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January 19, 1990

Mr. Steve Tribble
Director of Records and Reporting
Florida Public Service Commission
101 East Gaines Street
Tallahassee, FL 32301

RE: Docket No. 891278-PU

Dear Mr. Tribble:

Enclosed for filing please find the original and fifteen (15) copies of the testimony of Hugh A. Gower in the above referenced docket.

Respectfully submitted,



Matthew M. Childs, P.A.

ACK

AFA 3

APP _____

CAF _____

CMU _____

CTR orig

EAG

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LIN cc: All Parties of Record

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DOCUMENT NUMBER-DATE
00595 JAN 19 1990
FPSC-RECORDS/REPORTING

CERTIFICATE OF SERVICE
DOCKET NO. 891278-PU

I HEREBY CERTIFY that a true and correct copy of Hugh A. Gower's testimony on behalf of Florida Power & Light Company has been furnished by U. S. Mail and Hand Delivery to the following individuals on the 19th day of January, 1990.

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FLORIDA POWER & LIGHT COMPANY

TAMPA ELECTRIC COMPANY

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 891278--PU

JANUARY 19, 1990

IN RE: AMENDMENT OF RULE 25-14.003, F.A.C.,

CORPORATE INCOME TAX EXPENSE ADJUSTMENT:

MIDPOINT AND ADDITIONAL CHANGES

TESTIMONY OF

HUGH A. GOWER

DOCUMENT NUMBER-DATE

00595 JAN 19 1990

FPS-C-RECORDS/REPORTING

1 BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

2 ON BEHALF OF FLORIDA POWER & LIGHT COMPANY

3 AND TAMPA ELECTRIC COMPANY

4 TESTIMONY OF HUGH A. GOWER

5 DOCKET NO. 891278-PU

6

7

8 Q. PLEASE STATE YOUR NAME, OCCUPATION, AND ADDRESS.

9 A. My name is Hugh Gower, and I am a partner in Arthur Andersen & Co., a
10 firm of independent public accountants, at 133 Peachtree St., N.E.,
11 Atlanta, Georgia.

12 Q. PLEASE OUTLINE YOUR EDUCATIONAL AND PROFESSIONAL QUALIFICATIONS AND
13 EXPERIENCE RELATED TO REGULATED COMPANIES AND RATE-MAKING MATTERS.

14 A. I am a graduate of the University of Florida with a bachelor of
15 science degree in accounting and economics. I am a certified public
16 accountant in the states of Florida, Georgia, Alabama, and several
17 others. I am a member of the American Institute of Certified Public
18 Accountants and other professional organizations. I have been
19 continuously engaged in the practice of public accounting since
20 graduation.

21 Currently, I am area director of the utilities and telecommunications
22 industries practice of Arthur Andersen & Co. for the southeastern
23 region of the United States. As such, I have responsibility for
24 directing the services provided for our clients, training of
25 personnel, and various administrative matters. I also have, or have

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FPSC-RECORDS/REPORTING .

1 had, direct responsibility for the services we provide to several
2 electric, gas, telephone, and motor carrier clients located in the
3 Southeast.

4 While I have had experience in a number of industries, substantially
5 all of my work for more than 25 years has been devoted to our public
6 utilities and telecommunications practice. In addition to electric
7 utility companies, our practice includes gas distribution, gas
8 transmission, telephone, motor carriers, and airline companies. I
9 have performed independent audits of public utilities, as a result of
10 which Arthur Andersen & Co. issued reports on the financial statements
11 of such companies, and have supervised work in connection with the
12 issuance of billions of dollars of securities by public utilities. I
13 have also participated in and supervised work in connection with
14 audits of various statements, schedules, and other data required in
15 connection with annual reports or rate applications before the Federal
16 Energy Regulatory Commission or state public service commissions.
17 I have directed revenue requirements studies involving the analysis of
18 rate base, operating revenues, and operating expenses. I have
19 provided expert testimony and assisted other members of Arthur
20 Andersen & Co. and clients in the preparation of rate case testimony
21 and exhibits in cases before federal and state regulatory commissions,
22 including the Florida Public Service Commission ("FPSC" or the
23 "Commission"). In addition, I have participated in the preparation of
24 Arthur Andersen & Co.'s position statements on utility accounting and
25

1 rate matters being considered by legislative bodies and regulatory
2 agencies.

3 I chaired the Auditing and Regulatory Subcommittee of the
4 Telecommunications Industry Advisory Group which advised the Federal
5 Communications Commission in connection with its adoption of its new
6 Uniform System of Accounts (Part 32). Specifically, the subcommittee
7 dealt with issues regarding compliance with generally accepted
8 accounting principles and proper reporting for both regulatory and
9 general-purpose financial statements when regulatory rate-setting
10 practices are based upon methods other than generally accepted
11 accounting principles or when multiple commissions having jurisdiction
12 over the same company follow different accounting and rate-making
13 methods.

14 A substantial part of my work in recent years has been devoted to
15 consulting with public utilities and others regarding the economic
16 effects of contemplated transactions and regarding various rate-making
17 concepts and practices. I have also directed management audits, the
18 purpose of which was to assess whether management systems and
19 procedures promote economy and efficiency of operations.

20 I participated in the development of one of the earliest corporate
21 financial forecasting models developed in the electric utility
22 industry. I have also conducted reviews of financial forecasts for
23 companies employing both manual and mechanized forecasting systems.

24 In addition, I have participated in the development of accounting and
25 management information systems as well as a variety of operating

1 systems and directed other special studies designed to enhance control
2 over utility resources, including fuel, construction, materials, and
3 labor.

4 During recent years, I have worked closely with our clients to address
5 and implement the various financial accounting and income tax changes
6 which have occurred, including the Tax Reform Act of 1986. As such, I
7 am familiar with the impacts and applications of such matters,
8 particularly as they affect utility operations.

9 Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

10 A. The purpose of my testimony is to comment on certain proposed
11 amendments to Rule 25-14.003 of the Florida Administrative Code for
12 Corporate Income Tax Expense Adjustments ("Rule 25-14.003" or the
13 "Rule"). Specifically, my testimony will explain:

- 14 . Why it is inappropriate to amend the definition of "midpoint" in
15 Section 1(f) of the Rule to:
- 16 - Assign zero cost for all investment tax credits ("ITC").
 - 17 - Utilize the most recent Commission-approved return on common
18 equity in the calculation of weighted average cost of capital.
- 19 . Why the proposal of Staff to exclude nonrecurring operations and
20 maintenance ("O&M") expenses from the earnings calculation is
21 improper and inconsistent with the intent of the Rule.
- 22 . Why the proposal to incorporate the O&M expense benchmark
23 methodology as a component of the Rule is not appropriate.

24 I will also suggest how the rule might be changed to benefit rate
25 payers, utilities, and the FPSC.

GENERAL COMMENTS

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Q. ARE YOU FAMILIAR WITH RULE 25-14.003 AND THE PROPOSAL OF STAFF TO AMEND CERTAIN EXISTING PROVISIONS?

A. Yes. I am generally familiar with the proceedings before the FPSC which resulted in development of the Rule. In addition, I am familiar with the current rule-making proceeding which seeks to clarify requirements, streamline reporting procedures, and ensure the use of the most recently authorized rate of return on equity in determinations of tax savings refunds or deficiency collections.

Q. IS THE CURRENT RULE 25-14.003 A FAIR AND REASONABLE MANNER TO ADDRESS THE EFFECT OF CHANGES IN CORPORATE INCOME TAX RATES?

A. Yes (but I believe that certain changes I will discuss later would benefit rate payers, utilities, and the FPSC). The Rule was adopted in 1982 as a means of recognizing the effects of changes in federal and state income tax rates in a straightforward and administratively efficient manner. It was designed to be a simple calculation based upon the actual book results of operations of the respondent utility. The most significant aspect of the Rule is that it involves the refunding or collecting of prior period amounts. This aspect makes it important that it be consistently designed and administered by the Commission to ensure a fair and equitable result which properly balances the interests of the utility's customers and investors.

Q. HAVE THERE BEEN CHANGES SINCE ADOPTION OF THE RULE WHICH HAVE AFFECTED THE ABILITY OF THE RULE TO OPERATE AS ORIGINALLY INTENDED?

1 A. While there have been widely acknowledged changes in capital cost
2 rates (among other changes), I believe the Rule could operate as
3 originally intended. That is, application of the Rule would have
4 isolated the actual income tax expense increase or decrease (and the
5 effect on realized returns) for any given year due to tax rate changes
6 since the preceding general rate case.

7 Q. BUT HAVEN'T POST-1982 CHANGES PREVENTED THE RULE FROM OPERATING AS
8 INTENDED?

9 A. Not really. It is true, however, that the Rule has not operated as
10 originally intended. Because of changes in capital cost rates since
11 1982, in certain cases, the Commission, respondent utilities, and
12 other parties made pragmatic decisions to stipulate lower than
13 previously authorized common equity costs for purposes of applying the
14 Rule. This had the effect of returning to customers amounts greater
15 than originally contemplated when the Rule was adopted. But it was a
16 practical solution to an obvious problem. In my opinion, this, in and
17 of itself, did not prevent the Rule from operating as originally
18 intended.

19 On the other hand, those who believe the Rule is too limited have
20 sought to adopt within the scope of the Rule numerous other issues
21 such as new accounting proposals and justification and/or elimination
22 of O&M expenses based upon a benchmark methodology. Consideration of
23 such other issues represents a fundamental departure from the
24 Commission's established rate-making practices. Critical issues such
25 as the proper level of return on common equity have not previously

1 been subject to annual adjustment based on limited-scope hearings.
2 Also, attempts to apply an arbitrary standard for evaluating the
3 reasonableness of expense items could result in the refund or
4 collection of more than 100% of (the revenue effect of) a tax savings
5 or deficiency. Such other issues should be closely monitored between
6 general rate cases, but their inclusion in a limited-scope proceeding
7 such as encompassed by the Rule creates a real risk of inconsistent
8 application of Commission rate-making policy.

9 Q. WHY IS CONSISTENCY A FUNDAMENTAL PREMISE IN THE DESIGN OF RATE-MAKING
10 MECHANISMS SUCH AS RULE 25-14.003?

11 A. Consistency in rate-making procedures is important for at least four
12 reasons.

13 First, the purpose of a limited-scope rate-making tool such as the
14 Rule is to expeditiously adjust the level of revenue requirements for
15 specific events which may occur during the period between general rate
16 cases. If the Rule utilizes inconsistent rate-making practices, it
17 will not operate as originally designed, and its calculations will not
18 isolate the effect of the event or change being sought.

19 Second, a mechanism such as Rule 25-14.003 should be designed to
20 maintain the integrity of the overall rate-making practice. This Rule
21 is clearly not the forum for effecting change in underlying Commission
22 policy or for addressing those types of issues which are uniquely
23 complex or interrelated with other variables which should more
24 appropriately be raised in a full general rate case proceeding.

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1 Third, because the Rule involves adjusting rates for prior periods,
2 consistency in its application is essential to avoid undue financial
3 risk from retroactive rate making and so that utilities can properly
4 account for the expected effect in the applicable year and fulfill
5 their external financial reporting obligations.

6 Finally, the introduction of new issues unnecessarily frustrates the
7 objective of recognizing income tax rate changes in a straightforward
8 and administratively efficient manner.

9 Aside from the impact of the stipulated changes to authorized returns
10 on equity, the only revenue impact of the utilization of
11 Rule 25-14.003 in 1987 and 1988 was the return to rate payers of the
12 revenue effect of the amount by which realized returns exceeded
13 authorized levels due to actual income taxes saved as a result of
14 income tax rate changes. Such results are consistent with the
15 original intent of the Rule.

16 ITC COST RATE

17 Q. WHAT COST RATE HAS BEEN ASSIGNED TO ITC IN PREVIOUS FPL AND TECO
18 GENERAL RATE CASES AND OTHER RATE-MAKING PROCEEDINGS?

19 A. The Commission has consistently recognized that, in order to meet the
20 requirements of IRC Sec. 46(f)(2), the cost of capital to be assigned
21 to ITC must be at least equal to the overall weighted average cost of
22 capital that would have been provided by common and preferred
23 stockholders and long-term creditors if the credit were unavailable.
24 Such cost rate has been utilized in the final orders for general rate
25 cases (consistent with Docket No. 850172-GU, Order No. 16257) and in

1 the 1987 and 1988 Tax Savings Refund calculations under Rule 25-14.003.

2 Q. ON WHAT BASIS HAS THE WEIGHTED AVERAGE COST OF REPLACEMENT CAPITAL FOR
3 ITC BEEN UTILIZED IN PREVIOUS ANNUAL FILINGS UNDER THE RULE?

4 A. Aside from the need to comply with IRC Sec. 46(f)(2), the report form
5 prescribed by Staff (Note C on page 4) specifies the need for
6 consistent application of Commission policy: "Cost rates and capital
7 structure should be the average for the period covered by this report
8 and reflect current Commission policy."

9 Q. HOW WOULD THE LACK OF CONSISTENCY IN ITC COST RATES CONTAINED IN
10 STAFF'S PROPOSED RULE AMENDMENT AFFECT UTILITIES?

11 A. First, amounts of refunds calculated pursuant to the Rule would be
12 significantly greater than the amounts which the Rule was originally
13 designed to isolate. For example, if this proposal were now applied
14 to prior years (1988 and 1989) for which final tax savings refunds
15 have not been decided by the Commission, there could be significant
16 earnings reductions for affected utilities.

17 Aside from issues of undue financial penalty and equity, this
18 treatment would violate IRC Section 46(f)(2) which clearly is not in
19 the best interests of rate payers who now share in the benefits
20 associated with ITC.

21 Q. HOW DOES THE SHARING OF TAX BENEFITS OCCUR UNDER SECTION 46(f)(2)?

22 A. Under this section, the customers benefit by receiving credit for ITC
23 as an "above the line" reduction in cost of service over the average
24 life of the property. The investors benefit by having the opportunity
25 to earn a return on plant investment financed with ITC (which is

1 represented by unamortized ITC).

2 Q. WHAT WOULD BE THE CONSEQUENCES OF A VIOLATION OF THE CODE AND ITS
3 REGULATIONS FOR ITC?

4 A. As recognized by the Commission in its prior orders (see, for example,
5 Docket No. 830465-EI, Order No. 13537, page 55), the use of a zero
6 cost for ITC would place utilities and rate payers in jeopardy of
7 losing the benefits associated with ITC. In fact, these are
8 substantial benefits, amounting to hundreds of millions of dollars to
9 Florida electric utilities' customers. Clearly, such a result is not
10 'n the interests of either rate payers or investors.

11 Q. DO THE NORMALIZATION REQUIREMENTS PREVIOUSLY DESCRIBED ALSO APPLY TO
12 LIMITED-SCOPE PROCEEDINGS SUCH AS RULE 25-14.003?

13 A. Yes, the Internal Revenue Code and related regulations are clear that
14 they do apply when utilities' rates are adjusted. Section 46(f)(2) of
15 the Code states:

16 "SPECIAL RULE FOR RATABLE FLOW-THROUGH.--If the taxpayer
17 makes an election under this paragraph within 90 days after
18 the date of the enactment of this paragraph in the manner
19 prescribed by the Secretary, paragraph (1) shall not apply,
20 but no credit determined under subsection (a) shall be
21 allowed by Section 38 with respect to any property described
22 in Section 50 (as in effect before its repeal by the Revenue
23 Act of 1978) which is public utility property (as defined in
24 paragraph (5)) of the taxpayer--

25

1 (A) COST OF SERVICE REDUCTION--If the taxpayer's cost of service
2 for rate-making purposes or in its regulated books of account
3 is reduced by more than a ratable portion of the credit
4 determined under subsection (a) and allowable by Section 38
5 (determined without regard to this subsection), or

6 (B) RATE BASE REDUCTION--If the base to which the taxpayer's rate
7 of return for rate-making purposes is applied is reduced by
8 reason of any portion of the credit determined under
9 subsection (a) and allowable by Section 38 (determined
10 without regard to this subsection)." (Emphasis added.)

11 Further, Section 1.46-6(b)(3)(ii) of the regulations states that:

12 "(A) In determining whether, or to what extent, a credit has been
13 used to reduce rate base, reference shall be made to any
14 accounting treatment that affects rate base. In addition,
15 in those cases in which the rate of return is based on the
16 taxpayer's cost of capital, reference shall be made to any
17 accounting treatment that reduces the permitted return on
18 investment by treating the credit less favorably than the
19 capital that would have been provided if the credit were
20 unavailable. Thus, credit may not be assigned a 'cost of
21 capital' rate that is less than the overall cost of capital
22 rate, determined on the basis of a weighted average, for the
23 capital that would have been provided if the credit were
24 unavailable." (Emphasis added.)

25

1 The final Treasury regulations go even further and indicate that
2 normalization violations of Section 46(f)(2) would result from several
3 types of indirect reductions to rate base, including "any rate-making
4 decision in which the credit is treated less favorably than the
5 capital that would have been provided if the credit were unavailable"
6 (Reg. 1.46-6(b)(4)(ii)).

7 Q. ARE YOU AWARE OF STAFF'S POSITION THAT THE RULE IS NOT COVERED BY IRC
8 SECTION 46(f)(2)?

9 A. Yes, but Staff's contention that a tax savings or tax deficiency
10 adjustment "should also be outside the restrictions of the Internal
11 Revenue Code and underlying regulations" based on an IRS private
12 letter ruling relating to the use of zero cost ITC for purposes of
13 calculating AFUDC is wholly unsupported. The ruling concluded that
14 the use of a zero cost rate for ITC in an AFUDC calculation was "a
15 discretionary matter not contemplated by the Code." Thus, no
16 violation of the normalization requirements would occur since the
17 method of calculating AFUDC has no impact on the manner in which the
18 benefit of ITC is returned to rate payers and stockholders. Any
19 reduction in the ITC cost rate in calculations under Rule 25-14.003
20 would, however, clearly have the effect of increasing a refund or
21 reducing a collection made by utilities to or from customers. The end
22 result is obviously the same as using zero cost for ITC when
23 calculating a general rate increase.

24 It seems clear that use of zero cost ITC when applying the rule would
25 place the utility and its rate payers at considerable risk of losing

1 the benefit of all unamortized tax credits due to accelerating the
2 return of the credit to rate payers.

3 RETURN ON COMMON EQUITY

4 Q. PLEASE COMMENT BRIEFLY ON THE APPROPRIATENESS OF STAFF'S PROPOSAL TO
5 UTILIZE THE MOST RECENT COMMISSION-APPROVED RETURN ON COMMON EQUITY IN
6 THE CALCULATION OF WEIGHTED AVERAGE COST OF CAPITAL UNDER
7 RULE 25-14.003.

8 A. As a general premise, I think it would be difficult to successfully
9 take sufficient evidence to set appropriate common equity returns
10 within the confines of a limited-scope proceeding. Such a procedure
11 would require the Commission to decide an issue which is uniquely
12 complex, interrelated with and affected by many other variables, and
13 risk a result which may not be appropriate and fair. The crux of the
14 issue was summarized by the Supreme Court of Florida in a case which
15 addressed the appropriate equity return on which to base a refund
16 (United Telephone Company versus Mann, 1981):

17 "Since changes in the cost of common equity are not easily
18 calculable, they are not proper subjects for interim
19 hearings."

20 The Court also observed that to have heard and considered the
21 extensive evidence on equity return "would have been tantamount to
22 holding a comprehensive rate-making proceeding."

23 The degree of exposure to an improper return on common equity result
24 depends on a number of factors, including the period of time since
25 return on equity was set in a general rate proceeding, the stability

1 of capital markets, and of course, just how this proposal would be
2 administered in practice. For example, staff proposals suggest the
3 Commission adopt a return on equity based on staff's estimate of such
4 costs contained in a Quarterly Report on Equity Cost Rates. Such a
5 practice would appear to be one-sided and hardly comport with due
6 process.

7 Q. DO YOU BELIEVE THAT RATE MECHANISMS SUCH AS THE RULE ARE AN
8 APPROPRIATE FORUM FOR EXPEDITING CHANGES TO AUTHORIZED RETURNS ON
9 COMMON EQUITY?

10 A. No, but I also understand the sense of frustration when, due to
11 changed circumstances, some utilities may be experiencing earnings
12 deficiencies while others may appear to be over earning. But the Rule
13 we are dealing with in this docket was not designed to correct such
14 situations, and issues such as earnings in excess of authorized
15 returns and the appropriateness of authorized levels of return are
16 best handled in the context of a general rate case. The Commission
17 has established a mechanism of surveillance reports which monitors the
18 actual level of earnings between general rate cases. Other remedies
19 are available to both the utility and Staff to address these issues.
20 The purpose of the Rule should be to provide an efficient means of
21 correcting for the economic impact of changes in income tax rates
22 between general rate cases. The proposal of Staff to introduce
23 changes in authorized levels of return on common equity into the Rule
24 is inconsistent with established prior practice.

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NONRECURRING EXPENSES

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Q. STAFF'S PROPOSED AMENDMENTS INCLUDE A CLARIFICATION THAT THE ELEMENTS INCLUDED IN THE CALCULATIONS MUST BE REASONABLE, JURISDICTIONAL, PRUDENT, RECURRING, AND MUST OCCUR WITHIN THE YEAR IN QUESTION. DO YOU AGREE WITH STAFF'S DEFINITION OF ALLOWABLE COST ELEMENTS?

A. While I agree that allowable O&M costs should be reasonable and prudently incurred, Staff's exclusion of nonrecurring elements from the earnings calculation is improper and inconsistent with the intent of the Rule.

Q. PLEASE EXPLAIN.

A. Staff's recommendation to only consider recurring elements in the Rule's earnings calculation ignores a fundamental difference between a general rate case which is designed to establish future rates based on total revenue requirements and a limited-scope proceeding such as Rule 25-14.003 which is designed to approve a refund or to collect a shortfall of actual prior periods' base rates attributable to one specific element of cost of service. In a general rate case where rates are being set for the future, regulators frequently adopt adjustments so that the total revenue requirements will be representative of actual operating conditions expected to exist when the new rates will be in effect. In contrast, adjustments for nonrecurring items are not consistent with the intent of a limited-scope proceeding such as Rule 25-14.003. In addition, any attempt to exclude nonrecurring cost of service items would not be administratively efficient. Consider the possibility of

1 the potentially endless debate concerning whether specific costs--such
2 as power plant overhauls--meet the test of a recurring event. For
3 example, if Plant Manatee underwent overhaul in 1988 and Plant Riviera
4 is overhauled in 1989--both in accordance with reasonable and prudent
5 maintenance procedures--is either of these events "nonrecurring"? The
6 fact is, regulators have had difficulties with such questions when
7 considered in the context of full general rate cases, and the
8 difficulty would not be lessened in a limited-scope proceeding.

9 Q. WHY IS THE FOCUS ON NONRECURRING ITEMS FOR PRIOR PERIODS INAPPROPRIATE
10 UNDER RULE 25-14.003?

11 A. The Rule was designed to address the actual increases or decreases in
12 income tax expense based upon actual earnings of the utility,
13 calculated in a manner consistent with Commission policies and
14 procedures, for purposes of effecting a refund of tax savings or
15 collection of tax deficiencies where such income tax expense changes
16 cause realized returns to be over or under authorized levels.
17 Adjustments for nonrecurring items would not be reflective of the
18 actual earnings of a prior period and could result in rate adjustments
19 greater or less than the intent of the Rule.
20 Perhaps more importantly, if nonrecurring expenses (however defined)
21 are always excluded for rate-making purposes, utilities would never
22 earn their authorized returns.

23 Q. HOW DOES THE REPORTING MECHANISM UNDER THE RULE REFLECT THIS ORIGINAL
24 INTENT?

25

1 A. On both the current and the newly proposed report form (Staff
2 Recommendations, Attachment D, page 4 of 4), the purpose of the report
3 and the types of adjustments which are appropriate are specified, as
4 follows:

5 "Include and describe adjustments necessary to reflect
6 current Commission policy, excluding going-forward and
7 annualized adjustments. Going-forward adjustments should be
8 excluded because the purpose of this form is to display
9 earnings for a specific past period, unlike a rate case
10 which looks to future earnings."

11 Q. WHAT WOULD BE AN EXAMPLE OF A GOING-FORWARD OR ANNUALIZED ADJUSTMENT?

12 A. A very common going-forward adjustment--at least when historic test
13 periods are used--frequently made in a general rate case proceeding is
14 a weather normalization adjustment. An example of an annualized
15 adjustment is an adjustment which reflects a future salary increase on
16 an expected annual basis. Clearly, neither of these types of
17 adjustments is consistent with the purpose of the Rule. These types
18 of adjustments attempt to normalize a test year to be representative
19 of expected future conditions. The purpose of the Rule, however, is
20 to refund or collect for actual, historical tax savings or
21 deficiencies.

22 Q. WHAT TYPES OF ADJUSTMENTS ARE APPROPRIATE FOR PURPOSES OF APPLYING
23 RULE 25-14.003?

24 A. One category of expenses which should be removed from consideration by
25 the Rule is those expenses which, under Commission policy, are

1 recovered other than through base rates; e.g., fuel cost recovery
2 expenses, conservation cost recovery expenses, and oil back-out cost
3 recovery expenses.

4 Another category of expenses which should be removed from
5 consideration by the Rule is those specific expenses which the
6 Commission has previously found as a matter of policy to be unrelated
7 to the provision of electric service; e.g., charitable contributions,
8 certain industry association dues, and promotional or image-building
9 advertising expenses.

10 It goes without saying that all expenses included must be prudent and
11 reasonable (but the question of "nonrecurring" has nothing to do with
12 prudence or reasonableness).

13 Q. DO GENERAL RATE CASES IGNORE NONRECURRING ITEMS?

14 A. Given the difference in focus (i.e., prospective-looking) of a general
15 rate case, some nonrecurring expense items may be removed from cost of
16 service. However, even general rate case proceedings do not totally
17 ignore nonrecurring items. Significant nonrecurring items are
18 frequently amortized over a period of years to allow recovery of these
19 items. It is generally recognized that every year, some level of
20 nonannual expense occurs which repeats itself in the aggregate, if not
21 specifically. As long as these items are prudent, they are part of
22 the necessary cost of doing business.

23 Q. WHAT WOULD BE THE CONSEQUENCES OF EXCLUDING NONRECURRING ITEMS FROM
24 RULE 25-14.003?

25

1 A. Potential inequities to both rate payers and investors could result.
2 All earnings components should be considered in the earnings
3 calculation (both recurring and nonrecurring) if they are considered
4 reasonable and prudent. Inequities to the rate payers would occur if
5 nonrecurring revenue items are not passed on to the benefit of the
6 rate payers. Inequities to investors would occur if nonrecurring
7 expense items that are necessary to provide service to customers are
8 not recovered from the rate payers. Stated another way, if a prior
9 year cost which is necessary, reasonable, and prudent but deemed
10 nonrecurring were eliminated in calculations under the rule, the rate
11 payers would receive the associated tax benefit while investors would
12 bear the cost. In my judgment, this clearly would be retroactive rate
13 making.

14 Q. SHOULD EXPECTED FUTURE SAVINGS (BENEFITS) THAT WILL RESULT FROM
15 EXPENDITURES INCURRED DURING THE PERIOD COVERED BY THE RULE BE IMPUTED
16 FOR PURPOSES OF DETERMINING THE EARNINGS FOR THE PERIOD?

17 A. No. Such imputed future savings would not be reflective of actual
18 earnings--and, therefore, income tax costs--for the period, and such
19 inclusion is inconsistent with the purpose of the rule. The focus of
20 the Rule is on actual past results of operations, not on future
21 conditions. In fact, Staff's proposed amendment to clarify the
22 definition of a cost of service element states the element "must occur
23 within the year in question." Future savings should be reflected in
24 the calculations under the Rule for the year that the actual savings
25 materialize.

O&M BENCHMARK

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Q. STAFF HAS INCLUDED ON ITS PROPOSED REPORT FORM (STAFF RECOMMENDATIONS, ATTACHMENT D, PAGE 1 of 4) A REQUIREMENT TO PROVIDE A CALCULATION OF THE O&M BENCHMARK. IS SUCH A REQUIREMENT CONSISTENT WITH THE INTENT OF RULE 25-14.003?

A. No, it is not. As previously described, the Rule has been designed to approve a refund or to collect a shortfall of actual prior periods' base rates attributed to a single element of cost of service--income taxes. The focus of the calculation of earnings under the Rule is on actual prior earnings, adjusted only for specific cost elements recovered through a separate recovery clause or for expenses previously excluded from consideration as a matter of Commission policy.

Q. WHAT IMPACT COULD SUCH A REQUIREMENT HAVE ON PROCEEDINGS UNDER THE RULE?

A. Such "codification" of the O&M benchmark tool as a component of the Rule would provide an implication that Commission policy had changed to utilize the O&M benchmark as more than just an analytical tool. Inclusion of the O&M benchmark analysis in every filing under the Rule would create an enormous and unnecessary reporting burden which would frustrate the administrative efficiency of the Rule. It could create the potential for additional arbitrary rate-making adjustments which would not be consistent with the Commission's intent or prior application of the O&M benchmark.

1 Inclusion of issues other than income taxes as a formal part of the
2 Rule is clearly contrary to the purpose of this proceeding. Any
3 concerns over utilities' earnings levels or operating expense levels
4 may be addressed through continuing surveillance, special inquiries or
5 studies, and, if necessary, "show cause" proceedings.

6 POSSIBLE RULE IMPROVEMENTS

7 Q. GIVEN THAT YOU BELIEVE THE RULE IS A FAIR AND REASONABLE RATE-MAKING
8 MECHANISM AND SHOULD BE RETAINED, DO YOU BELIEVE THE OPERATION OF THE
9 RULE COULD BE IMPROVED?

10 A. Fairness dictates that the Rule operate in essentially the same manner
11 regardless of whether the tax rate changes are up or down.

12 Additionally, because the rule deals with one element of cost of
13 service--income tax expenses--there is no compelling reason to
14 continue the regulatory lag which has been associated with the
15 operation of the rule. Consistent with these notions, I believe that
16 rate payers, utilities, and the FPSC would benefit from certain
17 changes to the Rule.

18 First, the Rule should be amended so that rate increases or decreases
19 would be implemented coincident with the date income tax increases or
20 decreases are effective, rather than after the year in which the
21 change occurs. In addition to adjusting consumers' bills more
22 promptly, this would expedite the resolution of the matter and benefit
23 both utilities and the FPSC.

24 Second, the Rule should be changed so that the previously determined
25 revenue effect of tax increases or decreases being passed on to rate

1 payers are included in utilities base rates after a period of
2 time--say one year--rather than continuing to be passed on through
3 operation of the Rule until the affected utilities undergo another
4 general rate proceeding. This would significantly reduce the
5 reporting requirements and other costs of the Rule's application--both
6 for utilities and the FPSC.

7 Q. HOW COULD BILLING ADJUSTMENTS BE IMPLEMENTED COINCIDENT WITH THE DATE
8 OF TAX RATE CHANGES?

9 A. As income tax rate changes are rarely surprises, this could be
10 accomplished by filings under the Rule based upon the most recent 12
11 months' actual data reasonably available prior to the effective date
12 of the income tax rate increase or decrease. For example, if a tax
13 rate change were scheduled to become effective on July 1, a filing
14 could be prepared based upon 12 months ended March 31 data. This
15 would allow time for limited-scope hearings and review prior to the
16 tax change.

17 Q. HOW WOULD THE EFFECT OF TAX RATE CHANGES BE INCLUDED IN BASE RATES?

18 A. The Rule could be changed to require billing increases or decreases
19 effected as I described earlier to be included in base rates after one
20 year.

21 Q. WOULDN'T RATE PAYERS BE EXPOSED TO OVERBILLINGS IF CHANGES UNDER THE
22 RULE WERE IMPLEMENTED AS QUICKLY AS YOU SUGGEST?

23 A. It's true that the time period I suggested would not allow for
24 extensive field audits by Staff. For this reason, it would be
25 appropriate to provide a vehicle for consideration of any questions

1 which may arise during staff audits or otherwise during the first 12
2 months after billing changes under the Rule are begun.

3 Q. WILL CHANGES IN CAPITAL COST RATES MAKE THE RULE, EITHER AS IT
4 PRESENTLY EXISTS OR AS YOU PROPOSE IT, UNWORKABLE?

5 A. No. The rule, as it presently exists or as I propose it, would
6 isolate the revenue effect of changes in the tax rate, even if changes
7 in capital cost rates are ignored. Whether this issue will cause
8 "problems" in applying the Rule, of course, depends on whether there
9 are significant changes in capital cost rates in the future, but most
10 predictions suggest that such rates are likely to remain stable. In
11 my judgment, however, it is important to recognize that a
12 limited-scope mechanism which can deal with any eventuality without
13 regulatory lag is not practical. Certain events will simply require
14 other forums and proceedings.

15 Q. DOES THIS CONCLUDE YOUR TESTIMONY?

16 A. Yes, it does.

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