State of Florida

# Public Service Commission

CAPITAL CIRCLE OFFICE CENTER • 2540 SHUMARD OAK BOULEVARD
TALLAHASSEE, FLORIDA 32399-0850

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

**DATE:** APRIL 8, 1999

**TO:** DIRECTOR, DIVISION OF RECORDS AND REPORTING (BAYÓ)

**FROM:** DIVISION OF AUDITING AND FINANCIAL ANALYSIS (MAILHOT, LESTER, SLEMKEWICZ, MAUREY)
DIVISION OF ELECTRIC AND GAS (E. DRAPER, KUMMER, BREMAN, TEW)
DIVISION OF LEGAL SERVICES (ELIAS, COLLINS)

**RE:** DOCKET NO. 990250-EI - INVESTIGATION INTO THE EARNINGS AND AUTHORIZED RETURN ON EQUITY FOR GULF POWER COMPANY.

DOCKET NO. 990244-EI - PETITION BY GULF POWER COMPANY FOR APPROVAL OF PROPOSED PLAN FOR AN INCENTIVE REVENUE SHARING MECHANISM THAT ADDRESSES CERTAIN REGULATORY ISSUES INCLUDING A REDUCTION TO THE COMPANY'S AUTHORIZED RETURN ON EQUITY.

**AGENDA:** 04/20/99 - REGULAR AGENDA - PROPOSED AGENCY ACTION (ISSUES 1 AND 2 ONLY) - INTERESTED PERSONS MAY PARTICIPATE

**CRITICAL DATES:** NONE

**SPECIAL INSTRUCTIONS:** NONE

**FILE NAME AND LOCATION:** S:\PSC\AFA\WP\990250.RCM
ATTACHMENT A IS NOT AVAILABLE

## CASE BACKGROUND

Staff met with Gulf Power Company (GPC, Gulf, or the Company) and the Office of Public Counsel (OPC) in December 1998 and January 1999, to discuss staff's concerns with the Company's authorized return on equity (ROE) and the treatment of certain regulatory assets. Staff, the Company, and OPC also had conference calls in January and February 1999. Staff initiated the meetings with OPC and the Company after the Commission's decision at the December 1, 1998 Agenda Conference, to accept Florida Power and Light's (FPL)

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proposal to reduce its authorized ROE. Staff believes that the Commission should address GPC's regulatory assets, earnings, and authorized ROE.

On March 2, 1999, GPC filed a Petition for approval of an incentive revenue sharing mechanism. Staff filed a recommendation on March 4, 1999. At the March 16, 1999 Agenda Conference, the Commission directed the staff, the Company and intervenors to continue to try to resolve the issues in this docket through negotiation. Also, the Company agreed to record an additional accrual of $3.0 million annually to its Property Insurance Reserve, effective January 1, 1999, to avoid placing revenue subject to refund. Staff, the Company and the intervenors met several times but did not reach an agreement. Attachment A is the Company's revised proposal as of April 7, 1999. Attachment B is staff's position.

Issue 1 is staff's recommendation on the Company's revised proposal. In Issue 2, staff proposes an incentive sharing plan. The Plan presented by staff is a combination of concepts previously ordered by this Commission and not necessarily what staff would recommend after a comprehensive hearing. If Issue 2 is not approved then staff recommends in Issues 3 and 4 that an earnings investigation be initiated and that GPC be required to file Minimum Filing Requirements. Issue 5, recommends that revenues be placed subject to refund pending a review of GPC's Contract Service Agreements.

**DISCUSSION OF ISSUES**

**ISSUE 1**: Should the Commission approve GPC's revised proposal for an incentive revenue sharing mechanism that addresses certain regulatory issues including a reduction to the Company's authorized ROE (Attachment A)?

**RECOMMENDATION**: No. The Commission should not approve GPC's revised proposal. (MAILHOT, LESTER)

**STAFF ANALYSIS**: On March 2, 1999, GPC filed a petition to implement a sharing plan and to address certain regulatory assets and its authorized ROE. On April 7, 1999, the Company filed a revised proposal. The revised proposal targets GPC's earnings at a 12.2% ROE through the write down of a regulatory asset, the recording of an additional accrual to its Property Insurance Reserve, and a customer credit of $3.7 million. Staff believes that the Company's revised proposal does not adequately address its earnings, regulatory assets or authorized ROE. Staff's analysis is limited to the points of the revised proposal with which we disagree.

The Company proposes to reduce its authorized ROE from 12.0% to 11.6% and then to share any earnings in excess of 12.6% on a 40%, 20%, 40% basis. 40% is to be retained by the Company. 20% is to be applied to the write off of certain regulatory assets and to the Property Insurance Reserve. 40% is to be refunded to customers through a credit. The Company reported achieved earnings of 12.99% ROE on its December 1998 Earnings Surveillance Report (ESR) and is projecting a 12.85% ROE for 1999. Both of these earnings amounts include a discretionary $3 million accrual to the Property Insurance Reserve. Without these discretionary accruals, GPC would be earning in excess of its currently authorized ROE ceiling.

Point 2 of the plan proposes a new authorized ROE of 11.6% with a range of 10.6% to 12.6%. Staff believes that 11.6% for GPC is inappropriate given current capital market conditions. In its original proposal, GPC stated that it believes its ROE should be reviewed in light of its reliability and quality of service, its competitive rates, and its equity ratio. Regarding the quality and reliability of service, staff believes that these issues do not have a direct bearing on the determination of the cost of capital. GPC can be proud of its record on customer service, but customers should not have to pay a higher cost of capital for receiving such service. GPC should not be rewarded through a higher cost of capital for doing the job the public expects.

Currently, GPC has the lowest residential rates among the major investor-owned electric utilities in Florida. Staff believes this is caused by differences in cost conditions for GPC and the other electric utilities, and efficiency could be part of these cost conditions. However, staff does not believe lower rates to customers warrant a higher ROE or cost of capital. The ROE is determined by the capital markets. Investors are properly compensated when they receive a return commensurate with the risks of the investment and the returns on similar investments. No additional compensation is necessary or appropriate.

Presented below are GPC's equity ratios for the past 6 years.

**Gulf Power Company's Equity Ratios, 1993-1998**

| Date | Sep. 30, 1998 | 1997 | 1996 | 1995 | 1994 | 1993 |
|---|---|---|---|---|---|---|
| Percent | 49.3 | 46.8 | 47.2 | 45.4 | 45.3 | 44.9 |

Source: Standard & Poor's Financial Statistics, September 30, 1998; Standard and Poor's Utility Credit Report, Gulf Power Company, June 1997

GPC's equity ratio has ranged from 44.9% to 49.3%. This equity ratio is within the range of equity ratios for electric utilities with A+ bond ratings, and staff is not recommending the Commission consider adjusting GPC's equity ratio. A low equity ratio may need to be compensated with a higher ROE. However, GPC's equity ratio is not low when compared with other electric utilities with the same bond rating. Staff does not believe GPC's equity ratio justifies its proposed ROE of 11.6%, given current market conditions.

As discussed in Issue 3, staff believes GPC's proposed ROE of 11.6% is excessive given current market conditions. GPC's offer to reduce its authorized ROE by 40 basis points is not sufficient given the decline in interest rates and the allowed returns approved in other jurisdictions. For these reasons, staff believes GPC's proposal does not adequately address its authorized ROE.

Point 6 of GPC's proposal requests that the Commission cease removing non-utility investment solely from common equity in reconciling the capital structure and rate base. The Proposal would have GPC's merchandising operations and other non-utility investment removed from the capital structure either on a pro rata basis (instead of totally from equity) or based on a proxy capital structure of companies engaged in the financing of merchandise sales, whichever capital structure has the greater equity ratio.

GPC's non-utility investment consists primarily of receivables arising from the sale of appliances to customers. Inventory is also part of this investment. This adjustment, from specific removal of non-utility investment from equity to pro rata removal, affects earnings by approximately 20 basis points. The revenue effect is approximately $1.2 million.

The current practice of removing non-utility investment from equity for surveillance purposes was approved in Order No. 23573 issued October 3, 1990 in GPC's last rate case. In this Order, the Commission stated:

> Next, we believe all non-utility investment should be removed directly from equity when reconciling the capital structure to rate base unless the utility can show, through competent evidence, that to do otherwise would result in a more equitable determination of the cost of capital for regulatory purposes. In the case of Gulf, we believe that the non-utility investments should be removed from equity. This will recognize that non-utility investments will almost certainly increase a utility's cost of capital since there are very few investments that a utility can make that are of equal or lower risk. Removing non-utility investments directly from equity recognizes their higher risks, prevents cost of capital cross subsidies, and sends a clear signal to utilities that ratepayers will not subsidize non-utility related costs.

The adjustment to remove non-utility investments from equity has been made in several cases. In the matter of GTE Florida, Inc. in Docket No. 920188-TL, the Commission's decision to remove non-utility investments from equity was approved in Order No. PSC-93-0108-FOF-TL issued January 21, 1993, affirmed on reconsideration in Order No. PSC-93-0818-FOF-TL issued May 27, 1993, and upheld on appeal to the Florida Supreme Court.

Staff believes the Commission should continue its practice of removing non-utility investment from common equity. Staff does not agree with the methodology of using a proxy capital structure , as proposed by GPC. This proposed method would provide GPC with an incentive to finance riskier investments through the utility's capital structure. For these reasons, staff recommends the Commission reject this aspect of GPC's proposal.

Point 7 of GPC's proposal addresses the sharing point and sharing percentages, along with the disposition of any amounts to

be shared. The Company proposes that it start sharing at 12.6% ROE and be allowed to retain 40% of earnings above the 12.6% ROE. Staff does not agree with the Company's proposal.

The primary differences between the Company and staff are the ROE at which earnings are targeted, the ROE at which sharing begins, the sharing percentages, a productivity factor for 2000 and 2001, and changing the treatment of non-utility investments from the last rate case. Approving GPC's revised proposal would begin the incentive sharing plan at a level of earnings which staff believes is above the level indicated by current market conditions. For these reasons, staff recommends that GPC's revised proposal should not be approved.

In evaluating the Company's proposal, staff considered the most likely outcome of a rate case. In a rate case, rates would be set at a midpoint. Based on other Commission actions, decisions in other states and changes in the capital markets, we believe an ROE of 11.2% or below would be set. Also, we don't believe the Commission would deviate from its long standing practice of removing non-utility from equity. Considering these factors, there is at least a 120 basis point difference ($7.2 million in revenue), between Gulf's proposal and a likely rate case result.

**ISSUE 2**: Should the Commission approve the plan listed in Attachment B?

**RECOMMENDATION**: Yes. The Commission should approve the sharing of earnings plan in Attachment B for Gulf Power Company. (MAILHOT)

**STAFF ANALYSIS**: As discussed in the Case Background, staff met with the Company and the Office of Public Counsel to resolve issues concerning GPC's earnings, authorized ROE and certain regulatory assets on GPC's books. We were unable to reach any resolution. Staff has prepared a plan, detailed in Attachment B, which we believe adequately addresses our concerns.

Staff is recommending a sharing of earnings plan for GPC for the years 1999, 2000, and 2001. The Commission implemented a sharing of earnings plan for BellSouth in Docket No. 880069-TL, by Order No. 20162, issued October 13, 1988. The sharing of earnings concept was applied to BellSouth from 1988 through 1997. Staff believes that the concept worked well for the ten year period, providing significant benefits through rate reductions and refunds to the customers and allowing BellSouth the opportunity to earn higher rates of return.

In Order No. 20162, the Commission found that:

> Traditional utility regulation has historically taken the form of rate of return regulation (ROR) by independent regulatory authorities such as this Commission. Under this approach, privately-owned utilities such as Southern Bell are given the opportunity to collect rates which will cover operating costs and earn a reasonable rate of return on property devoted to providing the regulated service. In recent years in Florida, the Commission has calculated a rate of return as a mid-point and generally allowed a 100 basis point zone of reasonableness around that point.
>
> In our view, the disincentives of the present regulatory system are most likely to occur when the utility is earning at or near the top of its authorized range. Below this level, the company has the same incentive to raise productivity and offer new services as any other business. It is only when one sees no reward for doing what would otherwise be prudent that disincentives set in. No empirical evidence was offered to support the theory of disincentives under ROR regulation. However,

> this theory does have logical appeal. The analogy of the salesman working on commission selling more goods than the salesman working for a flat salary is instructive. The difference is that the one salesman has an incentive to sell more goods and will do so. A company's management and stockholders are no different. They make investment decisions based on the return they will receive. One can reasonably expect that given the opportunity to earn a higher return, even if it has to be shared, will encourage further investments and efficiencies as well as new services.

Order No. 20162 also notes that it was not a generic endorsement of the concept of sharing and expressed no opinion as to other companies or industries.

Staff believes that the time is right to apply the sharing concept to GPC. The Company is currently earning at its authorized ROE ceiling and disincentives may set in. GPC is expected to bring additional generating capacity on line in 2002, which will increase revenue requirements. To prepare the Company for this, we should implement a plan which reduces future revenue requirements by writing off past costs before 2002 and encourages the Company to become more efficient by allowing it the opportunity to earn a higher ROE in 1999, 2000, and 2001.

In item 2 of attachment B, staff has proposed certain returns on equity. The proposed ROE midpoint is 11.2%. Staff believes this is a reasonable proposal for GPC given the recent 11.0% midpoint for FPL, which the Commission approved as part of a stipulation by Order No. PSC-99-0519-AS-EI, issued March 17, 1999. GPC has suggested that the Commission consider its equity ratio in determining its ROE. Staff calculated a leverage formula, in the manner of the water and wastewater leverage formula. This formula indicates that, relative to the decision in the FPL case, the additional 20 basis points is appropriate for GPC's 49% equity ratio. Therefore, staff believes the 11.2% ROE midpoint is appropriate. The point at which earnings are targeted is 11.8%.

Item 3 of Attachment B addresses two regulatory assets on GPC's books and its Property Insurance Reserve. Staff recommends that each of these regulatory assets be written off in equal amounts per year during 1999, 2000, and 2001. The Commission previously approved the write off of the balance of the flow through portion of the FAS 109 regulatory asset for FPL.

Item 4 of Attachment B requires a credit to the customers. Staff has calculated the amount based on targeting the Company's earnings at 11.8% ROE. In addition staff has included the effect of the write offs of the regulatory assets in item 3 of Attachment B.

Item 5 of Attachment B addresses earnings above the sharing point of 12.2% ROE. Since staff is proposing to target earnings at 11.8% ROE which is above the midpoint of 11.2% ROE, staff is recommending a sharing of the earnings on a 66.7%/33.3% basis in the ratepayers' favor. In the case of BellSouth, the Commission required additional rate reductions each year of the plan to account for accretion or the normal improvement in earnings and productivity. In this case, staff is not recommending that additional rate reductions or credits be implemented for 2000 and 2001, but that the same amount ($7.0 million) of credit be applied each year. Staff is not certain of the amount of accretion or normal productivity gains that can be expected to occur. Therefore, staff is recommending a more conservative approach. The plan requires that additional amortization be recorded to the Property Insurance Reserve for 2000 and 2001 only if earnings exceed the 12.2% ROE sharing point.

Item 6 of Attachment B removes the flexibility previously granted by the Commission to GPC for the recording of additional amounts of amortization to the Property Insurance Reserve. Item 5 specifies how any additional amortization to the Property Insurance Reserve is to be determined. In addition, we do not believe it is reasonable to allow GPC the flexibility to reduce the amount of sharing to which the ratepayers may be entitled under this plan.

Item 7 of Attachment B requires that the jurisdictional separations factors be updated based on 1998 data.

Item 8 of Attachment B requires interest on any amounts to be credited to the ratepayers. For the purpose of calculating interest, any amounts to be credited to the ratepayers should be assumed to be earned equally throughout the year.

The primary changes to staff's March 4, 1999 recommendation are 1)an increase in the rate setting point from 11.2% ROE to 11.8% ROE; 2) an increase in the sharing point from 12.0% ROE to 12.2% ROE; 3) a decrease in the Company's sharing percentage from 40% to 33.3%; and 4) a decrease in the productivity factors from $3 million and $6 million to $2 million and $2 million for 2000 and 2001, respectively. Staff recommends that the Commission approve the sharing of earnings plan in Attachment B for Gulf Power Company.

**ISSUE 3**: Should the Commission initiate a proceeding to investigate Gulf Power Company's earnings and authorized ROE?

**RECOMMENDATION**: Yes. If Issue 2 is not approved, staff believes that an investigation should be initiated and a limited proceeding hearing should be held to determine the appropriate ROE and range. (LESTER, MAILHOT)

**STAFF ANALYSIS**: Gulf Power Company's last rate case was in Docket No. 891345-EI. In that proceeding, the Commission set GPC's authorized ROE at 12.55% by Order No. 23573, issued October 3, 1990. This order contained a 50 basis point reduction to the ROE for mismanagement, and rates were set at 12.05%. After 2 years, the reduction no longer applied.

By Order No. PSC-93-0771-FOF-EI, issued May 20, 1993, the Commission approved a stipulation between Gulf Power Company, OPC, and FIPUG that set GPC's authorized ROE at 12.0%. The 12.0% is the midpoint of a range of 11.0% to 13.0% for any and all regulatory purposes. The Commission typically allows a range of 100 basis points around the authorized midpoint for earned ROEs. With the 12.0% midpoint, GPC can earn up to a 13.0% ROE without overearning.

In May 1993, when the Commission set GPC's current ROE of 12.0%, the monthly average yields on the 30-year treasury bond and A-rated public utility bond were 6.92% and 7.86%, respectively. As of February 1999, the yield on the 30-year treasury bond was 5.37% and the yield on the A-rated public utility bond was 7.09%. Staff believes this decline in interest rates indicates a corresponding decrease in the required return on common equity for electric utilities. In addition, Staff's ROE models indicate a decline of approximately 95 basis points in Gulf's ROE from June 1993 to December 1998. These interest rates, GPC's authorized ROE, and the spread above the A-rated public utility bond are presented below.

| **Analysis of Gulf Power Company's ROE and Concurrent Bond Yields** | | | | |
|---|---|---|---|---|
| | February 1999 | January 1999 | May 1993 | October 1990 |
| A-rated Public Utility Bond | 7.09% | 6.97% | 7.86% | 10.05% |
| 30-year Treasury Bond | 5.37% | 5.15% | 6.92% | 8.84% |
| Gulf's Authorized ROE | 12.0% | 12.0% | 12.0% | 12.55% |
| ROE Spread above A-rated Bond | 4.91% | 5.03% | 4.14% | 2.50% |
| Source for Bond Yields: Moody's Credit Perspectives | | | | |

In Docket No. 960502-GU, the Commission set City Gas' ROE at 11.3% in Order No. PSC-96-1404-FOF-GU, issued November 20, 1996. In Docket No. 980696-TP, the Commission set the ROE for BellSouth Telecommunications, Sprint, and GTE Florida at 11.5% in Order No. PSC-99-0068-FOF-TP, issued January 7, 1999, as part of a cost determination docket. Staff believes that GPC has less risk than BellSouth, Sprint, or GTEFL. Finally, by Order No. PSC-99-0519-AS-EI, issued March 17, 1999, the Commission approved a stipulation for FPL that set the ROE midpoint at 11.0%, with a range of plus or minus 100 basis points.

The following table shows ROEs recently set by other state regulatory commissions:

| S & P RATING | COMPANY | ORDER DATE | ROE | STATE |
|---|---|---|---|---|
| A+ | PacifiCorp | 03/04/99 | 10.50% | Utah |
| A- | AEP-Virginia Power | 02/11/99 | 10.85% | Virginia |
| A+ | Georgia Power Company | 12/21/98 | 12.5%* | Georgia |
| AA | Northern States Power | 09/17/98 | 11.90% | Wisconsin |
| A- | Empire District Electric | 07/21/98 | 9.50% | Arizona |
| A- | Metropolitan Edison | 06/26/98 | 10.00% | Pennsylvania |
| A+ | Pacificorp | 05/05/98 | 10.00% | Oregon |

Source: Rate of Return Data Book, 3rd Qtr., 1998, 4th Qtr., 1998, Kan & Assoc.
*The top of the range; sharing begins at this point.

Compared with the decline in interest rates and the returns approved in other jurisdictions, GPC's currently authorized ROE of 12.0% appears excessive. Therefore, staff recommends the Commission hold a limited proceeding hearing to set the appropriate ROE for Gulf Power Company for all regulatory purposes.

According to its ESR for December 1998, GPC earned 12.99% for 1998. The utility's budget for 1999 indicates that it will earn a return of 12.85%. If the Commission lowers GPC's ROE, the amount of overearnings will increase. A 100 basis point change in ROE for GPC equates to approximately $6 million. Therefore, staff recommends that the Commission hold a limited proceeding hearing to determine a new ROE for measuring Gulf's earnings. After authorizing a new ROE, the Commission can determine if it needs to place additional funds subject to refund and its course of action.

By Order Nos. 22205, issued November 21, 1989 and 22490, Issued February 5, 1990, United Telephone Company of Florida (United) and FPL, respectively, were ordered to reduce its ROE. The new ROEs were then used to place money subject to refund. In both instances, the Commission decided that the appropriate range for ROE was 50 basis points on each side of the midpoint instead of the norm of 100 basis points. The ROE was then reviewed again during the pendency of the rate proceeding. Therefore, the range for the ROE should be an issue for the limited proceeding.

Staff notes that in order to provide adequate protection for the ratepayers, the Commission should hold the limited proceeding on the appropriate ROE and its range at the earliest possible date. Staff believes a bench decision is warranted and the Commission should determine if additional funds should be held subject to refund.

**ISSUE 4**: Should the Commission order GPC to file Minimum Filing Requirements (MFRs)?

**RECOMMENDATION**: Yes. If Issue 2 is not approved, staff recommends that the Commission order the Company to file MFRs, by July 15, 1999, using 1998 as the base year, and 1999 as the projected test year. (MAILHOT)

**STAFF ANALYSIS**: Staff believes that the most appropriate test year is the year 1999. The Company has already prepared and filed with the Commission a budget for 1999. Therefore, Staff believes that preparing MFRs based on 1999 budget data is reasonable.

GPC should be directed to file the MFRs (Form PSC/EAG/11). In order to provide for adequate time to review the data and have rates placed into effect as soon as is reasonably possible, staff recommends that GPC file the MFRs by July 15, 1999.

**ISSUE 5**: Should the Commission initiate a review of GPC's executed Contract Service Agreements (CSA) under its Commercial/Industrial Service Rider tariff (CISR)?

**RECOMMENDATION**: Yes. For the twelve month period ending December 31, 1998, GPC reported an achieved ROE of 12.99%. The top of GPC's currently authorized ROE range is 13.00%. The addition of the revenues that would have been produced by GPC's otherwise applicable tariff and the revenues that are produced under the CISR (revenue shortfall) cause GPC's ROE to exceed the top of its authorized range. Order No. PSC-96-1219-FOF-EI requires the Commission to review each CSA if the addition of the revenue shortfall causes GPC to exceed the authorized top of its range. The amount of the revenue shortfall over the top of the range should be held subject to refund pending the completion of the review. (E. DRAPER, SLEMKEWICZ)

**STAFF ANALYSIS**: GPC's CISR tariff allows the Company to enter into negotiated contracts with commercial/industrial customers. Order No. PSC-96-1219-FOF-EI (Order), issued September 24, 1996, in Docket No. 960789-EI. To receive service under the CISR, the customer has to demonstrate to Gulf that without the negotiated contract, the customer would leave Gulf's system, would not expand existing load, or, in the case of a new customer, would not locate in Gulf's territory (at-risk customer). If Gulf and the customer agree on the price and other terms and conditions, they would execute a CSA. The order does not require that the Commission review each CSA, however, the order specifies two triggering events that would result in a Commission review of each executed CSA. The first triggering event is a request by Gulf for a base rate increase. The second triggering event would result from conditions identified through the Commission's monthly surveillance reporting system discussed below. The Commission may also initiate a prudence review of any CSA upon its own motion.

Gulf provides a confidential supplement (Document No. 01906-99) to its monthly surveillance report that reports the difference between the revenues that would have been produced by Gulf's otherwise applicable tariff and the revenues that are produced under the CISR (revenue shortfall). If the revenue shortfall, when added to Gulf's achieved jurisdictional ROE, causes the ROE to exceed the top of its authorized range, the Commission will be required to review each CSA. The Commission review is to commence immediately following the occurrence of the triggering event. For the twelve month period ending December 31, 1998, Gulf reported an achieved ROE of 12.99%. The top of Gulf's currently authorized ROE

range is 13.00%. The addition of the revenue shortfall causes Gulf to exceed the authorized top of 13.00%.

During the review of each executed CSA, the Commission is to determine whether Gulf's decision to enter into any particular CSA was a prudent choice made in the best interests of Gulf's general body of ratepayers. Gulf has the burden of proof in demonstrating to the Commission that the CSAs were a prudent decision. For the review, Gulf will submit the CSA along with the supporting analyses and documents upon which Gulf relied in its determination that the CSA was a prudent decision. Gulf must specifically prove that any CSA customer was truly an at-risk customer as defined in the tariff. Pending completion of the Commission's review, the amount of the revenue shortfall that caused Gulf's ROE to exceed the top of Gulf's authorized range should be held subject to refund as possible overearnings. If at the conclusion of the Commission's review Gulf has not demonstrated to the Commission's satisfaction that the CSAs were a prudent decision, the revenue shortfall will be imputed. Gulf currently has executed two CSAs.

**ISSUE 6**: Should Docket No. 990244-EI be closed?

**RECOMMENDATION**: Yes. Docket No. 990244-EI should be closed if no person whose interests are substantially affected by the proposed action files a protest within the 21-day protest period. (ELIAS)

**STAFF ANALYSIS**: At the conclusion of the protest period, if no protest is filed, Docket No. 990244-EI should be closed.

**ISSUE 7**: Should Docket No. 990250-EI be closed?

**RECOMMENDATION**: No. Docket No. 990250-EI should remain open. (ELIAS)

**STAFF ANALYSIS**: The plans discussed in Issues 1 and 2 are mutually exclusive. If staff's recommendation for Issue 2 is approved, it will be issued as proposed agency action. Docket No. 990250-EI should remain open pending the investigation of GPC's CISR's and the disposition the revenues held subject to refund in Issue 5.

**Revised Proposal**
**4/06/99**

Attachment "A"[1]

The following is Gulf Power Company's proposal for addressing certain regulatory issues including a reduction to the Company's authorized return on equity ("ROE")[2]:

1. This plan covers calendar years 1999, 2000 and 2001.

2. Effective January 1, 1999, Gulf Power's authorized ROE will be established at a midpoint of 11.6% (reduced from 12.0%) for all regulatory purposes with an authorized range of 10.6% to 12.6%. For purposes of initiating this plan, a target earnings adjustment point of 12.2% has been used to calculate the amounts set forth in paragraph 4 below. The top of the authorized range, 12.6% will be used as the revenue sharing point for the purposes set forth in paragraph 7 of this plan.

3. The Company will accrue to its Property Insurance Reserve an incremental $1.0 million (a total of $4.5 million) on an annual basis for the calendar years 1999, 2000, and 2001. The flexibility to adjust accruals allowed under Order No. PSC-96-1334-FOF-EI is suspended during the duration of this revenue sharing plan for the years 1999, 2000, and 2001.

4. For calendar year 1999, the Company will issue a credit on all retail customers bills for the July 1999 billing cycle that will total $3.7 million. The credit will be calculated on a per kWh basis using projected kWh sales for the July 1999 billing cycle. Any difference between the amounts actually credited and the $3.7 million target credit will become part of the true-up calculation for the calendar year 2000 fuel and purchased power cost recovery factor.

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[1]This Revised Proposal is submitted as a replacement for the document entitled Attachment "A" that was part of Gulf Power's petition in Docket No. 990244-EI filed March 2, 1999. In all other respects, Gulf Power's petition remains unchanged.

[2]The provisions of this proposal will not take effect unless and until approved by an order of the Florida Public Service Commission that becomes final and is not subject to further review. The foregoing statement is not intended to restrict the ability of any person having legally sufficient interest to seek initiation of a rate proceeding during the period covered by the plan.

**Revised Proposal**
**4/06/99**

For calendar year 2000, the Company will issue a credit to all retail customers totaling $3.7 million which will be used to reduce the fuel and purchased power cost recovery factor applied to customer billings during calendar year 2000.

After the close of calendar year 2001, the Company will issue a credit to all retail customers equal to the lesser of any jurisdictional revenues in calendar year 2001 contributing to earnings above the target earnings adjustment point of 12.2% or $3.7 million. This credit will be calculated on a per kWh basis using projected kWh sales for the April 2002 billing cycle and will be applied as a credit to customer bills during such cycle. Any difference between the amounts actually credited and the calculated target credit will become part of the true-up calculation for the calendar year 2003 fuel and purchased power cost recovery factor. The credit amount based on actual earnings for calendar year 2001 shall be determined and removed from the Company's earnings for 2001 before the determination pursuant to paragraph 7 below whether actual earnings for calendar year 2001 have reached the revenue sharing point and, if so, the calculation of the amount of revenues that will be subject to sharing.

5. Effective January 1, 1999, Gulf Power will no longer accrue a deferred return on the cost of the third floor of the corporate office as authorized and identified by the Florida Public Service Commission in Order No. 23573 issued October 3, 1990 in Docket No. 891345-EI (Gulf Power's last full base rate adjustment proceeding). The accumulated balance of such deferred return together with the identified third floor investment amount shall be included in the Company's authorized jurisdictional rate base and be subject to depreciation and amortization for purposes of calculating the achieved jurisdictional return beginning January 1, 1999.

6. Effective January 1, 1999, Gulf Power's merchandising operations and any other non-utility investment excluded from the Company's jurisdictional rate base for surveillance purposes will be removed from the Company's capital structure either on a pro rata basis (instead of totally from equity) in order to be consistent with the manner in which the Company actually finances such investments or based on a proxy capital structure equivalent to that of a publicly traded company operating in Florida that is primarily engaged in the financing of merchandise sales, whichever produces the greater equity ratio.[3]

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[3]This item reflects the need to reassess the continued appropriateness of a decision reached nearly 10 years ago in Gulf's last rate case. This reassessment is of the same character as the reassessment reflected in item 5 above.

**Revised Proposal**
**4/06/99**

7. After the close of each calendar year covered by this plan, the amount of any actual revenues contributing to earnings above the revenue sharing point of 12.6% up to a ceiling on ROE of 14.6% (measured after sharing) for that calendar year will be divided into three shares on a 40%, 20%, 40% basis. These shares are to be distributed as follows:

One 40% share of such revenues shall be refunded to Gulf's retail customers during the following calendar year as a credit through the Company's fuel adjustment clause or in such other manner as may be approved by the Commission.

The 20% share of such revenues (such share hereafter referred to as "plan revenues") will be utilized to address certain regulatory issues under this plan as set forth in the remainder of this paragraph. The following items (in priority order) constitute regulatory assets that are to be addressed under this plan:

(a) outstanding balance of deferred returns on the cost of the third floor of the corporate office (approximately $2.9 million) ["Regulatory Asset A"];
(b) outstanding balance of the flow through portion of the FAS 109 regulatory asset (approximately $1.7 million) ["Regulatory Asset B"]; and
(c) outstanding balance of loss on reacquired debt (approximately $18.9 million) ["Regulatory Asset C"].

Plan revenues will first be applied to amortize the remaining balance of Regulatory Asset A. Any remaining plan revenues will be used to supplement the $3.5 million authorized annual accrual (and the incremental accrual referenced in paragraph 3 above) to Gulf Power's accumulated provision for property insurance ("Property Insurance Reserve") until a balance of at least $20 million is achieved. If any additional plan revenues remain after Regulatory Asset A is fully amortized and a balance of at least $20 million in the Property Insurance Reserve has been achieved, such remaining plan revenues will be applied first to amortize Regulatory Asset B and thereafter to amortize Regulatory Asset C. If any additional plan revenues remain after these two regulatory assets have been fully amortized, then such remaining plan revenues will be utilized first to further supplement the authorized annual accrual to the Property Insurance Reserve until a balance of at least $30 million has been achieved[4] and thereafter to amortize any additional regulatory assets as may be approved by the Commission.

[4]In Order No. PSC-96-1334-FOF-EI, the Commission established a target of $25 million to $36 million for Gulf Power's Property Insurance Reserve based on a study that had been requested by the Commission for its review.

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In exchange for the foregoing, in recognition of the Company's superior performance on key customer service indicators noted in paragraph 3 of the petition, and as an incentive to achieve even further efficiencies in operations of the Company, the Company's shareholders will be entitled to receive the remaining 40% share of actual revenues contributing to earnings above 12.6% up to a net earned jurisdictional return of 14.6% (measured after sharing).

The full amount of any revenues contributing to earnings above a net earned jurisdictional return of 14.6% (measured after sharing) will be deferred for use as directed by the Commission. The Commission will retain jurisdiction over all such deferred revenues.

8. The calculations of the actual jurisdictional ROE for calendar years 1999, 2000 and 2001 will be on an "FPSC Adjusted Basis" using the adjustments approved in Gulf Power's last full base rate proceeding as amended by this plan. Except as noted in the preceding sentence, all actual reasonable and prudent expenses and investment related to Gulf's retail electric jurisdiction will be allowed in the calculation and no annualized or proforma adjustments will be made.

9. The calendar year surveillance reports for 1999, 2000, and 2001 on which the sharing calculations will be based will continue to be filed no later than February 15 of the year following each plan year and will be subject to audit by the FPSC Staff and true-up consistent with paragraph 8 above. The Company will also submit a report on any revenues to be shared for the plan year for the Commission's review and approval.

10. The jurisdictional separation factors to be utilized in the surveillance report calculations referred to in paragraph 8 above will continue to be based on a cost of service study prepared in accordance with the same methodology as the cost of service study used in Gulf's last full base rate adjustment proceeding (Docket 891345-EI) however, the Company will complete an updated study using the surveillance report for the calendar year 1998 as a base period. The updated study will be completed and new separation factors will be available in time to be used in conjunction with the surveillance report calculations referred to in paragraph 8 above.

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11. Any revenues deferred pending Commission approval as to final disposition will accrue interest at the 30-day commercial paper rate as specified in Rule 25-6.109, Florida Administrative Code. Such deferred revenues will be assigned a cost rate in the determination of the cost of capital based on the rate used in the interest accrual for deferred balances consistent with the Commission's decision on this issue in Docket No. 950379-EI for Tampa Electric Company.

1. This plan covers calendar years 1999, 2000 and 2001.

2. Effective January 1, 1999, the following returns on equity (ROE) are set for Gulf Power:

   10.2% - Authorized Floor
   11.2% - Authorized Mid Point
   12.2% - Sharing Begins
   14.2% - Authorized Ceiling after Sharing

   The 11.2% ROE will be used as the equity return for other purposes as well, including but not limited to the equity portion of JDIC and calculating Gulf's allowance for funds used during construction (AFUDC) rate. After December 31, 2001, unless changed by the Commission, Gulf's authorized ROE mid point will be 11.2% with an authorized floor of 10.2% and an authorized ceiling of 12.2%.

3. Regulatory Assets and Liabilities-

   A. Effective January 1, 1999, Gulf Power will no longer accrue a deferred return on the cost of the third floor of the corporate office as authorized and identified in Order No. 23573 issued October 3, 1990 in Docket No. 891345-EI (Gulf Power's last full base rate adjustment proceeding). The accumulated balance of such deferred return together with the identified third floor investment amount shall be included in the Company's authorized jurisdictional rate base and be subject to depreciation and/or amortization for purposes of calculating the achieved jurisdictional return beginning January 1, 1999. The balance of deferred returns on the costs of the third floor of the corporate office (approximately $2.9 million) and the deferred depreciation associated with the corporate office third floor will be fully amortized in equal amounts per year during 1999, 2000, and 2001.

   B. The balance of the flow through portion of the FAS 109 regulatory asset (approximately $1.7 million) will be fully amortized in equal amounts per year during 1999, 2000, and 2001.

   C. For 1999, the Company shall record an additional accrual of $3.5 million to its Property Insurance Reserve. The $3.5 million is in addition to its approved annual accrual of $3.5 million.

4. Customer credit - Customer bills will be credited by $7.0 million on an annual basis beginning July 1, 1999, through the environmental cost recovery clause. The Company shall file revised tariffs to reflect this credit, effective, July 1, 1999.

5. Sharing - After the close of each calendar year covered by this plan, the amount of any actual revenues contributing to earnings above 12.2% ROE will be determined by the Commission.

   A. For calendar year 1999, the amount of any actual revenues contributing to earnings above 12.2% ROE up to a net earned jurisdictional return (after sharing) of 14.2% will be divided into two shares on a 66.6%, 33.3% basis. The 66.6% share will be used to write off first the balance of the loss on reacquired debt, and second to increase the Property Insurance Reserve. The Company's shareholders shall receive the 33.3% share. Any and all earnings over 14.2% after sharing will be refunded to the ratepayers.

   B. For calendar year 2000, the first $2 million of revenues above 12.2% ROE will be added to the annual accrual to the Property Insurance Reserve. Any additional actual revenues contributing to earnings above 12.2% ROE up to a net earned jurisdictional return (after sharing) of 14.2% will be divided into two shares on a 66.6%, 33.3% basis. The 66.6% share will be used to write off first the balance of the loss on reacquired debt, and second to increase the Property Insurance Reserve. The Company's shareholders shall receive the 33.3% share. Any and all earnings over 14.2% after sharing will be refunded to the ratepayers.

   C. For calendar year 2001, the first $2 million of revenues above 12.2% ROE will be added to the annual accrual to the Property Insurance Reserve. Any additional actual revenues contributing to earnings above 12.2% ROE up to a net earned jurisdictional return (after sharing) of 14.2% will be divided into two shares on a 66.6%, 33.3% basis. The 66.6% share will be used to write off first the balance of the loss on reacquired debt, and second to increase the Property Insurance Reserve. The Company's shareholders shall receive the 33.3% share. Any and all earnings over 14.2% after sharing will be refunded to the ratepayers.

6. During 1999, 2000, and 2001, Gulf Power shall not have the flexibility, as approved in Order No. PSC 96-0023-FOF-EI, to increase its annual accrual to the Property Insurance Reserve above $3.5 million, except as provided for in this plan.

7. The jurisdictional separation factors used in the earnings surveillance report will continue to be based on a cost of service study prepared in accordance with the same methodology as the cost of service study used in Gulf's last full base rate adjustment proceeding (Docket 891345-EI). However, the Company will complete an updated study using the surveillance report for the calendar year 1998 as a base period. The updated study will be completed and new separation factors will be used for calculating the earnings for 1999, 2000 and 2001.

8. Any revenues deferred pending Commission jurisdiction as to final disposition will accrue interest at the 30 day commercial paper rate as specified in Rule 25-6.109, Florida Administrative Code. Such deferred revenues will be assigned a cost rate in the determination of the cost of capital based on the rate used in the interest accrual for deferred balances consistent with the Commission's decision on this issue in Docket No. 950379-EI for Tampa Electric Company.