ORIGINAL FILE COPY

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO 891345-EI

REBUTTAL TESTIMONY AND EXHIBITS OF A. E. SCARBROUGH

Gulf Power

GULF POWER COMPANY

Before the Florida Public Service Commission
Rebuttal Testimony of
Arlan E. Scarbrough
In Support of Rate Relief
Docket No. 891345-EI
Date of Filing May 21, 1990

Q. Are you the same Arlan E. Scarbrough who testified earlier in this proceeding?

A. Yes, I am.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to rebut the testimony of Ms. Bass, Mr. Larkin, Mr. Seery, and Mr. Schultz and positions taken by them with respect to the issues raised in this proceeding.

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 (AES-2), comprised of 1 schedule, be marked as Exhibit ______.

Q. Mr. Scarbrough, Ms. Bass has recommended that a return on equity penalty be imposed on the Company for mismanagement. Do you agree?

A. No. Mr. McCrary has clearly shown that an equity penalty is not justified. The fact is, we have been and currently are being financially penalized as a result of the various investigations. Obtaining rate relief adequate to maintain our financial integrity has been delayed at least a year as a result of our voluntary dismissal of the 1989 rate case. For 1989, our jurisdictional return on equity was 10.81 percent. Now, even granting the full requested increase in this case will result in the Company earning only 9.47 percent jurisdictional return on equity for 1990. As I stated on pages 9 - 11 in my direct testimony, and as shown on Schedule 12 of my exhibit (AES-1), the rating agencies are extremely concerned about the Company's financial position. Failure of the Company to obtain rate relief sufficient to earn a reasonable return on equity in this proceeding will only worsen the situation. If this occurs, not only will the Company and its shareholders suffer, but our customers will suffer as well from higher financing costs in the future.

Q. On page 22, line 11, Mr. Larkin has recommended the

disallowance of the acquisition adjustment related to Plant Scherer common facilities. Please discuss this transaction.

A. The Commission should consider the value received for the dollar paid in determining the appropriate amount to approve for recovery. Effective November 19, 1987, Gulf Power Company purchased production plant facilities common to all four units commensurate with its previously acquired 25 percent ownership position in Unit #3 of Plant Scherer. Georgia Power Company sold their undivided ownership in Plant Scherer Common Facilities to Oglethorpe Power Corporation and Dalton in 1980 and 1977, respectively. In addition, Oglethorpe and Dalton incurred subsequent construction expenditures and carrying costs until the date of the sale to Gulf. Gulf Power Company purchased 6.25 percent (.25 units x .25 ownership in one unit) of the common facilities from Oglethorpe Power Corporation and the City of Dalton for $25,841,510 and $3,290,340, respectively.

Q. **How is the purchase of common facilities recorded on the Company books?**

A. We recorded the purchase according to the guidelines prescribed in Electric Plant Instruction No. 5. This rule requires that, when an electric plant constituting an operating unit or system is acquired by purchase, the costs of acquisition, including expenses incidental thereto properly includible in electric plant, be charged to Account 102, Electric Plant Purchased or Sold. The accounting for the acquisition is completed as follows:

(1) The original cost of plant, estimated if not known, is credited to Account 102, Electric Plant Purchased or Sold, and concurrently charged to the appropriate electric plant-in-service accounts.

(2) The depreciation and amortization 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, Electric Plant Purchased or Sold, is then closed to Account 114, Electric Plant Acquisition Adjustments.

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.

Electric Plant Instruction No. 5 in the <u>Code of Federal Regulations</u> states that "the depreciation and amortization <u>applicable to the original cost of properties purchased</u> shall be charged to Account 102, Electric Plant Purchased or Sold." It was necessary for the Company to re-compute the accumulated depreciation reserve balance for the following reasons:

(1) City of Dalton carried no depreciation on their books,

(2) Oglethorpe Power Corporation vintaged the majority of original cost of common facilities in year 1984; whereas, the correct in-service date for the facilities was 1982, and

(3) If the Company had used the data as submitted by Oglethorpe Power Corporation and Dalton, the Floirda Public Service Commission (FPSC) would re-allocate the accumulated depreciation reserve using Gulf's rates to be filed in its next Depreciation Study in 1991. The reason for this re-allocation is because the accumulated depreciation reserve would have been understated by using Oglethorpe's and Dalton's reserve balance.

The acquisition adjustment of $8,680,507 was recorded in accordance with the Plant Accounting Instructions applicable to this purchase. The Federal Energy Regulatory Commission (FERC) accepted the Company's proposal to clear Account 102, Electric Plant Purchased or Sold, including depreciation, on November 2, 1988.

The purchase of the common facilities was in accordance with the agreement to purchase a 25 percent interest in Plant Scherer Unit #3. The $8.7 million is a prudent cost relating to Plant Scherer and should be included in rate base. To illustrate this point and the significant value to our customers, it is estimated that Plant Scherer's Unit #3 depreciated book cost for 1990 will be $760 per kw, which is well under the $1,163 estimated per kw cost to construct a new coal unit in 1990, a savings of approximately $85.4 million.

Q. On page 23, Mr. Larkin states that the acquisition adjustment "artificially inflates the cost to be borne by ratepayers. In this instance, the benefit flows to the Southern Company through Georgia's Power's inflation of the purchase price which Gulf paid for the Scherer Unit." Is this a fair

characterization of these transactions?

A. Absolutely not. There was no net book gain or economic gain to Georgia Power Company or Southern Company related to the purchase of Plant Scherer Unit #3 or any of the related common facilities purchased by Gulf from Oglethorpe and Dalton.

Q. The issue of accounting for the Caryville "sod farm" has been raised by staff. How does Gulf account for the "sod farm"?

A. Gulf's revenues and expenses from the Caryville "sod farm" are recorded in Account 417 - Revenues from Non-Utility Operations 'below the line' on the books and records of the Company. Income Taxes are recorded in Account 409-2 Income Taxes - Other Income and Deductions and Payroll Taxes are recorded in Account 408-2 Taxes Other Than Income Taxes - Other Income and Deductions. The investment in the trailer and equipment is recorded in Account 121 - Non-Utility Property and the lease payment for use of the land paid by the sod farm to Gulf is credited to the electric department Account 455 - Interdepartmental Rents.

Q. The issue of allocating all of the appropriate

investment and expenses to its appliance division has been raised by staff. How does Gulf allocate the investment and expenses to its appliance division?

A. Gulf records all merchandising revenues and expenses as well as the income and payroll taxes of the Appliance Sales and Service operation 'below the line.' The rate base is adjusted to remove the investment in plant and equipment related to merchandising.

Q. **Mr. Larkin has proposed the disallowance of all of Gulf's investment in the Tallahassee Office. Is this appropriate?**

A. No. All of the State agencies that regulate Gulf Power are located in Tallahassee. The Tallahassee office is routinely and regularly used as office space and conference facilities by Company employees and representatives who participate in Commission or other governmental hearings, workshops, meetings, or other activities which occur in the State's capital city. For example, in 1988 there were over 50 occasions when more than 65 individual Gulf employees or represntatives, other than Mr. Henderson or Mr. Connell, were involved in hearings, meetings, and workshops with PSC Staff. This does not include the use of the office by other Gulf employees who were meeting with staffs of the Departments of Revenue, Environmental Regulation, Natural Resources, etc. Moreover, none of Mr. Connell's work involves lobbying, and much of what Mr. Henderson does out of this office does not constitute lobbying. These facilities are used primarily for regulatory and other administrative work, and are properly included in rate base as a reasonable and prudent utility investment. In the interest of removing unnecessary controversy from this docket, we have agreed to remove 25 percent of the office space allocated to Mr. Henderson's location from rate base. The remaining investment should be allowed.

Q. **Is Mr. Larkin's adjustment to exclude prepaid pension cost justified?**

A. No. In 1988, the Company recorded $1,385,000 of pension expense on its books. This amount was calculated using the "projected unit credit" actuarial method that is required by the Financial Accounting Standards Board (FASB) Statement No. 87. However, the Company is allowed under section 404 (a) (6) of the Internal Revenue Code to claim a larger tax deduction for the 1987 tax year if the actuarially determined maximum tax deduction for the 1987 year is funded to the plan prior to September 15, 1988. The Company decided to take advantage of this provision to maximize the tax deduction (based on the higher 1987 Federal income tax rates) and, therefore, funded an amount in excess of the expense determined for book purposes in order to secure the increased tax deduction. The prepayment included in working capital is the thirteen month average of the difference between the amount funded and the amount expensed. The customer receives the benefit of the related deferred taxes in the capital structure. This was a <u>prudent</u> decision by the Company and the prepayment should be included in working capital.

Q. Beginning on page 50, Mr. Schultz talks about non-recurring expenses for rebuilds. Has the Commission addressed the issue of capitalizing versus expensing in a generic docket?

A. Yes. In 1984, the Commission opened Docket No. 840204-EI to address the broad spectrum of retirement units and the issue of capitalizing versus expensing. A recommendation was made that an approved list of retirement units be developed for the electric utilities in Florida.

This process was completed when the Florida Administrative Code was updated to include the new procedures in the Revision dated August 1987. A list of Retirement Units (Electrical Plant) was also issued in 1987 by the FPSC. We believe that the Company is in compliance with the rules for expensing versus capitalizing addressed in Docket No. 840204-EI. To follow the recommendations of Mr. Schultz would be in direct conflict with FPSC and FERC Rules and Procedures.

Q. Are the Rules of the FERC and FPSC specific on retirement unit accounting and expensing versus capitalizing?

A. Yes. In the maintenance instruction contained in the FERC Section of the Code of Federal Regulations, Item 3 provides that work performed specifically for the purpose of preventing failure, restoring serviceability or maintaining life of plant is chargeable to expense, not plant. Item 8 in the same section states that replacing or adding minor items of plant which do not constitute a retirement unit is an expense process.

Q. On page 50 of Mr. Schultz's testimony, he has

recommended that certain items be capitalized rather than charged to operation and maintenance expenses. Please address this recommendation.

A. As indicated in Mr. Schultz's testimony on page 50, Gulf has begun rebuilding its heavy line vehicles. Prior to Gulf performing this work, an outside contractor would perform the work for Gulf. The outside contractor would replace the cab and chassis of the vehicle, a retirement unit for Gulf, and reinstall the old hydraulic lift systems. The cost of the new cab and chassis was capitalized and the replaced cab and chassis were retired. Currently, the work performed by Gulf involves the replacement of items such as transmissions and brakes or the rebuilding of engines, etc.; all of which involve the replacement of less than a retirement unit. The FPSC Rule that addresses this situation is Rule 25-6.0142 of the Florida Administrative Code which states:

> When a minor item is replaced independently of the retirement unit of which it is a part, the cost of replacement shall be charged to the maintenance account appropriate for the item, except that if the replacement affects a substantial betterment (the primary aim of which is to make the property affected more useful, more efficient, of greater durability, or of greater capacity) the excess cost of the replacement over the estimated cost at current prices of replacing without betterment shall be charged to the appropriate plant account.

Since the rebuilding process simply replaces minor items of property on the vehicles in question, the process is nothing more than maintenance under the above rule. A retirement unit for Gulf relating to vehicles, except as noted, is generally nothing short of the entire vehicle. Special bodies, truck-mounted hydraulic systems, air compressors, and etc., are treated as retirement units when transferred from one vehicle to another or retired from service. The cost of replacing any item less than a complete vehicle or the above mentioned items are properly chargeable to the automotive clearing account which is then allocated to Operation and Maintenance (O & M) expenses or capitalized based on vehicle usage.

Q. Is Mr. Schultz's proposed adjustment of Operation and Maintenance expense in the amount of $116,500 related to vehicle rebuilds proper?

A. No. As I have stated earlier, Gulf is accounting for the work being performed in accordance with FERC System of Accounts which has been adopted by this Commission. Mr. Schultz's adjustment proposes accounting treatment contrary to the Commission's accounting regulations.

Q. Is there any basis for Mr. Schultz's concern that "the rebuilds are expensed and also included in the absorption rate"?

A. No. The operation and maintenance costs of vehicles are charged into clearing accounts since the vehicles are used for various jobs, many of which may have different account classifications. The costs are then cleared to the proper Operation and Maintenance or Capital Account by applying an absorption factor based on the actual mileage or hours used.

The costs of minor component rebuilding of the heavy equipment are treated as any other vehicle maintenance cost and are charged to the clearing account. These costs are included when developing the absorption rate and are cleared by applying that rate. There is no "double-counting" of these expenditures.

Q. On page 84 of Mr. Schultz's testimony, he has recommended that certain recurring expenses relating to Underground Network System Repair be capitalized rather than charged to Operation & Maintenance expenses. Please address this recommendation.

A. Mr. Schultz indicates plant in service should be increased by $90,000 for the "remanufacturing" of network protectors and maintenance of network transformers. As I indicated previously in my testimony relating to truck rebuilds, the FPSC rule that relates to this situation is Rule 25-6.0142 of the Florida Administrative Code. Since the "remanufacturing process" simply replaces minor items of property on each of the 22 network protectors, the process is nothing more than maintenance under the above rule. Remanufacturing is synonymous with maintenance, as are other words used in the electric industry such as renovate, revitalize, restore, update, modify, refurbish, overhaul and the like.

In Docket No. 830525-EI, Generic Investigation of Production Plant Increases, the FPSC was very specific about their concerns regarding capitalizing projects that relate to maintenance. In its Memorandum dated February 7, 1985, the FPSC Staff stated in Item 5,

> There are some cases of capitalization which are questionable, based on the companies' descriptions of the operations. These include cases described as 'restoration,' 'repair,' repaint.

The expensing of the remanufacturing of the network protectors and the maintenance of network transformers (repainting and regasketing) clearly fall within the intent of Item 5.

Q. **Mr. Scott Seery, on page 18, and Mr. Hugh Larkin, on page 11, of their respective testimonies, recommend removing non-utility investment from the capital structure directly from equity rather than by a weighted average cost of capital method. Is this appropriate?**

A. Absolutely not. First of all, funds <u>are</u> fungible as stated by Mr. Seery. They cannot be traced to each individual investment or expense. Mr. Seery argues that the cost of capital should be based on the capital required to provide electric service. He also argues that regulated utilities are of relatively low risk, that there are few industries of lower risk and therefore any investments in non-regulated subsidiaries will increase the utility's cost of capital, thereby increasing the cost to the customer and subsidizing the non-utility operation. Mr. Seery's conclusion is inappropriate because, as stated by Dr. Morin on page 61 of his direct testimony, Gulf Power's non-utility operations represent a negligible proportion of its total operations and, therefore, investors would not perceive that they should expect a higher return because of Gulf's small investment in diversified activities. Gulf's stockholders should not be penalized as a result Mr. Seery's generalization.

Q. **Public Counsel has raised an issue regarding the Company's corporate goal to increase its level of equity in relation to other sources of capital. Is this goal appropriate?**

A. Gulf Power has adopted a long-term goal of attaining a common equity ratio of 40-45 percent. The timing at which this goal is achieved is dependent upon a number of factors, including the annual external financing requirements of Gulf Power Company. The common equity target reflects Gulf Power's desire to maintain a strong 'A' bond rating.

Q. **Why is it important that Gulf maintain a strong bond rating?**

A. The bond rating is the single most important and visible indicator of creditworthiness for a utility. The ratings are primarily the products of three rating agencies (Moody's Investors Service, Standard & Poor's, and Duff & Phelps) which rate debt and preferred stock securities for investors according to the degree of risk to the investor. Generally speaking, the higher the rating the lower the interest and dividend rate.

Standard & Poor's (S & P) has developed financial standards for rating investor-owned electric utility bonds. One of the standards, debt leverage, has a 44-52 percent debt ratio established for the 'A' rating. It is apparent that a 40-45 percent common equity target in conjunction with a 10 percent preferred stock component results in a debt target which falls within the S & P standard for a single 'A' utility. Gulf's debt and preferred stock were downgraded by S & P in 1987, from "A+ and A" to "A and A-", due primarily to a highly leveraged capital structure, after issuing the $60 million of debt used in the Daniel Coal Buyout.

The 'A' bond rating is the lowest rating that permits Gulf Power the constant access to financial markets necessary for Gulf to meet its obligations to provide electricity in a growing economy. In the 1970's, 'BBB' rated companies were often shut out of the market even though 'BBB' is considered investment grade. Many institutional investors have established a policy of not investing in bonds with ratings lower than 'A'. When credit market conditions tighten, 'BBB' rated companies often have great difficulty selling their securities as investors attempt to upgrade their holdings. The 'A' bond rating also provides a buffer that allows a utility to finance ongoing capital requirements even if unexpected adverse developments result in a downgrade.

The 'A' rating will provide for an overall lower cost of service. When tight credit conditions exist, utilities rated lower than 'A' are often required to cut back construction, delay investments, or complete them at higher costs resulting from inefficiencies and cost escalations occurring with construction delays. 'A' ratings will thus require somewhat lower revenue requirements over the long term.

A strong 'A' rating will provide Gulf Power with frequent and ready access to the security markets at desirable terms and conditions almost all times. When considering the additional benefits of lower revenue requirements, maintenance of a strong 'A' rating is even more imperative. The attainment of a capital structure which adheres to the standards for an 'A' rated investor-owned electric utility has thus been adopted as a corporate goal.

Q. What are the Post-Retirement Benefits discussed on page 41 of Mr. Schultz's testimony?

A. They are medical and life insurance benefits provided by the Company to its retired employees.

Q. How does the Company account for these benefits?

A. In 1987, the Company implemented FASB Statement No. 87, "Employer's Accounting for Pensions," which required the use of the "projected unit credit" actuarial method for financial reporting purposes. At that time, FASB also began to concentrate on accounting for other post-retirement benefits. Therefore, the Company decided to review its accounting for all retirement benefits. As a result of this review, we determined that it is more appropriate to recognize these benefits on an accrual basis using the "aggregate cost" actuarial method which spreads the expected cost of such benefits over the remaining periods of employees' service as a level percentage of payroll costs.

Q. What method has Mr. Schultz proposed for the accounting and ratemaking treatment of these costs?

A. Mr. Schultz has proposed that the Company account for these costs on a "cash basis." That is, he proposes that we not recognize the expense until the employee has retired and is receiving the benefits.

Q. Do you agree with Mr. Schultz's proposal?

A. No. The accrual basis is the only proper method for use in the regulatory process. Post-retirement benefits reward Gulf's employees for effective service and enable Gulf to attract and retain qualified people to provide electric service to the citizens of Northwest Florida. As with other expenses, such as pensions and depreciation expense, the accrual basis recognizes the expense in the proper period pursuant to the generally accepted "matching" principle and provides for recovery of the costs from the customers that receive the benefit of service. The cash basis method inappropriately shifts cost recovery for present services to future customers.

Q. What is the status of the FASB's deliberations on the accounting for other post-retirement benefits?

A. The FASB has issued its exposure draft which would require accrual accounting. In other words, the FASB proposal, as drafted, will require accrual of the costs over each employee's working life. It is expected that a final FASB statement will be issued by the end of this year requiring accrual accounting for Post Retirement Medical and Life Insurance benefits in 1991.

Q. On page 40, lines 13 through 18, Mr. Schultz suggested that an additional adjustment of $628,000 may be necessary. Please comment on this.

A. Apparently, there is some confusion between funding and actual payments to retirees. If the additional adjustment Mr. Schultz suggests was made, the Company would not be allowed to recover any costs related to post-retirement medical and life benefits. The $628,000 represents the Company's estimate of actual payments to retirees during 1990, not a funding of the reserve.

Q. Has the Company funded any of these benefits

A. Yes. The Company funded $2.1 million for post-retirement medical benefits in 1989. However, the Company has never been able to fund the reserve for post-retirement life benefits.

Q. Please comment on Mr. Schultz proposed adjustment to uncollectible expenses which is discussed on pagec 37 and 38 of his testimony.

A. On page 37, Mr. Schultz acknowledges that the amount budgeted "...produces a representative amount for

1990. Therefore, I am not recommending that the 1990 budget for uncollectibles be adjusted." His statement is correct in that, because rates are being set for the future, no adjustment should be made in this proceeding.

However, he goes on to state that the accounting adjustment made in 1989 should be amortized over four years on the assumption that the rate payers were charged for this over-accrual. This assumption is totally incorrect. In Gulf's last rate case (Order No. 14030), the Commission allowed bad debt expense of $523,000. For the period of 1985 through 1988, the Company's accrual to the reserve for uncollectible expense far exceeded the allowed amount in each year, averaging $782,670 per year. Therefore, his basic assumption that, "the accounting charge that resulted in a credit to the 1989 O&M expense in the amount of $813,000 was charged to the ratepayers over a period of years," is incorrect.

Q. **Does Mr. Schultz take issue with Gulf's request for amortization of rate case expense for this Docket No. 891345-EI?**

A. Yes. He believes an amortization period of five years, instead of two years, is representative based on the fact that Gulf's last rate case began in 1984 and the current case was not filed until the end of 1989.

Q. Why does Gulf believe a two year amortization period is proper?

A. Gulf filed requests for rate increases in 1979, 1981, 1982, 1984 and 1989. This equates to approximately one case in every two years since 1979. Based upon this historical analysis, two years is appropriate.

Q. On page 28 of Mr. Schultz's testimony, he questions the amount of input Gulf has in determining the appropriate Southern Company Services (SCS) expense budget for Gulf. On page 34 of his testimony, Mr. Schultz believes an adjustment to Gulf's budget for SCS is warranted because of lack of support for SCS specific budget amounts. Do you agree?

A. No. As discussed in Mr. Gilbert's rebuttal testimony, Gulf has significant involvement in the SCS budget preparation, review, and approval process.

Each SCS department prepares and maintains working papers to substantiate its budget amounts. These budget amounts become the basis for each operating company's SCS Work Order Billing Budget. Gulf relies on SCS to maintain the appropriate level of workpapers to support the 1990 Billing Budget. Gulf maintains its copy of the SCS Work Order Billing Budget as the basis for its 1990 SCS budget.

Q. Has Mr. Schultz supported his recommendation on page 37 that $734,595 budgeted SCS expenditures be disallowed?

A. No. Mr. Schultz bases his recommendation on information obtained from a three year old review related to a rate proceeding in another jurisdiction. Mr. Schultz has not performed such a review of the 1990 SCS budget support in conjunction with this proceeding.

The Commission should base its decision on the allowance of SCS expenditures based upon the justification provided for SCS variances in MFR C-57 and in the direct and rebuttal testimony of Mr. Lee and Mr. Parsons.

Q. Mr. Scarbrough, would you like to comment on whether duplicative functions exist at SCS and the sister companies, including Gulf Power?

A. Yes, I would. The services provided by SCS do not duplicate but complement activities of Gulf Power Company and other companies of the Southern electric system. The purpose of Southern Company Services is to provide certain professional and technical services, at cost, and in a more efficient manner than would otherwise be possible. The sharing of knowledge and resources within the system has resulted in cost savings for both Gulf Power Company and our customers. Economies of scale have made it possible for certain functions to be provided to each operating company with less duplication, more consistency, a higher level of expertise, and at a lower cost. An example of this is the Customer Accounting System utilized by the operating companies. Southern Company Services processes customer meter readings, produces customer bills, and posts payments and other transactions to the customers' accounts. On-line access to account information is also provided in order to promptly respond to customer inquiries. The benefits derived from the use of the standard Customer Accounting System are greater than could otherwise be possible if each company maintained its own hardware and software.

Centralized fuel procurement has allowed the Southern electric system to benefit from its large buying power and realize lower cost and improved service.

Economic load dispatching has resulted in lower fuel cost for our customers as well as greater overall system reliability. The operating companies within the Southern electric system have agreed to plan and operate their generation and transmission facilities from a common control center as if those facilities were part of a single electric utility. Because of this commitment, the common dispatch power pools provide each operating company, including Gulf Power Company, with more reliable power at less cost than would otherwise be possible.

So, rather than duplicating functions, SCS provides services which complement the operating companies, including Gulf Power Company, thus providing a means by which each of the operating companies can avoid, to a great extent, duplicative functions.

Q. In his testimony pages 19-23, Mr. Schultz states that the Company does not seem to be able to control its costs related to Plant Daniel and Plant Scherer. Can you please describe the processes by which the Company controls both the budgeted and actual costs related to these plants?

A. Yes. There are numerous controls in place which, in the aggregate, enable us to rely on both the budgeted and actual costs related to our ownership of Plant Daniel and Plant Scherer. I will first describe those controls which relate to budget information. I will then describe the procedures in place to monitor the actual costs which are billed to Gulf.

Both Plant Daniel's and Plant Scherer's budgets are developed using sophisticated budgeting techniques and management review processes similar to those used at Gulf. As discussed in his testimony, Mr. Lee is Gulf's representative on the Plant Daniel supervisory committee. This Committee has significant input to decisions concerning operating expenses and future planned expenditures. In addition, our Corporate Planning Department and Power Generation Department review the budgets for reasonableness paying particular attention to significant variations from prior budget and actual amounts.

To monitor actual results, Gulf's operating personnel, as well as its accounting personnel, maintain open and frequent communications with their Mississippi Power Company and Georgia Power Company counterparts. Significant new or unusual issues are reviewed with all parties to ensure proper resolution in accordance with the provisions of the operating agreements. Gulf also reviews actual operating results in comparison to budget estimates on a quarterly basis. Gulf's Corporate Planning and Power Generation Departments, with input from Gulf's Accounting Department, assist in analyzing differences between budget estimates and actual costs of Plant Daniel and Plant Scherer.

Periodic audits of the joint ownership agreements are performed by the Southern Company Service Internal Auditing Department. These audits include reviews of applicable intercompany billings for proper computations, adequate support, and compliance with the operating agreements. The most recently issued audit report for the audit performed at Plant Daniel was for the 15 month period ended September 30, 1988, while the last issued report for the audit of the Plant Scherer operating agreement was for the 12 month period ended December 31, 1988. Reviews of intercompany receivable and payable balances are performed by the Company's external auditors in their annual audits. Discrepancies in intercompany balances are reported to management and all significant differences are resolved.

Q. Mr. Schultz has stated on page 21 of his testimony that the Company does not perform audits of Mississippi Power Company to verify the propriety of Plant Daniel related charges to Gulf. Is this correct?

A. No. Although Gulf Power's internal audit personnel do not perform audits of Mississippi Power Company, Georgia Power, the SCS Internal Audit Department, at Gulf's request, performs scheduled audits of the jointly-owned plants' operating agreements. Such audits allow for an objective third party to make observations and recommendations as to compliance with the terms of the operating agreements.

Q. On page 23 of Mr. Schultz's testimony, he proposes an adjustment to Gulf's Production expenses associated with Plant Daniel in the amount of $646,000. Is this adjustment appropriate?

A. No. The basis for Mr. Schultz's recommendation is his opinion as to the adequacy of controls over Plant Daniel's budget and expenditures. As I have stated above, Gulf performs adequate reviews of the Plant Daniel budget amounts and has effective control over Plant Daniel expenditures.

As is emphasized by Mr. Lee in his testimony, we have adequately justified the Plant Daniel benchmark variance in MFR C-57, demonstrating the need for the budgeted Plant Daniel expenditures. Mr. Schultz makes his recommendation without even attempting to address any of the justifications provided by the Company regarding the benchmark variances, but rather bases his recommendation on an inaccurate assertion that Gulf has no control over Plant Daniel's O & M expenditures. In addition to Gulf's controls I have previously mentioned, his assertion also ignores the fact that Mississippi Power controls its own expenditures.

Q. **On page 23 of his testimony, Mr. Schultz suggests that it is not appropriate to include in the benchmark calculation $425,000 of expenses for Plant Daniel Transmission Facilities charges which were excluded in Gulf's 1984 rate case. Please explain this adjustment and why it is appropriate to add the Plant Daniel Transmission Line Rentals adjustment to the benchmark.**

A. As I have explained in my direct testimony beginning on page 24, line 14, and continuing through page 29, line 8, the Plant Daniel Transmission Line Rental disallowance in the 1984 Rate Order of $425,000 was the result of an improper benchmark calculation. Schedule 1 of my exhibit shows the inappropriate methodology used by the Company to calculate the transmission benchmark for 1984 and compares it to the appropriate methodology. It also shows how staff backed into the disallowance of $425,000 by dividing the improperly calculated transmission benchmark by the customer growth factor. Had the appropriate methodology been used, no adjustment to Plant Daniel Transmission Facility charges would have been made. The total 1984 requested amount for the Daniel Transmission Facility charges was $1,380,929. The Commission did not find the amount to be unreasonable or imprudent, only that Gulf used the customer growth multiplier incorrectly. Yet, it allowed Gulf to recover only $956,329 of the amount it needed to pay for its contractual obligation for Daniel Transmission Facility charges. The transmission facility charges were shown to be the best alternative for transmitting electricity generated by Plant Daniel to Gulf Power's customers and, therefore, the total cost of $1,380,929 should have been allowed in 1984.

Q. Mr. Schultz has recalculated the Production-related

A & G benchmark by removing Plant Daniel A & G disallowed in the last case and the 1990 Plant Scherer A & G of $263,000 from his calculation. In his opinion, Gulf has a Production-related A & G benchmark excess of $1,435,000. Mr. Schultz recommends on page 25 of his testimony that an adjustment be made for Plant Daniel A & G of $1,172,000 (Schultz benchmark excess of $1,435,000 less 1990 Plant Scherer A & G of $263,000). Are these adjustments appropriate?

A. No. Mr. Schultz has not calculated the benchmark appropriately. In the 1984 case, Gulf inappropriately escalated total Administrative and General expenses by customer growth and inflation. In this case, Gulf has separated the A & G into production-related and other A & G and escalated the production related A & G by inflation only in order to avoid double-counting the addition of new plants (capacity) and customer growth. As explained in my prefiled testimony on pages 29 through 34 and clearly portrayed in my Exhibit Schedule 7, the Commission's disallowance of the Plant Daniel A & G expenses in Order No. 14030 was based solely on Gulf's misapplication of the customer growth factor and justification related to new plant.

Q. **By separating production-related A & G from other A & G, does Gulf eliminate double-counting for customer growth and new plant?**

A. Yes. Gulf escalates new plant by inflation only. This is the same rationale used by Gulf for separating Transmission Facility Charges (production-related transmission) from other transmission expenses, and escalating them by inflation only as instructed by the Commission in Order No. 14030.

Q. **Why does Mr. Schultz recommend the disallowance of Plant Scherer in A & G?**

A. He states on page 28 that "All of Plant Scherer costs should be removed because Plant Scherer capacity is all for unit power sales." This, as the Commission knows, is an inaccurate statement. Sixty-three of the 212 mw of Scherer is for Gulf's territorial customers. Gulf has added the Scherer A & G to the benchmark because it is associated with the addition of new plant and is not accounted for in the Gulf's benchmark calculation by customer growth.

Q. **Has Gulf stipulated to removing lobbying and other expenses of its registered lobbyists budgeted in the test year?**

A. Yes. Gulf inadvertantly included $101,977 of lobbying expenses in the 1990 test year which should be removed pursuant to Commission policy to disallow lobbying expenses even though these expenses are for the purposes of establishing and maintaining reasonable laws to ensure that the ratepayers are not burdened with unreasonable costs. Gulf has also agreed to remove $151,288 of expenses related to the information gathering and administrative activities of its registered lobbyists.

Q. Should $6,600 of expenses associated with Tax Services for Executives be removed?

A. No. $6,600 is a small price to pay for ensuring that executive level employees do not make inadvertent errors on complicated tax returns which would take them away from their work to respond to Internal Revenue Service questions.

Q. The issue of the portion of Edison Electric Institute (EEI) dues, which are spent on lobbying, has been raised by staff. To your knowledge what percent of EEI dues should be considered lobbying?

A. EEI informs Gulf each year of the appropriate amount of the dues to be allocated to lobbying expenses.

For 1990, EEI has informed Gulf that approximately 1 percent of the dues should be considered lobbying. This information is the most recent and reliable available.

Q. Mr. Scarbrough, would you please summarize your testimony?

A. Yes. Gulf Power Company needs and deserves the rate relief requested in these proceedings. By the time of the Commission decision in this case, Gulf will have already experienced two years of inadequate earnings.

The disallowances to the Company's rate base and its expenses recommended by Public Counsel witness Larkin and Schultz are unsupported and unreasonable. Rates based on their version of rate base and expenses would be totally inadequate and confiscatory.

The Company's proposed rate base and expenses have been fully justified and are reasonable and necessary in order for the Company to continue to provide low cost, reliable and sufficient electric service to the citizens of Northwest Florida. Without the requested rate relief, the Company's earnings will continue to be inadequate.

Q. Does this conclude your testimony?

A. Yes.

AFFIDAVIT

STATE OF FLORIDA)
)
COUNTY OF ESCAMBIA)

Docket No. 891345-EI

Before me the undersigned authority, personally appeared A. E. Scarbrough, who being first duly sworn, deposes and says that he/she is the Vice President-Finance of Gulf Power Company and that the foregoing is true and correct to the best of his/her knowledge, information and belief.

____

Sworn to and subscribed before me this 9th day of May, 1990.

Peggy W. Lassiter
Notary Public, State of Florida at Large

My Commission Expires:

[illegible] State of Florida
[illegible] March 23, 1991
[illegible] Inc.

Gulf Power Company
Transmission Expense Analysis
1984 Rate Order 14030

	Description		Inappropriate Methodology used by Gulf in calculating the benchmark in the 1984 Rate Case Total Transmission
1	1979 Actual (Base for 1984 case)		$1,443,572
2	Compound Multiplier for 1979 to 1984 (1)		1.7332
3	1984 Benchmark		2,501,999
4	1984 Transmission Request		3,993,684
5	Variance		$1,491,685
6	(1) Inflation & Customer Growth multiplier		
7	Justifications provided in 1984 Case		System
8	Plant Daniel Transmission Facility Charges		1,380,929
9	System Planning Studies Capitalized in 1979, Expensed in 1984		111,000
10	Total Justifications		1,491,929
11	Disallowances in 1984 Rate Order 14030		System
12	Salaries		(120,000)
13	Consumer Price Index Change from 4.8 to 4.3		(12,000)
14	Southern Company Services		(29,000)
15	Transmission System Planning Studies		(111,000)
16	Plant Daniel Transmission Line Rents		(424,600)
17	Total Disallowed in 1984 Order 14030		(696,600)
18	Calculation of the 1984 Disallowance Related to Plant Daniel		
19	Transmission Line Rents (Facility Charges)		System
20	Benchmark with customer growth	a	$2,501,999
			/
21	Divided by: Customer growth only multiplier		1.20439
			=
22	Benchmark without customer growth	b	2,077,399
23	This difference was inappropriately disallowed See Page 2	a-b	$424,600

Florida Public Service Commission
Docket No. 891345-EI
GULF POWER COMPANY
Witness: A. E. Scarbrough
Exhibit No. ___ (AES-2)
Schedule 1
Page 2 of 2

Gulf Power Company
Transmission Expense Analysis
Appropriate Methodology as
Established by the FPSC in
Order 14030

Appropriate Benchmark Methodology

	1 Production Related Transmission Rents Acct 567 (a)	2 Other Transmission (b)	3 Total Transmission
1979 Actual (Base for 1984 case)	$6,382	$1,437,190	$1,443,572
Multiplier for 1979 to 1984	1.4379	1.7332	
1984 Benchmark before adding new facilities charges	9,177	2,490,938	2,500,114
Transmission Facility Charges related to Plant Daniel (New Plant)	1,380,929		1,380,929
1984 Benchmark including Facility Charges	1,390,106	2,490,938	3,881,043
1984 Transmission Request	1,386,880	2,606,804	3,993,684
Variance	($3,226)	$115,866	$112,641

a. Production Related Transmission expense is multiplied by inflation factor only
b. Other Transmission expense is multiplied by inflation & customer growth factor

This analysis shows that Plant Daniel Facilities Charges were in fact the major reason that Transmission costs had risen so dramatically from 1979 to 1984.

This analysis does not double count customer growth and Plant Daniel Transmission Facility Charges.

This analysis provides the necessary evidence that an inappropriate adjustment of $424,600 of the $1,380,929 contractual obligation of Gulf to pay for the facilities necessary to obtain electricity from its new plant was made in the 1984 Rate Order 14030.