculating the 1990 Benchmark?

A. Yes. In Order No. 14030, the Commission disallowed expenditures related to the transmission line rentals and the Administrative and General (A & G) expenses for Gulf's 50 percent ownership of Plant Daniel. We have adjusted the 1990 benchmark calculation to reflect the proper treatment of the costs for transmission line rentals and Administrative and General expenses incurred exclusively for Plant Daniel Production facilities.

Q. Please describe the adjustment made in Order No. 14030 related to Plant Daniel transmission line rentals.

A. The Commission excluded $425,000 of expenses for rentals of transmission lines necessary to transmit Gulf's 50 percent share of the Plant Daniel generation from Mississippi to Gulf's service territory. The disallowance was based on the calculation of the benchmark in which Gulf escalated 1979 base year transmission expenses by customer growth and inflation in accordance with benchmark methodology. We then justified the variance between the benchmark and the 1984 budgeted expenses by using transmission line rentals which were not included in the 1979 base. In 1984, this variance amounted to $1.4 million.

The Commission indicated that it was not proper to escalate the base year by customer growth and inflation and then ask for recovery of the line rentals. The Commission stated that "...we find the transmission line rentals to be comparable to new generating plants in purpose and shall disallow that portion of the requested expense that exceeds growth for inflation alone." I agree that transmission line rentals are comparable to new generating plants in purpose and should be treated in a like manner. I disagree with the Commission's position that Gulf's 1984 benchmark should have been reduced by customer growth in order to attain the proper treatment. The disallowance was calculated by determining the customer growth component of the 1984 benchmark, which amounted to $425,000. Schedule 5 shows the calculation of the Commission's adjustment of $425,000 related to transmission line rentals. The transmission line rentals are required in order for Gulf to receive the electricity generated by the new Plant Daniel facility and should be allowed in the same manner as the new capacity. The rentals should be added to the calculated benchmark prior to the determination of the benchmark variance.

Q. **Please compare the treatment of transmission line rentals in Order No. 14030 with the proper treatment.**

A. Gulf's 1979 expenses in Account 567, Rents, included $6,000; hardly an amount representative of the annual rental of a transmission line. The remaining expenses in the transmission function were for the normal operation and maintenance of Gulf owned transmission facilities for a total of $1,444,000. Gulf escalated the total 1979 expenses by customer growth and inflation and compared this amount to the projected 1984 expenses. The variance was explained primarily by $1,381,000 of transmission line rentals.

The transmission expenses included in 1979 represent the operation and maintenance costs of only Gulf owned transmission facilities. All depreciation expenses associated with those facilities are reflected in Account 403, Depreciation Expense, and the carrying cost of the investment is included in base rates through the rate of return calculation. The use of customer growth and inflation to calculate the benchmark is proper to cover the operation and maintenance costs of any new Gulf owned transmission facilities. However, rentals for transmission lines not only reflect the operation and maintenance costs of the rented facilities but also include depreciation and carrying costs of the owning utility. For that reason, it is not proper to conclude that the benchmark calculated only on the expenses associated with Gulf owned transmission facilities would be sufficient to cover the costs associated with the rental of transmission lines from others.

Schedule 5 contains the calculation of the Commission's adjustment which removed the customer growth component from the 1984 benchmark related to transmission. Also included on Schedule 5 is a 1984 benchmark calculation related to the transmission function which reflects the proper treatment of transmission line rentals. As shown, the proper treatment of transmission line rentals in the 1984 benchmark would have resulted in Gulf's being only $111,000 over the benchmark.

Q. **Please describe the treatment of transmission line rentals in the calculation of the 1990 benchmark.**

A. Schedule 6 contains a detailed calculation of the 1990 benchmark for transmission expenses. We have treated transmission line rentals in the same manner as we would treat a generating unit in calculating the 1990 benchmark. The transmission expense allowed in Order No. 14030 was divided between transmission line rentals and other transmission expenses. Other transmission expenses were escalated using customer growth and inflation in keeping with the benchmark methodology. In calculating the 1990 benchmark for line rentals, we added the Commission's transmission line rental adjustment of $425,000 as shown on Schedule 5, to the 1984 allowed amount for line rentals to arrive at the proper base. This base was then escalated by inflation only to calculate the 1990 benchmark for transmission line rentals. The total transmission benchmark for 1990 amounts to $7.2 million. The 1990 budgeted transmission expenses total $7.3 million resulting in the transmission function being over the benchmark by $143,000. Justification for this benchmark variance is included in MFR C-57.

Q. **How is the inclusion of Plant Daniel transmission line rentals in Gulf's O & M expenses justified?**

A. It is obvious that a means of transporting the power from Plant Daniel in Mississippi to Gulf's service area is required. Several options were evaluated to determine which option would be the most economical for Gulf to pursue. Rental of the transmission lines from Mississippi Power Company and Alabama Power Company was determined to be the most economical option. The testimony of Mr. Howell addresses the justification for renting the necessary transmission lines rather than selecting the other available alternatives.

Q. **Please describe the adjustment made in Order No. 14030 related to Plant Daniel Administrative and General expenses.**

A. The Commission excluded $1,573,000 of the Administrative and General expenses which are incurred solely as a result of Gulf's 50 percent ownership in Plant Daniel. The justification for the reduction was:

> ...we reject Gulf's attempted justification for this amount in excess of the CPI and customer growth benchmark. We reject it, not because we find the amount to be unreasonable or imprudent, but because we find that Gulf has already included this amount in a previous justification. This is so because we find that A & G for new plant is accounted for in the base O & M and to accept it as additional justification would result in counting this expense twice.

The A & G expenses for the new plant (Daniel) was not accounted for in the base O & M.

Q. Do you agree with the adjustment made by the Commission in Order No. 14030 relating to Plant Daniel A & G expenses?

A. No. Here again, the Commission applied the rationale that customer growth provides for sufficient increases in the base year level of A & G expenses to offset the increase in A & G expenses occasioned by the increase in new generating plant. This rationale is true for the addition of plant owned and operated by Gulf, as the base year includes A & G expenses of a similar nature. However, in the case of Plant Daniel, Gulf entered into a contract with MPC whereby MPC operates Plant Daniel for the benefit of Gulf and MPC. Under this contract Gulf is allocated a portion of MPC's A & G expenses as well as 50 percent of the production expenses of Plant Daniel.

The A & G expenses for our 50 percent ownership of Plant Daniel are incurred by Gulf exclusively for the operation of the plant by MPC. There were no Plant Daniel A & G expenses included in the 1979 base year. It is inappropriate to assume that an adjustment for customer growth when applied to a base year which included only Gulf A & G expenses would cover expenses for the A & G billed to Gulf by MPC for Plant Daniel.

Q. Please describe the treatment of Plant Daniel A & G in the calculation of the 1990 benchmark.

A. We have separated A & G expenses into production-related A & G and other A & G. Schedule 7 contains a detailed calculation of the 1990 benchmark for Administrative and General expenses. The A & G expense allowed in Order No. 14030 was allocated between production-related A & G and other A & G. The production-related A & G is composed of a portion of Gulf's pension and benefit expenses and property insurance expenses as well as the A & G costs billed to Gulf by Mississippi Power for the operation of Plant Daniel. Gulf's pension and benefit expenses were allocated to production based upon production labor to total O & M labor, and the property insurance expenses were allocated based upon insurable values. These components of A & G expense were included as production-related A & G since the level of these expenditures would fluctuate in direct proportion to the addition of new Gulf operated generating plant. Gulf's portion of Plant Daniel A & G is also included as production-related A & G.

In calculating the 1990 benchmark for production A & G, we have added the Commission's adjustment for Plant Daniel A & G to the allowed production-related A & G to arrive at the proper base. This base was then escalated by inflation only to calculate the 1990 benchmark for production-related A & G. The 1990 benchmark for other A & G expenses was calculated by applying the customer growth and inflation factors to allowed other A & G expenses. The 1990 benchmark for A & G was calculated to be $39.2 million. The 1990 budgeted A & G expenses, adjusted for the appropriate Net Operating Income adjustments, total $38.4 million which is $.8 million less than the benchmark.

Q. **Why did you add the 1984 Daniel A & G disallowance to the Benchmark?**

A. Gulf added the 1984 Daniel A & G expense disallowance to the production-related A & G benchmark for three reasons: (1) The Commission did not rule that the Plant Daniel A & G expenses were either unreasonable or imprudent; (2) the

Commission authorized the inclusion of Plant Daniel in rate base and the recovery of the production expenses in the last rate proceeding, and the disallowed A & G expenses were exclusively for production; and (3) these disallowed A & G expenses are a specific component of the Plant Daniel operating agreement between Gulf and Mississippi Power Company.

Q. **Please summarize the justification for recovering the Plant Daniel A & G expenditures from Gulf's customers.**

A. Gulf has a contract with MPC which allocates to Gulf a portion of MPC A & G expenses and 50 percent of the Production expenses of Plant Daniel. The A & G expenses for our 50 percent ownership of Plant Daniel are solely for the operation of the plant by MPC. The billings to Gulf by Mississippi are audited by the Internal Auditors of Southern Company Services on a periodic basis in order to determine whether such billings are in compliance with the terms of the operating agreement.

The approval by the FPSC of Plant Daniel capacity in Gulf's rate base in the last rate case, as well as the allowance of the production O & M expenses, recognizes that Plant Daniel costs are properly recoverable from Gulf's customers. Since the A & G expenses are a necessary component of the operating cost of Plant Daniel, they should also be recoverable from Gulf's customers.

Q. **How have you handled the O & M expenses associated with the addition of Plant Scherer for benchmark purposes?**

A. In calculating the 1990 benchmark, we have treated the O & M expenses for Plant Scherer the same as for Plant Daniel. We have included the Production O & M expenses, the A & G expenses for Plant Scherer billed to Gulf by Georgia Power, and the transmission line rentals billed to Gulf which are necessary for Gulf to receive the electricity generated by our 25 percent interest in Georgia Power's Plant Scherer Unit No. 3. These are expenses incurred by Gulf solely for the new generating capacity at Plant Scherer Unit No. 3 and as such should be included in the benchmark. This treatment is consistent with the treatment specified by the Commission in Order No. 14030 and given to our 50 percent ownership in Plant Daniel which we previously discussed.

Q. **Have you made any other adjustments in calculating the 1990 Benchmark?**

A. Yes. We have made an adjustment related to certain Customer Service and Information (CS&I) expenses which were recovered through the Energy Conservation Cost Recovery (ECCR) mechanism in 1984 but are budgeted to be recovered through base rates in 1990.

Q. **How were CS&I expenses handled in the 1984 case?**

A. In 1984, Gulf budgeted $5.4 million of CS&I expenses. Our original rate filing with the FPSC in that case indicated that $2.1 million of conservation expenses would be recovered through the ECCR mechanism and the remainder of the conservation expenses would be recovered through base rates. The Commission ruled that all conservation expenditures should be recovered through ECCR and, as directed, Gulf moved $1.6 million from base rates to ECCR. These expenses were not disallowed. There was simply a change in the mechanism through which these expenses were to be recovered from our customers. Consequently, the Commission in Order No. 14030 provided for the recovery of $1.5 million of CS&I expenses through base rates and for the recovery of $3.7 million of CS&I expenses through the ECCR clause.

Q. **What has happened during the period 1984 through 1989 regarding the level of Customer Service and Information (CS&I) expenditures being recovered through ECCR?**

A. Since 1984 Gulf has continued to budget for and recover conservation expenses from our customers through the ECCR mechanism. However, due to changes in the conservation marketplace and FPSC rulings that certain of Gulf's programs were more customer service in nature, there has been a shift in the recovery of CS&I expenses from ECCR back to base rates. The Commission did not disapprove the programs but rather determined that they were no longer appropriately recovered through ECCR. Once again, the result was a shift in the method by which CS&I expenses should be recovered from our customers.

Q. **Please describe the adjustment that you made in calculating the CS&I benchmark.**

A. As mentioned above, the FPSC has ruled that the expenses associated with certain programs which were designated to be recovered through the ECCR mechanism in the 1984 rate case should no longer be recovered through that mechanism in 1990. The programs themselves were not disapproved. In order to properly calculate the 1990 benchmark it was necessary to reflect in the benchmark the change in the method of recovery of the CS&I expenses of certain programs. We identified the following programs which were designated for recovery through the ECCR clause in the 1984 rate case: (1) Gulf's Good Cents - New; (2) Good Cents - Improved; (3) Energy Education; and (4) Seminar programs and added the 1984 budgeted amounts for these programs to the CS&I expenses allowed to be recovered through base rates in Gulf's 1984 rate case. The affect of this adjustment is to determine a base year to be used to calculate the 1990 benchmark for CS&I expenses that is consistent with the recovery mechanisms being used to recover those CS&I expenses. This adjusted base level of CS&I expense was then escalated by customer growth and inflation to calculate the 1990 CS&I benchmark.

Q. **Why was this adjustment made?**

A. This adjustment was made to eliminate the effect of the method of recovery of CS&I expenditures on the 1990 benchmark. Mr. Bower's ~~Exhibit~~ Schedule No. 3 shows that, in total, Gulf's CS&I expenses are under the benchmark. However, without adjusting for the recovery mechanism in the base year, the benchmark methodology could artificially create benchmark variances. Of course, the adjustment for the recovery mechanism change does not eliminate Gulf's need to justify the CS&I programs.

Mr. Bower's testimony provides justification for the programs included in the CS&I function in 1990. The programs are justified on their merits without justifying benchmark variances due to a shift in the recovery mechanism.

Q. Who is responsible for addressing the expenditures that exceed the 1990 benchmark as shown on MFR C-57?

A. The 1990 non-fuel O & M expenses are compared to the benchmark for each of the seven functional areas Schedule 8 contains a listing of all benchmark variance justifications included in MFR C-57 and the witness responsible for providing the justification.

Q. Have you compared Gulf's O & M salaries to the benchmark?

A. Yes. Schedule 9 of my exhibit contains the benchmark calculations related to salaries for all functions. As shown on Schedule 9, Gulf's total salaries are $912,000 more ~~$1.3 million less~~ than the benchmark because ~~even though~~ Gulf's Production, Sales, and Administrative and General functions exceed the benchmark for salaries.

Q. Please elaborate on the reasons for the increases in salaries.

A. Gulf's compensation program is designed to achieve the two primary objectives of (1) attracting, motivating, and retaining qualified employees and (2) appropriately rewarding employee performance. In order to attain these objectives, Gulf strives to maintain pay levels at a competitive position in the job market while at the same time ensuring internal equity and individual recognition. Gulf regularly monitors its pay practices in relation to other companies through industry surveys.

During the 6-year period 1985-1990, Gulf's compound average annual merit increase for the group of employees exempt from the wage-hour law was 4.36 percent and for the non-exempt group was 3.87 percent. During the same period, the compound average annual general and step increases for the union group were 3.73 percent. In addition to merit increases, Gulf included in the 1990 budget 4.00 percent of the salaries of exempt and non-exempt employees for the Performance Pay Plan. The purpose of the plan is to focus the attention and efforts of the employees on achieving goals which have direct and significant influence on individual, organizational, and corporate performance. By attaining individual, organizational, and corporate goals, employees will be eligible to receive a one-time, lump-sum incentive award. Incentive awards are not added to base pay and must be earned every year.

Gulf's compound average annual exempt merit increase is 4.36 percent for the period 1985-1990, inclusive. For this same period, the compound average annual merit increase of several utilities and industries surveyed is 5.30 percent. Gulf's entry rate salary level for non-exempt employees is compared to the local businesses with which we compete for employees. In 1989 and projected 1990, Gulf is at 91.10 percent and 88.70 percent, respectively, of the average entry rate. The average annual general wage increase for Gulf's union group during the period 1985 through projected 1990, inclusive, is 3.73 percent compared to an increase of 3.74 percent in the Consumer Price Index for the same period. In addition, Gulf's average maximum journeyman lineman wage rate is 2.90 percent below the average for southeastern electric utilities. Gulf's salary and wage levels are reasonable when compared with other businesses with which we compete for employees, and our compensation program continues to meet its prime objectives.

Q. Please identify the major items comprising the benchmark variance related to the Customer Accounts function.

A. As shown on Schedule 3, the Customer Accounts expenses are under the benchmark by $1.6 million. Improvements in the processing of customer bills and increased computer enhancements have allowed Gulf to hold these expenses significantly below the benchmark level.

Q. What is the amount of the benchmark variances related to production-related A & G and other A & G expenses?

A. As shown on Schedule 3, production related A & G expenses are under the benchmark by $790,000 due primarily to a reduction in the property insurance attributable to production.

Other A & G expenses are over the benchmark by

$43,000 due to salary increases. I have previously justified Gulf's compensation philosophy and the overall salary increases for the period 1985 through 1990. Detailed justification is provided in MFR C-57.

Q. **Have you compared Gulf's level of O & M expenses with other utilities?**

A. Yes. We routinely develop several indicators with which we compare Gulf's O & M expenses, excluding fuel and purchase power, to other utilities throughout the southeast. Schedule 10 is a graph which compares Gulf's O & M expenses less fuel and purchased power per kilowatthour (kwh) generated to the average for the Southeastern Electric Exchange (SEE) companies for the period 1983 through 1988. As shown, Gulf's O & M expense per kwh generated is significantly less than the SEE average. Schedule 10 graphically depicts the reasonableness of Gulf's O & M expenses when compared to other electric utilities in the southeast.

Q. **Mr. Scarbrough, does this conclude your testimony regarding the benchmark justification?**

A. Yes, it does. However, I would like to emphasize once more that detailed justifications are provided in MFR C-57. I would also request that the Commission carefully consider Gulf's O & M expense budget process and the importance which we place on keeping our O & M expenses as low as possible while maintaining our historically high quality of service. We feel very strongly that the budgeted O & M expenses in 1990 are reasonable and necessary if we are to continue to maintain this reliable level of service for our retail customers.

Q. Please discuss the purchase of the Plant Scherer Common Facilities.

A. Georgia Power Company sold their undivided ownership in Plant Scherer Common Facilities to joint owners Oglethorpe Power Corporation (OPC) and Dalton in 1980 and 1977, respectively. On November 19, 1987, Gulf Power Company purchased its 6.25 percent (four unit plant - 25 percent x 25 percent ownership in one unit) proportionate share of the production plant facilities common to all four Scherer generating units commensurate with its previously acquired 25 percent ownership in Unit No. 3 of Plant Scherer. Gulf purchased its share of the common facilities from OPC and Dalton. Gulf paid a net price of $29,131,850 for these facilities. The original cost of the facilities was $24,266,406. The difference of $4,865,444 represents the interest (carrying costs) incurred by OPC and Dalton on the facilities purchased by Gulf until the date of the sale to Gulf. In addition, Gulf paid legal fees of $18,687 in connection with the purchase.

Q. How was the purchase of the Plant Scherer common facilities recorded on Gulf's books?

A. We recorded the purchase in accordance with the Uniform System of Accounts published by the FERC and adopted by the FPSC. Electric Plant Instruction No. 5, included therein, requires that when electric plant constituting an operating unit or system is acquired by purchase, the costs of acquisition ($29,131,850), including expenses incidental thereto ($18,687) properly includible in electric plant, be charged to Account 102, Electric Plant Purchased or Sold. The required accounting for the acquisition continues as follows:

(1) The original cost of plant ($24,266,406) is credited to Account 102, Electric Plant Purchased or Sold, and concurrently charged to

the appropriate electric plant-in-service accounts.

(2) The accumulated depreciation ($3,796,376) and amortization (estimated if not known) applicable to the original cost of the properties purchased is charged to Account 102, Electric Plant Purchased and Sold, and concurrently credited to the appropriate account for accumulated provision for depreciation or amortization.

(3) The amount remaining in Account 102 ($8,680,507), Electric Plant Purchased or Sold, is then closed to Account 114, Electric Plant Acquisition adjustments.

The Federal Energy Regulatory Commission accepted the Company's proposal to clear Account 102, Electric Plant Purchased or Sold, including depreciation, on November 2, 1988.

Q. What does the acquisition adjustment of $8,680,507 represent?

A. The $8,680,507 acquisition adjustment amount is made up of three components: interest or carrying cost in the amount of $4,865,444; Accumulated Depreciation $3,796,376; and A & G Cost (legal) in the amount of $18,687.

Q. **Is it reasonable and prudent to include the acquisition adjustment of $8,680,507 in rate base?**

A. Absolutely. Unlike other circumstances which have been reviewed in the past by the Commission, particularly in the area of water and sewer utilities, the selling utilities made no profit on the sale of the common facilities to Gulf.

The Commission should not rely on a required accounting methodology in determining the prudency of a purchase but should compare the value of the asset received with the total amount paid for the asset in determining the appropriate amount to approve for recovery. To illustrate this point and the significant value to Gulf's customers, it is estimated, as shown in Mr. Parson's testimony, that Plant Scherer's Unit No. 3 1990 depreciated book cost including common facilities, of $760 per kilowatt is well under the estimated ~~$1,120~~ $1,163 per kilowatt cost to construct to a new coal unit in 1990, a savings of approximately ~~$76.3~~ $85.4 million.

Q. **Please explain the non-utility adjustment made to the capital structure described by Mr. McMillan in** his testimony?

A. In Gulf's 1984 rate filing, the Commission removed the Company's non-utility investments directly from equity, which was contrary to staff's own position in the staff recommendation. Staff acknowledged that each expenditure made by the Company has a multitude of effects on the Company's financial position which are impossible to quantify and that funds cannot be directly traced. No business can operate in today's competitive environment by financing with equity alone and expect to earn a reasonable return. The majority of our non-utility investments are related to Appliance Sales and Service, and a large percentage of that is the accounts receivable for merchandise sales. Recognizing that some items in the capital structure, such as customer deposits, may not be related to non-utility activities, we have adjusted the non-utility activities from the capital structure using long-term debt, preferred stock, and common equity sources of capital as a reasonable proxy for the cost of funds. As indicated in Dr. Morin's testimony, Gulf's non-utility activities do not increase the Company's cost of capital.

Q. What is the revenue deficiency in the test period brought about by the difference in the earned overall jurisdictional rate of return of 6.60 percent with present rates and the 8.34 percent requested?

A. The revenue deficiency is $26,295,000, as shown on Schedule 17 of Mr. McMillan's testimony.

Q. Would you please summarize your testimony?

A. Yes. As shown in my testimony, and the testimony of the other Company's witnesses, as well as the supporting documentation, Gulf Power needs and is entitled to the rate relief it is requesting. Without the interim and permanent rate relief requested, it will be impossible for the Company to sustain any reasonable level of financial integrity in the future. The need is immediate. We have been instructed by this Commission in the past not to cut expenses below that level necessary to provide quality reliable electric service to our customers. We have not done so. At the same time, our shareholders do not and should not expect to earn below a reasonable level on their investment in our Company. They are doing so. As the Chief Financial Officer of Gulf Power Company, it is my responsibility to see that the price of our product is sufficient to sustain the required level of service to our customers and to provide a reasonable level of return to our shareholders. We have, in our filings for interim and permanent relief, shown the need for the requested increase in our rates.

Q. Does this conclude your testimony?

A. Yes.

Q (By Mr. Holland) Mr. Scarbrough, have you prepared a summary of your testimony?

A Yes.

Q Please proceed.

A Yes.

The purpose of my testimony is to explain the need for immediate rate relief and to discuss the rate relief requested based on the 1990 test year approved by this Commission.

Gulf Power Company last received an increase in retail rates in December 1984, five years ago. Since 1984 Gulf and its investors have added $298 million of rate base items necessary to serve our retail customers. This is an increase in rate base of 48% since our last rate case.

Also, the Company has incurred significant increases in operating and maintenance expenses during that period, primarily due to inflation and customer growth. Offsetting the impact of these increased capital expenditures and O&M expenses to a significant degree, were benefits derived from extensive cost control efforts, increased nonterritorial sales, a declining cost of money, and a decrease in the corporate federal income tax rate, from 46% to 34%.

All of these changing factors were

concurrently reflected in the monthly surveillance reports that are filed by Gulf with the Florida Public Service Commission. These reports did not indicate a need for a significant adjustment in Gulf's retail rates until 1989.

The addition of this rate base, since the 1984 rate case, combined with the increases in O&M expenses during that period, created a significant 1989 retail revenue deficiency. This was not a surprise to Gulf Power Company. Since our last retail rate increase in 1984, our long-range financial forcasts have indicated a need for a substantial increase in retail revenues in 1989. Nevertheless, our Company has always placed great emphasis on attempting to find ways to avoid filing for rate relief.

Despite these efforts, and in rder to maintain our high quality of service to our customers in a reasonable level of financial integrity, Gulf requested an increase in retail rates of $25.8 million on November 14th, 1988.

Even though the Company's financial condition continued to deteriorate as forecasted, Gulf withdrew its request for rate relief on June the 9th, 1989, because of the difficulties encountered in conducting a rate case during a grand jury investigation.

At that time, the Commission told -- the Company told the Commission we would file another case when the situation was resolved. As stated by Mr. McCrary, investigation by the grand jury as it relates to Gulf Power Company was resolved on October 31, 1989.

As anticipated, Gulf's earnings have continued to deteriorate to a seriously unreasonable level. With present rates, the adjusted jurisdictional return on average rate base is projected to be 6.60% for 1990. This provides a return on the average common equity, which is the risk capital component, of 7.52%, which is significantly below the 13.5% determined by Dr. Morin to be appropriate for Gulf Power Company.

In fact, Gulf's actual return on equity for the 12 months ending April 1990 was only 8.78% as reflected in the monthly surveillance report filed with this Commission. This return is only slightly higher than the return any individual can get today on a government insured investment. As the chief financial officer of Gulf Power Company, it is my responsibility to see that the price of our product is sufficient to sustain the required level of service to our customers and to provide a reasonable level of return to our stockholders.

Therefore, Gulf Power Company is requesting additional revenues of $26,295,000 to achieve an overall rate of return of 8.34%. Without this increase, Gulf cannot restore its financial integrity.

That concludes my summary.

MR. HOLLAND: Tender Mr. Scarbrough for cross examination.

MR. BURGESS: Commissioners, I'd like to start with a question that Mr. Shreve had asked of Mr. McCrary, and it involves executive salaries and compensation. Mr. Holland has provided us with copies from 10K, is that correct?

WITNESS SCARBROUGH: Yes.

MR. BURGESS: For '86 through '89.

COMMISSIONER GUNTER: Do we all have it?

MR. BURGESS: No, you don't have it, we just got them this morning. And what I'm getting at is how you would like to proceed. What I was intending to do was sort of use this to develop information which I was going to seek, probably necessarily through some kind of late-filed, only because I would be surprised if Mr. Scarbrough has the detail that we were going to look for.

I could either make copies of this and pass them out so that we all have something to look for, in which case I would defer cross, if I could, and come back, perhaps after the Air Force has finished their cross examination, or something like that. Or simply go through the rest of the cross that I have and deal with it later. However you would like to proceed on that.

COMMISSIONER GUNTER: Well, in looking at the 10Ks, if I'm not mistaken, somebody, I don't know who to ask the question to, but the 10Ks is a summation of total cash benefits that would be received by any executive employee -- and in you all's case, I believe in reviewing the 10K, it was three of the senior executives getting total cash benefits, wasn't that right?

WITNESS SCARBROUGH: It would be five, the top five.

COMMISSIONER GUNTER: Was it five?

WITNESS SCARBROUGH: Yes.

COMMISSIONER GUNTER: I'm sorry, I thought it was -- well, however many, but that's total cash. And I think the thrust of the questioning yesterday had to do with the base cash salary and what the components were, what the individual components were that arrived at the total cash benefits as shown on the 10Ks.

MR. BURGESS: Exactly, Commissioner. And then we were going to ask about noncash compensation and then talk about the projections of it. But this --

COMMISSIONER GUNTER: If that's the thrust that you're trying to go to, the 10Ks are not going to get there.

MR. BURGESS: You're right, other than it is just going to be what would be included in this breakdown, just kind of as a guide to what we were seeking to get. But you're right, that is a possibility, simply construct here, theoretically, some type of exhibit that would present the information that we're seeking.

COMMISSIONER GUNTER: Sorry, I thought that was what was asked for yesterday.

CHAIRMAN WILSON: Why don't you proceed with your other cross examination and have somebody from Staff go ahead and duplicate those and get to it at the end of cross examination.

MR. BURGESS: All right.

And perhaps we may not need, we're going to go ahead and make the copies, in the event the Commission might find them useful.

Apparently Mr. Scarbrough, I think, can put together just from discussion the information we're seeking in some type of late-filed exhibit.

WITNESS SCARBROUGH: Steve, let me ask you about that. Is this the last time we're going to talk about this as fa- as -- before we prepare this?

MR. BURGESS: No, I don't think so.

WITNESS SCARBROUGH: Okay. Okay. I just want to make sure we don't prepare something that is not what you want.

MR. BURGESS: Okay.

CROSS EXAMINATION

BY MR. BURGESS:

Q The first question I have, Mr. Scarbrough, relates to rate case expense, Issue 56 in the Prehearing Order.

When do you anticipate, when would you anticipate rates would be established or implemented as a result of the hearings that we're engaged in right now?

A I would assume sometime in October.

Q In October of '90?

A Of '90.

Q And when were rates last implemented, a change in rates -- a change in base rates last implemented?

A I think it was December, 1984.

Q 1984. So it will have been about six years since a change in base rates, is that correct?

A That's correct.

Q And you are seeking to amortize any rate case expense that's allowed through this base rate change over two years, is that correct?

A That's correct.

CHAIRMAN WILSON: What was the amortization period allowed in the last rate case?

WITNESS SCARBROUGH: Two years.

Q (By Mr. Burgess) You would agree, would you not, that while recognizing that all expenses fluctuate, if you establish an amortization period that's shorter than the actual time for which rates are collected, that there is something of and over amortization of that individual item, is there not?

A It would be but, you know, that is not the case in this particular event here. And our assumption is that the two-year amortization is appropriate.

Q But if it turns out to be that you stay out longer, then you've got an expense that's continuing to be in the rates that were established, to be buried somewhere in the establishment of the rates that no longer exist? I mean, it's already achieved full recovery, is that correct?

A That's correct. On the other hand, if you have another rate case prior to that time, then you don't fully recover all those rate case expenses that you get in that rate case.

Q And you had a two-year amortization last time, and you've been out for six years?

A That's correct. However, I would just point out, we chose the two years. We didn't just pull this out of a hat. We chose the two years for two reasons: Number one, that's what the Commission last allowed; and, primarily, number two, is you look over the last ten years we've had five rate increases and five into ten gives you two, and that's how we arrived at two years. We had a rate case in 1979, in 1981, '84.

Q Some of those rate cases you received increases that were substantially below that which you sought, is that not true?

A Yes. Nevertheless, that didn't reduce the amount of th cost of asking for the rate increase.

COMMISSIONER BEARD: I've got to back up to something you said. Your comment was that to the extent that, for example, the hypothetical you amortize over three years, and you come back for a rate case in two years, you just eat that?

WITNESS SCARBROUGH: Well, that's correct.

COMMISSIONER BEARD: I don't think that is.

WITNESS SCARBROUGH: Well, you eat it unless it's included somehow or another in your test year.

COMMISSIONER BEARD: Well, I don't --

WITNESS SCARBROUGH: In other words --

COMMISSIONER BEARD: I haven't done an electric rate case before. I've done a lot of water and sewers and we deal with unamortized rate case expense all the time.

WITNESS SCARBROUGH: Let's put it this way: There is a method where you would not lose it. There's a method where you would lose it. If you include the unamortized balance in your rate base, and those kind of things, you could recover.

COMMISSIONER BEARD: So it's not automatically eat?

WITNESS SCARBROUGH: Not automatically.

COMMISSIONER BEARD: That's what I understood.

Q (By Mr. Burgess) But it is automatic that you'd overamortize if you were out longer than the duration set for the amortization of the rate case expense? There's no vehicle to recapture that, is there, unless you put it in some type of account whereby you pay it back the next rate case?

A That's probably true.

CHAIRMAN WILSON: What is the period of time under the revised Chapter 366 from last year for filing of minimum -- I mean, how often are you going to regularly be in front of the Commission?

WITNESS SCARBROUGH: Well, we would have had to be in front of the Commission in 1990 irrespective of this rate case, because we would have been required -- I think we were the first ones required to file MFRs, notwithstanding this rate case. so we would have been before the Commission in any event in 1990, without this rate increase.

CHAIRMAN WILSON: When will be the next time you'll be required to be in front of the Commission under those statutes?

WITNESS SCARBROUGH: My understanding, it's 1994.

Q (By Mr. Burgess) Mr. Scarbrough, can I get you to look at Issue 69 in the Prehearing Order, Page 38?

COMMISSIONER GUNTER: 69?

MR. BURGESS: Yes, sir.

Q (By Mr. Burgess) This is just verification of a number. Is 263,000 the amount of the A&G expenses, production-related A&G expenses, related with Plant Scherer?

A Yes.

Q Okay. Then if I could get you to move on to Issue No. 90 on Page 45.

A Okay.

Q Would you please explain the adjustment that was made that's at issue here, or would you like a more specific question? I don't know whether that troubles you, the generality.

A You mean the --

Q The adjustment. Did you make an adjustment for an overall accrual of uncollectibles?

A Yes; yes.

Q And is it correct that --

A Wait a minute. When you say make an adjustment for an overaccrual, I suppose that was the case. We felt like we were accruing the right amount each year, and what we did was change the method of doing it. We went to an aging method, and we went to the aging method, which we felt was a better method. We determined that we had about $800,000 too much in accumulated reserve for allowing for bad debts, and we adjusted that out.

Q So the way you adjusted that out was basically take a one-time shot, I suppose, to correct the excess that was in the reserve balance?

A That's correct. Whenever we debited the reserve and credited expense for $813,000, which actually gave us a negative amount for 1989.

Q A negative reserve balance?

A Expense.

Q Negative expense for '89. And according to your filing in the tax savings refund for the 1989 billings, you don't see a refund as being proper, is that correct?

A Not hardly, because we earned 10.81%.

Q So this will basically be a negative expense that will be reflected in a year that will not -- this negative expense will not go back to the ratepayers, so to speak, is that correct?

A Not for 1989. Well, I say it won't. I would assume that it wouldn't, but I reckon there's always that potential.

Q Based on Gulf's filings? I mean, it might be challenged by certain parties, but --

A Probably you, but in any event -- on the other hand, though, when you look at, let's say, 1985, we were allowed -- I don't remember the exact figure, but it was in the neighborhood of a half-million dollar expense, we wrote off something like -- (Pause) 1985 our bad debt expense allowed was $523,000. That's what we recovered from the customers in '85 as a result of the '84 rate case. We wrote off $622,667. The next year, 1986, we also recovered $523,000 from our customers as a result of the 1984 case, which was the amount allowed, and we wrote off $867,258. So this thing cuts both ways.

Q And that's part of -- those expenses that you cited are part of what led to the excess in the reserve, is that correct, that you then wrote off in 1989?

A The write-offs and the accruals together, when you take the write-offs and the accruals, of course the accrual increases the reserve, the write-off decreases the reserve. When we got to 1989, changed the method in the aging of the accounts receivable, we determined that we had, based on that aging, we had $813,000 too much in the reserve.

Q Okay, I'm sorry. The numbers you read off for 1985 and 1986 were write-offs and not the accrual amount, is that correct?

A I read both. What we --

Q The larger of the two amounts were the write-offs?

A Wait a minute. You're trying to compare accrual -- see, one time you're trying to state what I'm going to recover in 1989 from the customer, but you can't do that. You can't compare the accrual to the write-off. If you're going to start going like you're trying to do, compare what I'm going to recover from the customer, you've got to back and see what I really recovered, not what I accrued in 1985. What I read off was what I recovered from the customer, not what I accrued.

Q I'm afraid you're misunderstanding what I'm trying -- what I'm trying to do is understand your testimony now. I'm not suggesting anything from the testimony presented by our witnesses. I'm simply trying to find out what you were saying. And the numbers you read off were the accrual amount as a result of amount allowed.

A Let me read you the accrual amount. If for 1985 we were allowed 523, we accrued 592,188 and we wrote off 622,667.

I was anticipating your point there, I'm sorry.

CHAIRMAN WILSON: That was for '85?

WITNESS SCARBROUGH: Yes, sir.

CHAIRMAN WILSON: What about '86?

WITNESS SCARBROUGH: '86 we recovered 523,000.

CHAIRMAN WILSON: Is that your accrual?

WITNESS SCARBROUGH: No, sir. That's what was approved in the '84 case. We accrued 969,307, and we wrote off 867,258.

Q (By Mr. Burgess) And when you say "recovered", what you're saying is that amount was included in the previous base rate case?

A That's exactly right. Which is what we recover, or we can recover. That's what the base rates are set on.

Q Well, that's assuming all other factors remain constant.

A Just for that particular piece only by itself.

Q Right. And not recognizing the flow from one expense into another or revenues --

A Recognizing anything --

CHAIRMAN WILSON: Whoa, whoa, whoa. For the court reporter and for my sake, let's have a question, and when the question is over, then let's have an answer, and when the answer is over, then we can have another question.

MR. BURGESS: Yes. That's a point well taken. I apologize for my part -- I aplogize for Mr. Scarbrough, too. (Laughter)

Q (By Mr. Burgess) Was there a possibility -- would it be an alternative, alternatively proper to have dealt with the excess reserve on an ongoing basis.

In other words, rolled it in as into a factor into the accrual for the future?

A Beginning at what point in time?

Q Beginning at 1989, beginning at the point at which you changed the accrual method.

A The entry we made was the absolute way, we changed the method of doing it and based on that method we got the reserve balance right. That's the only way to do it. We could have done it --

COMMISSIONER BEARD: Time out a minute. Time out on minute. I want to confess ignorance here and get a little help. I understand recovered is actually the dollars you got back from the ratepayers.

WITNESS SCARBROUGH: Yes, sir.

COMMISSIONER BEARD: Help me understand the relationship of accrual and you wrote off.

WITNESS SCARBROUGH: Well, what we put on our books many times is different than what the Commission approves.

COMMISSIONER BEARD: I understand that. I understand recovered, that's fairly simple for me.

WITNESS SCARBROUGH: What do you do in a reserve for bad debts? You try to estimate in any particular year how much of your revenues for a particular year, let's say '86, are going to be uncollectible.

COMMISSIONER BEARD: And that's what you accrue on the books?

WITNESS SCARBROUGH: And you charge that to expense and put it in the reserve, and let's say it was for '86; that's one entry that you do that. And then, obviously, as something actually becomes uncollectible during that year, you write that off by charging the reserve and crediting the accounts receivable.

COMMISSIONER BEARD: So in '85, you underaccrued based on what you wrote off?

WITNESS SCARBROUGH: Yes, but the thing you have to remember is what you're accruing is based on how much you think you're going to not recover of the '86, let's say revenues, but the write-offs could be for a prior year, like it will be for a prior year.

COMMISSIONER BEARD: But accrual, you have write-offs over a span of time, four or five years, you can underaccrue because you wrote off more than you actually accrued or vice versa?

WITNESS SCARBROUGH: Yes, sir.

COMMISSIONER BEARD: Okay.

WITNESS SCARBROUGH: That's right. Over a long period of time, hopefully it balances out.

COMMISSIONER BEARD: Because you have got multiple years involved in any given time.

WITNESS SCARBRUOGH: Yes, sir.

Q (By Mr. Burgess) Okay. And if you would, if I could ask you again to address the question I asked of whether it's permissible or theoretically possible to have dealt with the excess that you found in the reserve as a result of changing the accrual method by accruing somewhat less over a number of years in the future as opposed to taking a one-time shot to the account in the year at which you changed the accrual?

A You could have done that. I don't think that's the proper accounting procedure, I wouldn't reflect it as being. But that would be an option if you wanted to sort of transition it in, but we wanted to get the reserve balance correct in that particular year so we would have it right for going forward because we changed the method in 1989 to an aging method.

Q What goes into the determination as what's correct? Are there accounting principals that apply that dictate one or the other methods of approaching this particular problem?

A Yes, there are. There is generally accepted accounting principals that, you know, that talk about this. But what we went through is an aging method, which basically takes the current month and then the four succeeding months, tries to determine, based on the past 12-month history for each of those current, one month, two month, three month, four month in arrears, get that relationship, the percentages; compare that to your accounts receivable balance just for that one month; multiply, come up with what you think the reserve ought to be, then you compare that with what the reserve is, and you make an adjustment. The adjustment we made in 1989, we now make that adjustment the same way every single month, January of '90, February, March, from now on, we'll do it the same way. We'll make the calculation, compare it to the balance in reserve, and either take in the -- add to the reserve or reduce the reserve each month as we go along. The whole idea is you try to get -- theoretically, if you can do it precisely, which you cannot, obviously, you know, accounting is not a science, but the whole idea, any point in time, the balance in the reserve should reflect the amount of your accounts receivable that you're not going to collect at any point in time.

CHAIRMAN WILSON: If you had changed methods that indicated you had a deficit in the reserve, would you have tried to make it up in a single year?

WITNESS SCARBROUGH: Yes.

COMMISSIONER BEARD: Let me go just a little further. Explain to me what happens when you've got $800,000 -- if I got my numbers correct -- roughly shift in '89 as opposed to a $200,000 shift, in 89, '91 and '92, okay, if you took the alternative?

WITNESS SCARBROUGH: Yes, if you --

COMMISSIONER BEARD: If you took the alternatives?

WITNESS SCARBROUGH: That just means that you're, had you wanted to phase this in, rather than reducing your expenses by $800,000 in 1989, you reduced them by 200, and 200, and 200, and 200.

COMMISSIONER BEARD: I understand that. Now, the question then becomes, what is the impact to the test year of the two opposite extremes? What happens? In other words, you have a $800,000 excess reserve -- I've got to go slow, okay? And it disappears in one year?

WITNESS SCARBROUGH: Okay, if everything else would have been --

COMMISSIONER BEARD: Everything else?

WITNESS SCARBROUGH: -- if everything else was constant, what you would have had, you would have had a credit of $200,000 in 1990, which would reduce your expenses by the $200,000, which would increase your net operating income.

COMMISSIONER BEARD: In lieu of that, you have an $800,000 expense reduction in '89, which gives you negative expense.

WITNESS SCARBROUGH: Yes.

COMMISSIONER BEARD: So you've got about, for the purposes of the test year, you have got about a $200,000 swing in expenses, comparing the two methods?

WITNESS SCARBROUGH: I reckon, if you had done it over a four-year period.

COMMISSIONER BEARD: Right. If you do it over two years, it's $400,000?

WITNESS SCARBROUGH: But remember. Remember, what you're trying to accomplish here is not get your expense right, that's not what you're trying to accomplish. Let me make this accrual, it's not to get the expense right.

What you're trying to do is get the reserve balance right compared to the accounts receivable; and whatever extent it takes to do that, that's what your expenses are.

Q (By Mr. Burgess) Mr. Scarbrough, does magnitude have anything to do with the way you would handle that correction in the reserve balance? If it were of a far greater significant magnitude, would that make a difference as to how would you determine that the correction should be made?

A I don't think so. I reckon if it was a, you know --

Q Several million?

A Few million dollars, or maybe not that high, but I mean if it was significant enough, could you make some kind of case for it. But we made the correct entry, accounting entry, no question in my mind about that.

Q In the nonpension postretirement benefits, in switching to an accrual method from a pay-as-you-go, when that switch was made, there was a significant deficiency in the reserve there, wasn't there?

A Well, it's not a reserve. What we did there is changed methods again.

Q Yes.

A From a pay-as-you-go. Which meant that we started accruing, based on actuarial assumptions, to expense --

Q So then you have a much greater --

REPORTER: I'm sorry, I didn't hear you?

Q I shouldn't have said anything. Go ahead.

A We started expensing the postretirement benefits based on an actuarial bases, so we can proper match revenues, proper match expenses, make sure that the expenses reflected the services that were received in that particular year.

Q And so then you had a deficiency, under that new method, you had a deficiency in the liability associated -- or, excuse me -- that had actually accrued over a number of previous periods, is that correct?

A You had an unfunded of liability, yes.

Q And you had to make that up, you had to do something to correct that unfunded liability, is that correct?

A Yes.

Q And you dealt with that, basically, by an additional amount of accrual on a going-forward basis?

A Yes.

COMMISSIONER GUNTER: Are you through with that one, Steve?

MR. BURGESS: Yes, sir.

COMMISSIONER GUNTER: I was going to get you to raise your hand when you get through.

MR. BURGESS: Okay.

COMMISSIONER GUNTER: Mr. Scarbrough, I'm not finding any fault for what you all did when you began to accrue for postretirement benefits, because recognizing where FASB is with their exposure draft and their history of once it gets exposure draft, that's what you're going to see. Does the Staff have a copy of your actuarial reports, with complete assumptions and what have you, that your actuary made on your postretirement benefits accrual?

WITNESS SCARBROUGH: I think they do, sir.

COMMISSIONER GUNTER: Could you tell me just very briefly what items are covered in there for postretirement? For instance, have you got life insurance in there?

WITNESS SCARBROUGH: We have just got two, medical benefits and life.

COMMISSIONER GUNTER: Medical benefits and life insurance?

WITNESS SCARBROUGH: Yes, sir.

COMMISSIONER GUNTER: What's the amount? What's your liability in that account today? Did they tell you that? Your total liability?

WITNESS SCARBROUGH: Let's see if we can find it, please. (Pause)

COMMISSIONER GUNTER: And the reason for asking that question, Mr. Scarbrough, I read the exposure draft that FASB has out, and there's some discussion of whether they're going to allow you 15 years or 20 years to catch up. And at the same time period, because of past accounting practices, you know, which were certainly appropriate in the time period of expensing versus accruing for that, you've got to get some idea as to what sort of basis the actuarial folks had on escalation of health insurance, those kinds of things that I would be interested in learning about.

Does Staff, do you know if Staff has a copy of that actuarial report?

MS. RULE: Commissioner, Staff has a copy, it's in your exhibit pile as No. 425.

COMMISSIONER GUNTER: 425, all right.

MS. RULE: That's the actuarial report of postretirement benefits as of 1-1-89.

COMMISSIONER GUNTER: All right. Do you treat -- this is going to get to be a generic thing, I think, with the Commission as you move forward because this is going to be big bucks. Do you treat your postretirement benefits fund the same way that you treat your cash pension? In other words, is that a funded reserve?

WITNESS SCARBROUGH: Today, it's not. We did. We've never funded any of the life portion of this reserve, but we were allowed to fund some of the medical accrual.

COMMISSIONER GUNTER: What would be the difference in, for instance, federal law established, I think, that you must fund your pension, your cash pensions, up to ERISA standards, to that minimum, you must fund that because recognizing the liability.

Now, what would be the difference if you have a noncash benefit, which translates itself to cash when an employee retires, what's wrong with the philosophy, of following that philosophy and requiring that that be funded, a funded reserve, versus just being on the books and the cash being used for other purposes?

WITNESS SCARBROUGH: Well, that is, there's nothing wrong with the philosophy, that's the exact philosophy that should be applied. That's the philosophy that we would like to apply. But the life and medical benefit plans are not what they call a "defined benefit plan" like the pensions are. And that's the reason that, thus far, the IRS will not allow us to fund that.

They did allow us to fund, as I said, some of the medical. Until the laws are changed, we're not going to be able to fund that.

There is, you know, there's a lot of bills --

COMMISSIONER GUNTER: Well, why can't you fund it, because of the tax? What precludes you --

WITNESS SCARBROUGH: Okay, well, wait a minute --

COMMISSIONER GUNTER: There is no federal law that would preclude you from funding it.

WITNESS SCARBROUGH: You're right. You're right. We cannot fund it, we cannot fund it and get a tax deduction.

COMMISSIONER GUNTER: Okay.

WITNESS SCARBROUGH: We could fund it, as you suggest, we could fund it but we would not get a tax deduction for it.

COMMISSIONER GUNTER: You don't get a tax deduction for it with the accounting treatment that you utilize today, do you?

WITNESS SCARBROUGH: You don't, not until you fund it, no, that's correct.

COMMISSIONER GUNTER: Okay. So it really doesn't matter, you don't get a tax deduction for the accounting treatment that you afforded it, whether you fund it or don't fund it, do you?

WITNESS SCARBROUGH: Yes, we get a tax deduction for the amount that we fund. Because, see, even though we're accruing one amount, we're actually funding it to the extent we're paying out for medical and life. So we do get a tax deduction for that, but we don't get a tax deduction for the total amount of the accrual.

COMMISSIONER GUNTER: Could you give me a copy of any correspondence you've got as a late-filed exhibit with the service on this? You're saying the Internal Revenue Service won't let you or they will let you, or what have you?

WITNESS SCARBROUGH: They wouldn't let you do it and take it as a tax deduction.

COMMISSIONER GUNTER: All right, would you give me, would you provide us as a late-filed exhibit the correspondence that Gulf has had with the Internal Revenue Service regarding your accounting treatment on this?

MR. HOLLAND: Commissioner Gunter, we provided as a late-filed in the tax refund docket --

WITNESS SCARBROUGH: Wait a minute, no, that's not what he's asking for.

COMMISSIONER GUNTER: No, no.

WITNESS SCARBROUGH: What he asked for there, and we gave him, was our requested transfer from the pension fund forward.

MR. HOLLAND: You're right, I'm sorry.

WITNESS SCARBROUGH: And I don't know if

we've got any correspondence, we've got income tax regulations that are pretty clear.

COMMISSIONER GUNTER: Well, if we don't have any correspondence, if you haven't been --

WITNESS SCARBROUGH: And we may have some correspondence, I don't know.

COMMISSIONER GUNTER: Okay. Then I have to tell you, with my NARUC activities, I'm meeting with IRS on this issue. And that's the reason I want to see if, in fact, you all have made the request to allow you to fund that postretirement benefit --

WITNESS SCARBROUGH: I can --

COMMISSIONER GUNTER: -- to give it the same treatment. Because logic would tell me that you would want to treat it the same way, because it is a liability that should be funded.

WITNESS SCARBROUGH: You can rest assured that we have requested that and we were allowed to do that; they withdrew the letter ruling and we can't do it now. But we'll get you a copy of that correspondence.

COMMISSIONER GUNTER: All right, fine, I will appreciate that.

CHAIRMAN WILSON: Excuse me, do you have an outstanding request?

COMMISSIONER GUNTER: Yes. I would like to have a late-filed exhibit, could we have a number?

CHAIRMAN WILSON: 549.

COMMISSIONER GUNTER: The IRS/Postretirement Benefits.

(Late-filed Exhibit No. 549 identified.)

CHAIRMAN WILSON: Mr. Scarbrough, on the nondeductability of the accrual in terms of taxes, if you're accruing an amount and you're paying out benefits for which you do get a tax deduction, is the amount that you don't get a tax deduction on the incremental difference between what you paid out and what you accrued?

WITNESS SCARBROUGH: Yes.

CHAIRMAN WILSON: All right.

MR. BURGESS: Commissioners, I have copies now of the pages, excerpts, from the 10K that I would like to pass out. And they may just be marginally useful as far as trying to develop the information that we're looking for; and perhaps, I don't know, the Commission may have some refinements, also.

CHAIRMAN WILSON: Why don't we take a five-minute break and you hand those out and then we can take that subject up.

MR. BURGESS: Very good.

(Brief recess.)

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Q (By Mr. Burgess) Mr. Scarbrough, you've provided us with information from the 10K on executive salaries. And as I see it, for each of five specific individual officers, there is listed cash compensation, which includes the PIP program and Employee Savings Plan, Stock Ownership Plan. Would you explain the Stock Ownership Plan, please?

A The -- none of these figures that you're looking here in the stock ownership include any figures with the Stock Ownership Plan because of the stock options that are issued to certain level employees because they have no value until the employee actually exercises those stock options. And the redemption value of those stock options, they are probably $5 a share higher now than the present market value of the selling company stock. So they really have no value until you, in fact, you know, exercise them. Then they have value. Then they would be income, of course, to the individual who exercises them. They've got potential value, but no actual value until they exercise them.

Q How is the redemption determined?

A I'm not -- I can't tell you exactly how it's determined. Bob Jackson could probably tell you how that's determined and he'll be one of the rebuttal witnesses, but I don't know exactly how that is determined, but I think it's probably -- I think it's like 29, the last time that they issued them, versus whatever the market is today, 24, $25. To my knowledge there's never been any of them exercised.

Q Never since the plan has been --

A That's right because it was a relatively new plan.

Q And, of course, that would be Southern Company stock?

A Yes.

MR. BURGESS: Commissioners, I was hoping to see if I could get from Mr. Scarbrough some type of exhibit that would break out the various types of compensation for the years that are provided, that have been provided through the document that we've distributed. And also for projected 1990.

COMMISSIONER BEARD: Can I ask a quick question?

Somewhere in my memory bank there are two components of the -- what's been termed a bonus but performance incentive, isn't there? There is a component associated with the general performance of the Company and then there's a performance associated with the performance of the individual?

WITNESS SCARBROUGH: There was beginning in 1989. There are two. One of them is called the PIP, "The Productivity Improvement Program," which is limited to probably 12 to 15 employees at Gulf Power Company. And then there is the "Performance Pay Plan," what we call the "PPP Plan." And that, in 1989, was available to your exempt employees. And in 1990 will be available both to your exempt and nonexempt employees but not available to the covered, the union employees.

COMMISSIONER BEARD: Okay. What I'm trying to delineate is dollars -- and I'll use the term "bonus." I don't mean to be prejudicial with it, but dollars in excess of base salary associated with the general performance of Southern Company, I don't think is where we were headed. I think it was more on individual performance. Is that a separate figure?

WITNESS SCARBROUGH: The Performance Pay Plan, which was initiated in 1989, has nothing to do with Southern Company's -- the Southern Company's performance. But the Productivity Improvement Plan does, is tied to the Southern Company performance.

COMMISSIONER BEARD: It's tied to Southern

Company and to the individual goals established at the beginning of the fiscal year?

WITNESS SCARBROUGH: At Gulf Power Company, yes, that's correct.

COMMISSIONER BEARD: For an individual. In other words, there is a way to delineate individual performance?

WITNESS SCARBROUGH: Oh, yes. Yes.

COMMISSIONER BEARD: Okay.

MR. BURGESS: In addition, Mr. Scarbrough is it possible to find out --

WITNESS SCARBROUGH: Let me -- I want to make sure that I fully answer Commissioner Beard's question.

In 1989 you had an individual component and a corporate component of the Productivity Improvement Program. The individual component had something to do with the individual's performance. In 1990, in this -- beginning in 1990, that individual component is no longer there; it's just the corporate component. And the corporate component really has nothing to do with the performance of the individual. It's the performance of the Southern Company.

COMMISSIONER BEARD: It probably works out as well. I was more interested in historically, anyway.

WITNESS SCARBROUGH: Yes, sir.

Q (By Mr. Burgess) Under this particular reporting method, how would you deal with it when -- if individuals redeem their stock options under this plan? Would it go into the following year? I mean, would you come up with some type of --

A It would go into the year that they exercised it.

Q Okay. So it would likely be the year following the year at which they earn the particular stock option, would that be correct?

A No. I think these stock options have like, I think ten years. You could go ten years and never exercise the thing. I mean if you have got a $29 redemption price and the stock never gets to a buck-29, nobody's going to exercise it. It has a potential value but it may not really have an absolute value, and that could just depend on what the the stock does.

Q Is there a lapsing mechanism on the options?

A Ten years.

Q Ten years. So they accumulate for ten years?

A Well, I mean, if you get one in 1989, it expires ten years later.

COMMISSIONER GUNTER: Let me ask you a question about that.

How would you show -- for instance, I think the one that I looked at in your filing is the price is something less than $22. And that's where the three folks were illustrated. That was Horton, McCrary and somebody else -- and Parsons. And the price was 2175 per share. And that's on 3-7 of your filing in your Section F. That's the 10-K I'm looking at here.

WITNESS SCARBROUGH: Could we get that please, sir?

COMMISSIONER GUNTER: I'm not going to talk about the numbers. I just want to talk about the operation.

WITNESS SCARBROUGH: All right.

COMMISSIONER GUNTER: If the price were 3175, would you show that in the year they exercised at $10 a share?

WITNESS SCARBROUGH: Yes.

COMMISSIONER GUNTER: All right. Then what would you do if, in fact, they held on to the stock? Because the only cash they would receive is if they bought it and then in turn sold it.

WITNESS SCARBROUGH: You would do it -- when they exercise the option whether they sold it or not, it would be then.

COMMISSIONER GUNTER: It would show it as a cash benefit. And if you fell on hard times and all of a sudden it went down to ten, that's just their problem.

WITNESS SCARBROUGH: That's exactly right. Although, you would have established a basis for it at the redemption value because you have got income, and then if it went down, you would have lost money but at lease you get a tax deduction for it.

COMMISSIONER GUNTER: All right. I understand. I just wanted to understand what the mechanism was there, whether you recorded the losses, too.

WITNESS SCARBROUGH: No. No, sir.

Q (By Mr. Burgess) Is the redemption value adjusted annually?

A The redemption value?

Q Yes.

A I'm not too sure, Steve. Mr. Jackson could -- I don't think that it is. I think once you get the issue for 1989, I think that redemption value is fixed, but I'm not absolutely sure of that, and Mr. Jackson can answer that question.

Q It's fixed for the options that you earn for 1989, but then 1990's would be adjusted for some --

A Could be. That's my understanding, but you may want to verify that with Mr. Jackson.

Q Do each of these individuals receive the same number of options or options for the same number of shares?

A No.

Q Would all have the same redemption price?

A Yes.

Q Can you make available in this the number of shares that each of the individuals receives options for in that given year?

A By year?

Q Yes, sir.

A Yes, we can.

MR. HOLLAND: Steve, let me clarify that. You don't want the number of the shares available to them but the number they actually --

WITNESS SCARBROUGH: No, he wants --

MR. BURGESS: No. I want the number of shares for which they earned options in a given year.

MR. HOLLAND: Okay.

Q (By Mr. Burgess) And then if you could also provide the redemption price, yes, the redemption price in a given year, for a given year's stock.

A Okay.

Q Now, as I understand it, what's presented here does not include various benefits such as insurance premiums and that type of thing?

A Well, there are several differences. You can't tie this figure -- might as well go ahead and get this out in the open so we'll both have an understanding because if we don't, we come back you say that's not what you wanted -- you can't tie this figure in the 10-K to the W-2 Form and there are several reasons. Number one, included in the 10-K is some contribution by the Company to the Employee Savings Plan. It's included in the 10-K, but that's not taxable to the individual until he actually, you know, withdraws those securities upon his retirement or termination from the Company. So it's on here as a cash compensation, but it's not on his W-2.

Another thing you have to remember is, what's shown here, let's say an example 1989, wasn't paid to these employees in 1989, it was accrued in '89, and trued up in 1990. But it's the actual amount that they got paid, but they got paid in 1990, but it shows here in '89.

Q The individual being on the cash basis for tax reporting purposes?

A That's right. And then there are those differences. And then on the W-2 you have things like, I reckon the two -- you have, for instance, like the personal use of an automobile would not be on here, but it would be on the W-2 Form. And also, as you said, there is a certain amount that is imputed as income if you have life insurance over, I think the figure is $50,000, and that is not on here, but would be on the W-2 Form. So I'm saying you can't actually match these, and I just wanted you to have a clear understanding of that.

Q Okay I appreciate that.

So in the breakout of trying to present a full compensation package of each of the individuals, would you be able to present certain benefits such as insurance premiums and that type of thing?

A Yes.

Q Okay. You have then listed below those that are identified individually, a group, executive officers as a group, and an amount for those. That group, for instance, in '86 includes eight persons. That would be three in addition to those five listed, is that correct?

A Let me make sure that -- right, it would be three people in addition to the eight.

Q Okay.

A It would be three people in addition to the five totaling eight, I'm sorry.

Q Can you then, whether it's a column or a row, simply lump the remaining three that would be included here and they need not be identified individually?

A Well, basically, you want the same breakdown for these three people as you want with the others.

Q Exactly. Yes, sir.

Q And I think that's all the information --

COMMISSIONER GUNTER: For each of the years, Steve, or the one year?

MR. BURGESS: Yes, sir. For each of the years, including 1990, looking for some type of trend or some type of examination on a trend basis.

COMMISSIONER GUNTER: Okay.

MR. HOLLAND: Mr. Chairman, let me just inquire of Mr. Burgess. It was my understanding from what Mr. Shreve said yesterday and in my conversation with Mr. Burgess that this is requested under Issue 50. Would that be a fair --

MR. BURGESS: Yes.

MR. HOLLAND: -- reasonableness of salaries and employee benefits?

MR. BURGESS: Right.

MR. HOLLAND: Okay.

CHAIRMAN WILSON: When will we be able to see this?

WITNESS SCARBROUGH: We should -- tomorrow.

CHAIRMAN WILSON: Okay. So I'll give it the No. 550. I'm not going to designate it a late-filed.

COMMISSIONER EASLEY: Is that all part of 549?

CHAIRMAN WILSON: Huh?

MR. HOLLAND: No.

CHAIRMAN WILSON: We've already gotten 549.

COMMISSIONER GUNTER: That was my effort.

CHAIRMAN WILSON: Because we'll see it before the end of the hearing.

COMMISSIONER EASLEY: Oh, okay. You hadn't given it a number yet.

(Exhibit No. 550 marked for identification.)

MR. BURGESS: Okay. And just to make sure what we're talking about, rather than the total compensation, or in addition to the total compensation, the breakdown into base pay and the amount under PIP, PPP, et cetera.

WITNESS SCARBROUGH: Basically, as I understand what you want to see is the 10K figure broken down between base pay, incentives, other cash compensation, and then other non- and then the noncash compensation, for a total. Which would basically give you the 10K numbers plus your noncash compensation.

MR. BURGESS: Yes, thank you very much. And that's all the questions we have of Mr. Scarbrough.

CHAIRMAN WILSON: Major Enders?

CROSS EXAMINATION

BY MAJOR ENDERS:

Q Good morning, Mr. Scarbrough. I just have a few questions for you. I want to visit with you on the write-up of Gulf's portion of Plant Scherer, contained on Pages 43 to 46 of your prefiled testimony. (Pause)

A Okay, sir.

Q The original cost of Plant Scherer, your portion of Plant Scherer to develop, was 24.266 million? (Pause) It's on 44.

A This has to do with only the common facilities for Plant Scherer. This is not all of Plant Scherer by any means. This is just the common facilities that go with our 6.25% of the total four-unit plant of Plant Scherer at Georgia Power Company. But that's right. That's the original cost of 24,266,406.

Q And on the next page, Page 4, The Accumulated Depreciation is approximately 3.8 million?

A That's correct.

Q But Gulf wants to include within rate base the Scherer facilities at 29.132 million, correct?

A Which is what we had to pay for those, which was the original, which was the cost of those facilities. It's the original cost plus the cost that the Oglethorpe Power Corporation and the City of Dalton, there's a carrying cost for them carrying those facilities that were our share for the period from the time they had them and the time that we purchased them. That's the difference between the 24 and the 29.

Q So basically, what you would term an acquisition adjustment for the interest or carrying charge?

A Well, it's not what I would term an acquisition adjustment. It's required by the Federal Energy Regulatory Commission that we account for it as a plant acquisition adjustment.

Q But would you agree with me that the original cost of the facilities, minus the accumulated depreciation, is some 8.68 million less than what Gulf wants to put in rate base?

A You're talking -- but you're talking about -- and that's exactly right. The answer to that is yes. And the 8 million you're talking about is the plant acquisition adjustment. It is there because of an accounting requirement that requires that when you purchase an electric system that the difference between the original cost, less accumulated depreciation -- which is the book value on the books of the person that you purchased it from -- and what you paid him for it, you have to record as a plant acquisition adjustment.

However, it does not mean that that was in excess of cost. Because in this particular case, what happened in 1977, in 1980, Georgia Power Company sold common facilities to Oglethorpe Power Corporation in Georgia with the agreement that they would buy them back later when Unit 3 came on line.

When we purchased --

MAJOR ENDERS: Thank you, sir.

MR. HOLLAND: Let him finish, please.

MAJOR ENDERS: Okay, he can go ahead.

MR. HOLLAND: Okay.

A So when we purchased 25% of Unit 3, we also, in that agreement, agreed that we would fulfill Georgia's responsibility to buy our fair share that related to the 6.25%, which is 25% of the units times 25% of the ownership of Unit 3, which would be 6.25%. We agreed to fulfill their responsibility to buy those common facilities from Oglethorpe and Dalton. Oglethorpe and Dalton had paid carrying costs that would have been paid by Gulf Power Company over this period of time from the time they purchased them up to the time that we bought them from 1977 up through 19 -- or '77 and '80 up through 1987. And all we did was reimburse them their carrying costs because it surely would not be proper for them to pay the carrying cost on something that belonged to Gulf Power Company.

Q Let me see if you agree with this question. Would you agree that the interest or carrying charge represents a claim for so-called regulatory lag?

A No.

Q Would it be fair to say that it's well-settled that utility plant added to rate base is added in the amount of the original cost minus accumulated depreciation?

A No. That's absolutely not. We've added the plant acquisition adjustment is part of this rate base.

Q Doesn't the accumulated depreciation represent funds that have already been paid to Gulf by the ratepayers?

A No. See, this accumulated depreciation wasn't on Gulf's books, this was on Oglethorpe and Dalton's books. The truth of the matter, if you really get down to the absolute truth of the matter, it wasn't actually on their books. Some of it was on their books, it was on there wrong, and Dalton didn't even have any depreciation on their books but we're required to estimate that depreciation.

Q Aren't we geting a new set of ratepayers to pay it a second time?

A First of all, I do not know how Oglethorpe and Dalton treated this. But let's just assume -- first of all, I'll assume they're unregulated, so to speak, like most municipals and cooperatives are, for ratemaking purposes. However, let's just assume that they did recover these carrying costs, this depreciation, during this period of time that they held it, from their customers.

When we purchased it back, we paid them those dollars. If their regulation is being done properly like it would be done in this Commission, they would have to give that money back to those same customers. So it's a zero cost to those customers. So they break even. And now we have it on our books.

Their customers were made whole, we paid our fair share for those common facilities. There was no profits involved here or anything like this. This is not like you have in some water and sewer cases, where a guy sells it and makes a big profit. This was not the case. The intent of this agreement was that you purchase these common facilities at cost. That's exactly what we did.

MAJOR ENDERS: I have nothing further, Mr. Chairman.

COMMISSIONER GUNTER: Let me just follow up just for a second. Mr. Scarbrough, those common facilities that you and the Major have been speaking of, whose AFUDC rate was utilized in the calculation of those figures? Do you know what that rate was?

WITNESS SCARBROUGH: You mean originally?

COMMISSIONER GUNTER: No.

WITNESS SCARBROUGH: For the original cost, or included in the amount -- the difference between the original cost and what we paid?

COMMISSIONER GUNTER: The difference between original -- you know, the FASB folks like to talk about creation of an asset.

WITNESS SCARBROUGH: Yes, sir.

COMMISSIONER GUNTER: And you have an AFUDC rate, a carrying cost rate, that you've been referring to. A carrying cost rate applied against those assets.

WITNESS SCARBROUGH: Right.

COMMISSIONER GUNTER: Whose AFUDC rate was that?

WITNESS SCARBROUGH: You're talking about on the original cost, developing the original cost?

COMMISSIONER GUNTER: I'm talking about what you paid for it. You know, you start with original cost, minus depreciation, plus the carrying cost as I understand -- and really, it's not minus depreciation. It's original cost, plus the creation of the asset through AFUDC, and that's what you paid for it. Isn't that right?

WITNESS SCARBROUGH: Yes, sir.

COMMISSIONER GUNTER: All right, now, a very simple question. Whose AFUDC rate did you use in order to arrive at that figure? Theirs? Yours? Southern Company's? Georgia Power's?

WITNESS SCARBROUGH: The original cost -- let's just take it one step at the time, if we can.

COMMISSIONER GUNTER: Okay.

WITNESS SCARBROUGH: The original cost, the $24 million, the AFUDC rate that was used for that, some of that would have been probably Georgia's rate to the extent that they had already begun construction prior to the time of selling it to them in 1979 and 1980. But you've got to remember, this plant -- these common facilities weren't completed in '77 and '80, they were under construction.

COMMISSIONER GUNTER: Well, we'll get into a chronology about when it was built, when it was purchased, and what have you. I have that and provided that to your attorney, so I know it's not a surprise.

WITNESS SCARBROUGH: I reckon what I'm saying, though, is some piece of it would be Georgia's, and then some piece of it would be Oglethorpe. And through AFUDC, and that's what you paid for it. Isn't that right?

WITNESS SCARBROUGH: Yes, sir.

COMMISSIONER GUNTER: All right, now, a very simple question. Whose AFUDC rate did you use in order to arrive at that figure? Theirs? Yours? Southern Company's? Georgia Power's?

WITNESS SCARBROUGH: The original cost -- let's just take it one step at the time, if we can.

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WITNESS SCARBROUGH: The original cost, the $24 million, the AFUDC rate that was used for that, some of that would have been probably Georgia's rate to the extent that they had already begun construction prior to the time of selling it to them in 1979 and 1980. But you've got to remember, this plant -- these common facilities weren't completed in '77 and '80, they were under construction.

COMMISSIONER GUNTER: Well, we'll get into a chronology about when it was built, when it was purchased, and what have you. I have that and provided that to your attorney, so I know it's not a surprise.

WITNESS SCARBROUGH: I reckon what I'm saying, though, is some piece of it would be Georgia's, and then some piece of it would be Oglethorpe. And then the difference between the original cost and what we paid them -- we wouldn't call it AFUDC, we'd call it carrying cost, but that was the weighted average debt cost during the construction period of Oglethorpe and Dalton.

COMMISSIONER GUNTER: That was the weighted --

WITNESS SCARBROUGH: Average debt cost.

COMMISSIONER GUNTER: -- average debt cost.

WITNESS SCARBROUGH: During that construction period.

COMMISSIONER GUNTER: Where can we see a chronological, year-by-year, calculation of that? Mr. Scarbrough, I have to be very honest with you, the day of "Trust me" are gone. You know, "Trust me about the calculation." I've got to see them.

WITNESS SCARBROUGH: Okay. I'll be happy to show you.

COMMISSIONER GUNTER: Where would we be able to see that and identify whose cost that was? If it's cost-to-debt, at what rate, that's fine. I've got no problem with that. But as I went through, I haven't been able to find that. Do you understand what I'm saying?

WITNESS SCARBROUGH: I think, we, that would be a pretty good task. We may very well have to go back to Oglethorpe and Dalton's books and get some of that. But I think we could make an attempt to do that.

COMMISSIONER GUNTER: But at some point in time when you make the purchase, it would appear that you would have told them to "Belly up, boys, before we buy it," as to how you reach that rate.

WITNESS SCARBROUGH: This has been, this transaction has been audited. And, in fact, it was audited rather recently and discovered that we ended up getting a $620,000 refund out of it

COMMISSIONER GUNTER: Okay. I'm just, I just need to see that portion, that asset creation portion, how that was done, you know. And whose was used. I understand it was under construction for a while and I understand --

WITNESS SCARBROUGH: It's probably going to end up being about two or three different people's done, but --

COMMISSIONER GUNTER: But at least it would give us, we would have a trail --

WITNESS SCARBROUGH: I understand.

COMMISSIONER GUNTER: -- of understanding what the figure is. Because I don't understand today what the figure is. I'm just honest with you.

WITNESS SCARBROUGH: You don't understand the original cost?

COMMISSIONER GUNTER: No. I understand what the original cost was. The original cost was the cost to construct it to the point that it was available for use, although at the time it was sold, it wasn't available for use because you didn't have the generator to use the common facilities on it.

But at the time that it would have come in and been a completed project, rubber-stamped off, from that point forward, that's the piece that I'm interested in, is how was that, how was that asset creation accomplished?

WITNESS SCARBROUGH: We'll make an attempt to get that for you.

COMMISSIONER GUNTER: Okay, could I have a late-filed on that, Mr. Chairman?

CHAIRMAN WILSON: 551.

COMMISSIONER GUNTER: 551.

(Late-filed Exhibit No. 551 identified.)

COMMISSIONER GUNTER: That would be "Carry Cost Calculations Annually for Common Facilities Scherer 3."

COMMISSIONER EASLEY: Who did that audit you just mentioned, Mr. Scarbrough?

WITNESS SCARBROUGH: Southern Company

Services.

COMMISSIONER EASLEY: When was that? Last year or two years?

WITNESS SCARBROUGH: Just a moment, I'll tell you.

COMMISSIONER EASLEY: All right, I was willing to settle for a ballpark. (Pause) Mr. Scarbrough, I really don't need an exact date, if you would just ballpark.

WITNESS SCARBROUGH: It was '89.

COMMISSIONER EASLEY: Okay. That's close enough for government work. And from whom did you receive the $620,000 refund?

WITNESS SCARBROUGH: Oglethorpe Power Corporation.

COMMISSIONER EASLEY: And where was that booked?

WITNESS SCARBROUGH: It was booked as a credit to plant service.

COMMISSIONER EASLEY: Okay. Thank you.

MS. RULE: Commissioner, one of our supplemental exhibits contains the audit that you're discussing.

COMMISSIONER EASLEY: Okay, I'm going to get the date after all.

CHAIRMAN WILSON: Go ahead.

MS. RULE: Commissioner, we have some supplemental exhibits. My understanding is that Gulf is willing to stipulate them in. And I would like to have exhibit numbers assigned at this time.

I passed out the other day a Staff supplemental exhibit list. It includes identification numbers and titles for Staff's 152 through 157. And Mr. Stone has indicated that Gulf would be willing to stipulate to these exhibits and I would like to ask if anybody else has any problem with stipulating the exhibits at this time?

CHAIRMAN WILSON: All the other parties that have seen this package have any concern with this? Any objection? No?

MR. BURGESS: (Shakes head from side to side.)

CHAIRMAN WILSON: Good. All right. The numbers you have assigned on here are just your numbers?

MS. PULE: Yes. We need hearing exhibit numbers and I believe the first one would be --

CHAIRMAN WILSON: 552, 553, 554, 555, 556 and 557.

MS. RULE: Thank you.

(Exhibit Nos. 552 through 557 marked for identification.)

CROSS EXAMINATION

BY MS. RULE:

Q Mr. Scarbrough, you should have in front of you, I believe, two exhibit packets, one labeled "Staff Exhibits" and the other "Supplemental Exhibits." And I believe we have also given you a copy of Exhibit No. 430, which is the Staff Audit Report.

In Mr. Larkin's testimony, he made the statement that resale agreements related to the acquisition of common facilities from Oglethorpe and the City of Dalton were all part of The Southern Company obligation and were not transactions negotiated by Gulf Power. To what extent did Southern Company participate in the negotiations and signing?

A The negotiations and signing of the transaction between Gulf and Georgia Power Company on purchase of Plant Scherer.

Q The resale agreements related to Gulf's acquisition of the common facilities.

A There may have been a couple of Southern Company Services employees at our request that was assisting with that, but for the most part, that was between Gulf Power Company and Georgia Power Company.

Q And that was largely negotiated by Gulf?

A The purchase of our portion of Plant Scherer?

Q Yes, sir. The resale.

A Yes.

Q Were any problems encountered by the Southern Company Services auditors in determining original costs and accumulated depreciation reserve balance of the common facilities? I believe you discussed the problem with depreciation balance.

A I'm not too sure I understand. Are you referring to something? Can I look at what you're referring to?

Q No, sir. You were discussing that the City of Dalton didn't carry a depreciation balance related to Scherer on its books, is that correct?

A That's correct.

Q How did you figure out one to put on your books?

A We went back and tried to recreate that based on an estimate of the depreciation for those type items for that period of time and made an estimate based on that.

Q Was this done by Gulf Power or by SCS?

A Gulf Power Company did.

Q Do you know why Oglethorpe Power began depreciation in 1984 instead of 1982 when the facilities went into service?

A I sure don't, but we adjusted that depreciation back to '82. We also had to do that also. We had to try to get the right amount of depreciation on the books in order to satisfy the FERC accounting requirements.

Q Mr. Scarbrough, I'd like you to look in the supplemental exhibit packet. We've identified an exhibit as No. 553, but on your copy it's identified as Staff's 153.

A Okay.

Q Do you have that before you?

A Uh-huh.

Q I'd like to direct your attention to part of that exhibit, the Gulf Power Company audit of the Oglethorpe Power Corporation, sales price adjustment for Plant Scherer common facilities. That's part of the December 8th, 1989 audit that Commissioner Easley was inquiring about, is it not?

A December 8th?

Q Yes, sir.

A Okay.

Q Looking at the last page of that report, Page 4 of 4, there's a statement that said -- it's about the fourth paragraph down. "In addition, there exists potential future adjustments to the common facilities cost and capacity buy-back components."

Do you see that?

A Yes, uh-huh.

Q What future adjustments may need to be made?

A We don't know. As I said, they're minor. I'm not sure there are any, but there are some possibilities. It's primarily got to do with the past buy-back components by Georgia Power Company, but, as it says here, they would probably be minor, and we don't know what they would be, but they would be minor. As far as we know, when you take into consideration these refund -- the overcharge because they included some of the Unit 2 costs in the Unit 3 common facilities, and we got the refund, that's the only refunds that we have received so far. And, you know, that's where we are today. But as to what these future adjustments -- if we had known what these were, we would have obviously made those.

Q Do you know what type of adjustments they will be?

A Well, they would be adjustments to the plant service balances, not the depreciation, but it would be adjustments, either up or down, to the plant service balances.

Q How will those be determined? Will that be through another audit?

A Yes.

Q Will that be a Gulf audit or SCS audit?

A It will be an SCS audit.

Q Do you know when that audit will be performed?

A No.

Q The same document that I just referred to you states on Page 3 of 4, the first paragraph, that Gulf has also requested information from Oglethorpe Power to recompoute the revised gain for Gulf's final booking of the electric plant acquisition adjustment. Could you tell me what that gain relates to? It's the first complete paragraph on that page.

A I'm not too sure exactly what they're talking about. I'll assume that they're talking about Georgia Power Company's gain, which has got to do with the capacity buy-backs, which, of course, affects the total amount. I'll assume that that's what they're talking about here. I can, you know, try to get the answer for you, but beyond that I do not know.

Q Did Georgia recognize a gain on the sale?

A Georgia billed Oglethorpe again earlier on for around a million bucks to do with the common facilities, and we got credit for that. And when you get the 29 million, that million dollars has been taken out of that figure. In fact, if you'll go -- we can identify that. If you've got -- do you have all three of these audits here together?

Q Yes, sir.

A If you'll look on Page 4, Page 2 of 4 of the audit dated January 10th, 1989 --

Q I believe that should be Page 10 of 20 of the exhibit.

A 10 of 20 of the exhibit, you're correct. And if you'll look right in the middle of the pages where it says, "Gulf's portion" over to the right-hand column under the total.

Q Yes.

A You see that they say Gulf's portion is 30,273,604.

Q Yes, under the "total" column.

A We've already talked about we booked $29,131,850. The difference is gain that we received a refund from Georgia Power Company. And that's the reason we only recorded $29 million. See, the audit shows 30, but we got a million dollars back which we credited to this account.

Q Have any additional adjustments been made to the price, or any other aspect of the purchase of common facilities, since the October '89 adjustment?

A Not to my knowledge.

Q What is the adjusted net sales price of the common facilities as of today? Can you provide that now, or would that be better provided in the late-filed exhibit?

A Now, this doesn't include any amortization or anything. If we were to do it today, straight up, transaction today, the net amount on Gulf's books would be 28,529,750.

Q Can you reconcile that amount to the $30,273,604 net sales price reported on Page 2 of 4 in that December '89 SCS audit?

A That's the million dollar gain and the 600 that we received from Georgia, take the million-dollar -- I say it's million, it's a million-one-something gain, plus the 600. In other words, we got that from Georgia Power. You start out with the 30 million that you're looking there, take the reimbursement that we got from Georgia Power Company of the 1.1 million, and the $620,787, which we also got from Oglethorpe Power Corporation because they had some Unit 2 items in there. If you take those two figures off of the $30 million you end up with 28,529,750.

Q Can you reconcile the adjusted net sales price as of today to the $29,131,850 that you've mentioned in your direct testimony on Page 44, Line 2?

A That's the $620,000.

Q What's the amount of the acquisition adjustment Gulf is requesting in rate base after making all the adjustments for refunds and the other ones we've discussed?

A Well, I don't know what the 13-month average would be, but I know the total plant acquisition adjustment that we originally recorded was 8,680,507, and that's in my testimony. And the plant acquisition now would be less than that. It would be $15,000 less. It would be 8,665,447, and that represents -- that $15,000 reduction is calculated -- that's the carrying cost on the $620,000 we got refunded from Oglethorpe Power Corporation, which reduced the acquisition adjustment.

Q What was the acquisition -- I'm sorry. Was the acquisition adjustment for Plant Scherer common facilities noted as a compliance exception by FERC in its audit for 1985 through 1988?

A I think there was a FERC issue there, yes. Let me see if -- (Pause) Yes.

Q And, in fact, did FERC order Gulf to amortize the acquisition adjustment to a below-the-line account, until Gulf can demonstrate specific offsetting benefits to all customers, or until the adjustment is ruled fully recoverable through rates by this Commission?

A I think that was their position, yes. Let me tell you what happened. Can I tell you what happened on that, please?

Q Certainly.

A Originally, we requested that that be amortized, the plan acquisition adjustment be amortized below the line to account 425. That was in 1988.

When I became aware of that, that was before we closed the books in 1988, and I thought that was totally improper. Whoever looked it up in the FERC classification account didn't read far enough, so that's how we started recording it.

Once I discovered that, in my opinion, it absolutely ought to be recorded above-the-line, so we made an adjustment and started recording it above the line at 406. We have -- and, of course, FERC has taken exception to that. We went back to FERC and asked them for approval to record it, you know, above the line at 406, and they came back, as you stated, and basically have said, "First of all, show us that all customers receive benefit of it," as you just stated, "and also if you receive recovery from it."

We, I reckon probably a month ago, have refiled with FERC, asking them to allow us to recovery this above the line to account 406, going into great detail explaining to them how this transaction benefits all of Gulf's customers, and have explained to them that we have requested it in this rate case.

We are sort of in a Catch 22 here, as I see it. You know, FERC wants us to get it approved by the Florida Public Service Commission before they'll approve it recorded above the line, and the Florida Public Service Commission wants to get FERC to approve it recorded above the line. And one is sort of waiting on the other and we're really on a box on the thing. But where we stand right now, we have again requested to FERC to allow us to recover it above the line.

Q And at this point you have received no authorization to do so, is that correct?

A No, ma'am.

Q No, it's not correct or no, you haven't received the authorization?

A No, we have not received the approval to do that.

Q Thank you. (Pause)

Mr. Scarbrough, I'd like to direct your

attention now to what's been identified as Staff's 152 and then numbered as Exhibit 552. You will not have 552 on your copy. It's contained in the supplemental exhibit packet in front of you.

The title of the document is, "Invoices of Timber Sales from Gulf Properties."

A Okay.

Q Staff's 152, now entered as Exhibit 552, consists of various invoices, payment vouchers and documents related to the sale of timber from Gulf Properties, does it not?

A Yes.

Q Are you familiar with timber sales at Plant Smith and Daniel, and the Caryville site?

A Yes.

Q As far as you can tell, does Exhibit 552 contain all the documentation regarding Gulf's sale of timber from those properties?

A I think that it does, '84 through '89, yes, ma'am.

Q Are there any revenues from timer sales budgeted for 1990 from these properties, or any other Gulf properties?

A No, ma'am, there are not.

We have asked our Land Department about that, if they have any plans for 1990, also if they have any plans for 1991, and they tell us that -- the supervisor of the Land Department told us that they have no plans for any sales of timber from any of our properties for the years 1990 through 1991.

Q Do they have plans beyond that?

A I do not know. That was the information that I received from them, '90, '91. We can get that information if they may have it, but all I have is they say they have no plans through '91.

Q Could you tell me whether competitive bids were solicited prior to any of these sales?

A I can't tell you, that was handled by the Land Department. I would assume that they were, but I do not know.

COMMISSIONER GUNTER: Have you reviewed these invoices?

WITNESS SCARBROUGH: Cursory, yes.

COMMISSIONER GUNTER: Wouldn't you think it would be -- the answer to your question, maybe and maybe not? Because wouldn't you think that it would be a little unreasonable to have a bid for less than 25 cords of wood? I'm talking about the practical aspect.

WITNESS SCARBROUGH: The materiality of it that's probably true, but when you are -- I would think, like in Caryville, in 1984 there was $425,000. I'll assume that they probably sent a forester out there and maybe had him coordinate some kind of bidding kind of thing.

COMMISSIONER GUNTER: That's the reason I said maybe or maybe not. You have got one that's a very large sale, which certainly you're going to go out for bids. Then there's some that I went through them, and you have some in there for 23.17 cords, I think.

WITNESS SCARBROUGH: I change my answer to maybe and maybe not. (Laughter)

COMMISSIONER GUNTER: Now, let me ask you a question. Have you got Page 1? You've got exhibits before you. Go to Page 5. You've got Page 1 of 2? It's not included in there. This is the second page, Page 5 of 25 is Page 2.

WITNESS SCARBROUGH: Yes, sir, I see.

COMMISSIONER GUNTER: I was wondering what Page 1 was. It's not included in the package?

WITNESS SCARBROUGH: That's a good question. I don't know.

COMMISSIONER GUNTER: Because, you know, it's sort of -- has Staff got that? It's a Staff exhibit.

WITNESS SCARBROUGH: I see it. Commissioner --

MS. RULE: I'm told this is everything we got from Gulf, sir.

COMMISSIONER GUNTER: Let me ask you a question then, Mr. Scarbrough.

MS. RULE: Commissioner, I believe it's out of order and the next page, Page 6, appears to be the first page of that packet.

COMMISSIONER GUNTER: Is that it, it's just backwards?

MS. RULE: I believe so, as far as I can tell.

COMMISSIONER GUNTER: All right. That was a piece I was trying to -- but that really didn't fit because there is a Page 2 on Page 7. And the typing is different. It's not the same letter.

MS. RULE: You're right.

COMMISSIONER GUNTER: You have a completion of a letter from St. Regis Paper Company on Page 6 that goes on and they have a signature page on Page 7.

MS. RULE: You're right and Page 5 is signed by --

COMMISSIONER GUNTER: I'm trying to find out where Page 1, that would accompany Page 5.

WITNESS SCARBROUGH: I don't know, I think we could probably get that for you. Apparently that is a letter written by Jim Dunning, who, at that particular time, was responsible for the Land Department.

COMMISSIONER GUNTER: Could you get that for us?

WITNESS SCARBROUGH: Yes, and I'm sure it's in the file because he wrote the letter to somebody explaining this to them.

COMMISSIONER GUNTER: Let me just ask you a question.

WITNESS SCARBROUGH: In fact, I have it here right now.

COMMISSIONER GUNTER: Well, that would be great. If we just get a copy of it, it would satisfy my curiosity.

WITNESS SCARBROUGH: It was a letter from Mr. Jim Dunning to Mr. Bill Pugh, who is our Manager of Plant Accounting.

COMMISSIONER GUNTER: All right. In making a determination of the value of plant held for future use, you have a land total book cost, and for tax purposes if you're going to go buy raw land, you go get that thing cruised, so that if you sell that timber you don't have to pay tax on it.

WITNESS SCARBROUGH: Right.

COMMISSIONER GUNTER: When did you all buy this property, the Caryville site?

WITNESS The 2,000 acres here?

COMMISSIONER GUNTER: Yeah. In the '70s?

WITNESS SCARBROUG: Can I gee some help here? Let me find out what year it was. We didn't buy all the land at the same time but it was over a period of time. (Pause)

Initially we bought some in '64, the majority of it was bought between '74 and '76.

COMMISSIONER GUNTER: The majority of it between '74 and '76. What was the date of this letter? You've got the first page of it.

WITNESS SCARBROUGH: Dated September 13th, 1984.

COMMISSIONER GUNTER: 1984. So the timber value on that property increased almost tenfold in ten years, 12 years, 14 years?

WITNESS SCARBROUGH: Yes. Wait a minute.

COMMISSIONER GUNTER: The reason I'm asking the question, Mr. Scarbrough, is about the taxability on the timber sale, $425,000 worth of timber. If you had a good cruise on the front end that's nontaxable to you when you sell it. That's you just getting your money back.

WITNESS SCARBROUGH: That's right.

COMMISSIONER GUNTER: I'm just a little interested -- I grow pine trees, you know. I don't have the kind of soil that would let me have a terfold return in anything less than a bunch of years. I was just wondering, in fact, if they're using Miracle Grow. That's what grows big vegetables?

WITNESS SCARBROUGH: Where are you getting -- and you're absolutely right,I don't see the --

COMMISSIONER GUNTER: I'm looking at the sale price of timber of $425,000. That's Page 5 of 25. And the estimated timber value at the time of purchase of $48,000.

WITNESS SCARBROUGH: All right, sir.

COMMISSIONER GUNTER: And even if you clear-cut every stick of it, you had about a ninefold growth in the value of the timber, and timber prices have not changed that much.

WITNESS SCARBROUGH: The only thing I can tell you is that that estimate was made by the St. Regis Paper Company and I assume they know what they have to do, and this is after the fact -- in fact, the question you're asking you not only have to do what you're describing to determine the taxability of it, but that's how you determine how much is capitalized and how much goes to revenue.

COMMISSIONEP GUNTER: I understand.

WITNESS SCARBROUGH: The 48,000 would have been the amount that would have been credited to the land account and the difference between it would have been accredited to revenue.

COMMISSIONER GUNTER: Okay. But you're going to get us Page 1?

WITNESS SCARBROUGH: Yes, sir, I have it here.

MS. RULE: Commissioner, I'm told that there is not a problem with Gulf producing the document. For some reason it was not copied into our exhibit. It's being copied right now and I'll distribute copies of that first page.

COMMISSIONER GUNTER: Okay. Fine. Thank you.

Q (By Ms. Rule) Mr. Scarbrough, at this point when does Gulf plan to come in for its next rate case?

(Laughter)

A That could be, you know, as early as before the end of this year; or as late as three or four or five years out.

Q And you've made certain assumptions in amortizing some amounts, have you not?

A In amortizing -- you're talking about the rate case expense?

Q For example, yes.

A The rate case expense, as I said this morning, this is obviously always a very subjective type of thing in making that determination.

The first thing we try to do in making any kind of estimate like that, we try to determine what, you know, what the Commission might do. And we looked and determined that you allowed us, in the last rate case, to amortize it over two years. And, in addition to that, we have had five rate cases in the last ten years, which is an average of one every two years, and that's how we arrived at the two rather than looking forward. (Pause)

Q Mr. Scarbrough, do you have Exhibit 430 in front of you? That's a Staff audit report. I believe that was not contained in your exhibit packet, but was handed to you at the beginning of cross examination.

A Yes, I do.

Q Beginning on Page 98 of the exhibit, the audit report discusses Disclosures 59 and 60, and those are the FERC audit exceptions and violations, are they not?

A Yes.

Q Have any of those been resolved with FERC?

A I think they have. Just a minute. Let's get a cheat sheet here and we'll see if --

MS. RULE: Commissioners, would you like to give this witness a few minutes to look through his material? This might be a good time to give him a break.

CHAIRMAN WILSON: Sure, let's take about five or six minutes here.

(Recess)

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MS. RULE: Commissioners, we are handing out now the first page of that two-page letter.

COMMISSIONER GUNTER: Hold on just a minute. (Pause)

MS. RULE: Page 5 -- it's not the right one.

COMMISSIONER GUNTER: That's Page 5.

CHAIRMAN WILSON: I think Mr. Scarbrough said he had it. (Pause)

MS. RULE: I'm told we preliminarily really thought we had it, and now we are really going to have it. And it's being copied is what I am told. This is subject to check and later review, of course.

COMMISSIONER BEARD: Subject to further review.

MS. RULE: The third final copy will be around soon.

Q (By Ms. Rule) Okay, Mr. Scarbrough, you were looking at some of the FERC audit exceptions and violations in Disclosure 59 and 60, and I had asked you had any been resolved with FERC.

A You just want to start 1, 2, 3 and 4?

Q Uh-huh.

A You just want to start --

Q That will be fine.

A Okay. Item 2 we have agreed.

Q What page are you on, sir? Are you looking at Exhixbit 430?

A Here we go, just a minute.

COMMISSIONER EASLEY: Mr. Scarbrough, you're confusing things when you want to start with 1, 2, 3 and 4.

WITNESS SCARBROUGH: Okay. On Page -- of your exhibit -- I don't see the exhibit number. It's Page -- let me look at the front. Exhibit 430, Page 99 of 114.

Q (By Ms. Rule) That's Audit Disclosure No. 59 continued, is it not?

A That's right. And Item No. 2 --

Q By "Item No. 2" do you mean FERC Exception 2?

A Yes.

Q What was the outcome of FERC Exception 1?

A We basically have agreed with FERC on 1, which has got to do with buy-out costs, and we have filed agreements, or are in the process of filing an agreement with FERC for approval, both our unit power sales customers and our wholesale customers. That's a fuel-related item.

No. 2, we have agreed to that adjustment.

Q That's the improper classification of payments to Alabama By-Product Corporation?

A That's right. Here, again, that's fuel-related.

Item 3 is fuel-related, and where we stand there, we are sticking with our position and they are supposedly reviewing their position. So that hasn't been resolved.

Q And FERC Exception 3 deals with payments made to Alabama By-Product Corporation in connection with the closing of Maxine Mine, correct?

A Yes.

Q Have you resolved FERC Exception 4?

A No. We're loggerheads on that still. Here, again, that's fuel-related also.

Q Have you resolved FERC Exception 5?

A That we have agreed; have actually received the refund from Georgia and have actually recorded that on our books.

Q That relates to the acquisition adjustment for Plant Scherer?

A No. That doesn't relate to the acquisition adjustment. That relates to the actual purchase of Plant Scherer itself, not the common facilities.

Q Thank you. Has FERC Exception No. 6 been resolved? That's the acquisition adjustment.

A That's what we reviewed earlier about the 406, and no, we have refiled with FERC and are waiting on their response.

Okay, on 59, 7, which is on Page 101 of 114 of your exhibit.

Q You're referring to Audit Decision No. 59, FERC Exception No. 7?

A That's correct.

Q That one deals with the accounting procedures for accruing allowance for funds used during construction?

A Right. Let me -- okay. What has happened there and what the issue is, back at the time when we could issue pollution control bonds, the way that works, you issue a pollution control bond for qualified pollution control facilities. It's tax exmpt to the purchaser of those bonds, and obviously you get a much lower rate than you would have if the interest, of course, was taxable to the purchasers of those bonds.

The requirements are you put those amount of dollars into an interest bearing -- well, it doesn't have to be interest bearing, but you put them into a fund with a trustee, in most cases a bank. Then as you make those pollution control expenditures and certify that you have actually made the pollution control expenditures, you, in effect, draw down. So if you've got 50 million in there, and you spend $3 million on pollution control facilities, you go and you with -- you drawn down $3 million. At the same time, that fund is earning interest.

And the Accounting Release No. 13 issued by the Federal Energy Regulatory Commission says that you charge AFUDC on your normal rate to the fund balance and that you credit plant with any earnings on that fund balance. And they've got -- we followed that to the tee. The problem is when Unit 3 went in service on January 1st, 1987, we had not drawn down all of those funds because we were still in the process of trying to certify which expenditures were pollution control. And you may think that would be pretty simple, but it's really not. It takes a room full of lawyers to really sometimes decide exactly whether this is a qualifying expenditure. So after -- normally when --

CHAIRMAN WILSON: That's your real problem, probably should have had some engineers in there.

WITNESS SCARBROUGH: Well, they are included also, but normally, obviously, when you --

CHAIRMAN WILSON: You should have had a couple of regulators there.

COMMISSIONER GUNTER: You'd need a bigger room.

WITNESS SCARBROUGH: Normally when you place any project in service, you stop calculating AFUDC on it, and that's exactly what we did on Plant Scherer, we stopped AFUDC on the expenditures of Plant Scherer because it went in service on 1-1-87. However, on this fund we continued from 1-1-87 until we made the final drawdown in 1988, calculating AFUDC on the fund, and also crediting plant with the earnings on the fund. And that's where we have a difference of opinion. They say that we should have stopped it. We said, "By your own regulation we are doing what you asked us to do, and we disagree on that." We think -- "here is just an opinion, we think that we've got them leaning our way on that, but that hasn't been resolved yet and that's what the issue is, but it still hasn't been resolved.

Q (By Ms. Rule) So there are two parts to FERC Exception No. 7, Plant Scherer and unfunded post-retirement benefits, and neither of those have been resolved?

A Okay, you're right, there is another piece of it. On the part on the post-retirement expenses, what they are saying there, and they are technically correct, what they are saying is we have accrued some post-retirement benefits for life and medical and that we have capitalized some of those expenditures -- I mean some of those accruals, not expenditures, but accruals, and that we had not made the payment. And we have had conversation with Mr. Gunter about that this morning already about the lack of funding and so forth. And what you normally do, you don't charege AFUDC on an expenditure that's accrued on the books and that you've actually made the expenditure. And that's what we always try to do.

In this particular -- in other words, if we set up an account and have it in Accounts Payable, it will be charged in the plant, but you will have a payable. You won't have actually paid out the cash, and, therefore, you exclude that from your base in calculating AFUDC. We did not do that with these pollution control -- I mean the post-retirement benefits that were capitalized. They were very small amounts. And with the new AFUDC rule, which says that you don't record any AFUDC, unless the expenditure is over $25,000, plus extends beyond a year's period. The AFUDC that's being recorded is very minimal, and to have to come up with a procedure would probably -- we'd probably have to spend 50 to $75,000 modifying the general ledger system and the plant accounting system to automatically pick that up for these post-retirement benefits.

So that's where we are on that. Basically, we technically agree with them, but we think it's so immaterial, particularly such a small amount of AFUDC that we are recording. And if we are directed to do it by this Commission, we'll fix it, but it's going to cost some money to do it.

Q Has FERC Exception 8 been resolved? That's the accounting for the sale of railroad cars and subsequent leasing of other railroad cars?

A That's a fuel issue and it has not been resolved.

Q On the next page is Audit Disclosure No. 60. It lists 13 compliance violations with the FERC Audit. I'd like you to go through those and tell me what they are and whether they've been resolved.

A Okay, No. 1 on Page 102 of your -- wait a minute. On Page 103 of your exhibit, 103 of 114, that Violation No. 1 is a generating plant spart -- excuse me, generating plant spare parts. That exception has been dropped by FERC. No. 2 has been also dropped by FERC. That has to do with land not currently being used in utility operation. That's been dropped. We have agreed with that and there was no impact on either income statement or the balance sheet.

We agree with the FERC on that adjustment and those corrections have been made and it's part of our system to follow their recommendation.

Q Are you referring to FERC Violation 3, Recording of Adjustments and Income Tax?

A 4, Accounting for Interest and Income Expense. (Pause)

Yes, we agree with that, with the second, we call it B, 4-B, the second part of Violation No. 4, and have made the adjustment for that.

Okay. And No. 5, we agree with that recommendation and we have made a correcting entry to that last year.

Q Could you tell me the adjustment on 4-B that was made and the correcting entry made in relationship to Violation 5?

A Excuse me, are you talking about on Compliance Exception No. 5? Marsha, are you talking about 4-B? It actually shows up under 4 but there is actually two pieces of that.

Q Yes. And I believe you said there was an adjustment made as a result of that.

A Right. In other words, rather than charging 514 and 562, which is Miscellaneous Steam Plant and Station Expenses, they said since that's a carrying cost, they are saying that we should have debited that to interest expense, which is Account 431 and we have done that.

Q What was the amount?

A Excuse me. The carrying charge accounting, which is the 4-B part, has not been changed. I was looking at the A part. The carrying charge accounting has not been changed. It's probably less than $1,000 a month.

Q What affect, if any, would that have on 1990s figures?

A Well, obviously it would take some money out of 514, 562 and it put it in interest expense

Q Mr. Scarbrough, I think we can hurry this up considerably, if you would provide me with a late-filed exhibit listing for each FERC violation any resolution that's been made, and any -- the amount and affect on the 1990 figures for any adjustments that were made.

A On the rate filing for 1990

Q Yes.

CHAIRMAN WILSON: That would be Exhibit 558.

(Late-Filed Exhibit No. 558 identified.)

A You're not asking for that on the exceptions, you're just asking for that on the violations.

Q If there is any such impact from the exceptions, yes, we'd like to know that, too.

CHAIRMAN WILSON: Let's break for lunch now. Come back at 1:00.

(Lunch recess.)