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BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO 891345-EI

REBUTTAL TESTIMONY
OF
R. J. McMILLAN

DOCUMENT NUMBER-DATE
04463 MAY 21 1990
FPSC-RECORDS/REPORTING

1 GULF POWER COMPANY

2 Before the Florida Public Service Commission
Rebuttal Testimony of
3 Richard J. McMillan
Docket No. 891345-EI
4 Date of Filing May 21, 1990

5

6 Q. Please state your name, business address, and
7 occupation.
8 A. I am Richard J. McMillan, my business address is
9 500 Bayfront Parkway, Pensacola, Florida, 32501, and my
10 business title is Supervisor of Financial Planning.
11
12 Q. Are you the same Richard J. McMillan who filed direct
13 testimony in this proceedings?
14 A. Yes, I am.
15
16 Q. What is the purpose of your rebuttal testimony?
17 A. I will address the inappropriateness of many of the
18 adjustments proposed by Mr. Hugh Larkin in his direct
19 testimony, and Mr. Schultz's proposed disallowance of
20 Gulf's 1990 bank service charges and lines of credit
21 fees.
22
23 Q. Mr. Larkin has proposed changes to the Company's
24 plant-in-service and accumulated depreciation balances,
25 and depreciation expense. Are his proposed adjustments

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1 reasonable and accurate?
2 A. No. Mr. Larkin's methodology of estimating
3 plant-in-service by using linear regression with actual
4 plant balances from January 1988 through February 1990
5 is invalid. Several large adjustments and retirements
6 took place during this time period which would distort
7 a linear regression. First, there was a large decrease
8 in plant-in-service in June 1988 caused by the entry to
9 move the Scherer Plant Acquisition Adjustment from
10 Account 102 to Account 114 (approximately $9 million),
11 and by the discontinuance of the manual control account
12 journal entry that cleared all DSO's to plant-in-service
13 in the month they were spent (approximately $9 million).
14 Second, during 1988 and 1989 the Plant Daniel Coal Cars
15 were retired, thus decreasing plant-in-service by $9.5
16 million (with an offsetting decrease to accumulated
17 depreciation). Finally, in December of 1989, a portion
18 of the purchase price of Plant Scherer Unit 3 was
19 refunded by Georgia Power, resulting in a $5.3 million
20 decrease to plant-in-service. These large
21 non-recurring decreases caused the results of
22 Mr. Larkin's linear regression to be misstated, thereby
23 understating plant-in-service. Using linear regression
24 of actual data to project future balances may be
25 distorted by unusual or non-recurring fluctuations in

1 the actual data, and will not properly reflect the
2 expected fluctuations in projected data that are
3 reflected in the construction budget.
4 Gulf's Capital Additions Budget and the 1990
5 forecast of our plant data is a more accurate basis for
6 estimating future plant balances. Construction
7 expenditures through March are only under budget by
8 $1.5 million due primarily to a slight delay on a few
9 large production projects, which are expected to catch
10 up in the second quarter.
11 As Mr. Larkin pointed out, Gulf's plant-in-service
12 balances for December 1989 through March 1990 are under
13 budget. This is due mainly to the adjustments in late
14 1989 related to the refunds from Georgia Power Company
15 and Ogelthorpe Power Corporation regarding the
16 reduction in the Plant Scherer Unit 3 purchase price.
17 In addition, the retirements associated with a few
18 large projects were over budget during this period,
19 which is simply a timing variance (not permanent)
20 caused by several retirements which were booked earlier
21 than projected in the budget. This variance in
22 plant-in-service caused by retirements is offset in the
23 accumulated depreciation reserve by the same amount.
24 The effect of the variance in retirements on net plant
25 is zero.

1 Q. **What about Mr. Larkin's calculations for depreciation**
2 **and the reserve for accumulated depreciation?**
3 A. Mr. Larkin's understatement of plant-in-service also
4 affects the calculation of depreciation expense and the
5 reserve for accumulated depreciation. Based on these
6 understated levels of plant, Mr. Larkin calculates a
7 reduction in depreciation and amortization expense of
8 $967,297. As stated earlier, the Company's projections
9 for plant-in-service, adjusted to reflect the reduced
10 costs related to Plant Scherer Unit 3, are more
11 accurate and reasonable; therefore, no other
12 adjustments to depreciation expense is warranted.
13 Nevertheless, the adjustment Mr. Larkin calculated was
14 also in error. After Mr. Larkin calculated his revised
15 electric depreciation and amortization expense based on
16 his understated plant balances, he compares his figure
17 to the incorrect amount for the Company's projected
18 expense. The Company figure he uses includes $255,000
19 related to the amortization of the plant acquisition
20 adjustment. This $255,000 is not included in
21 Mr. Larkin's revised calculation, causing his
22 adjustment to be overstated by the $255,000. Although
23 Gulf does not agree with Mr. Larkin's revised expense
24 calculation, the correct adjustment to depreciation
25 expense using his figures would be $712,297 instead of

1 $967,297. This adjustment also causes accumulated
2 depreciation to be understated.
3
4 **Q. Are there other errors in Mr. Larkin's calculation of**
5 **the reserve for accumulated depreciation?**
6 A. Yes. Mr. Larkin also has two other errors in his
7 projection of the depreciation reserve balance. First,
8 his reserve balances excluding the JDITC balance
9 (column (e) of Schedule HL-4) for actual January and
10 February of 1990 are understated by $200,000 and
11 $399,000, respectively. The $399,000 error carries
12 forward to the projected amounts for March through
13 December of 1990. The second error is an overstatement
14 of the reserve balance related to the JDITC amount
15 shown in column (f) of Schedule HL-4. In Order No.
16 16257 issued June 19, 1986, the Commission decided that
17 the depreciation reserve imbalance adjustment should
18 offset the JDITC amount. The net of these balances is
19 $290,000 in December of 1989. This is the net amount
20 that is actually in the reserve, not the $5,848,000
21 shown on Schedule HL-4. When these two corrections are
22 made, Mr. Larkin's adjustment to the Company's filing
23 would be a <u>decrease</u> of $1,513,000 instead of an
24 increase of $3,715,000, which resulted in a $5,228,000
25 understatement of net plant.

1 Q. **Mr. McMillan, what is your conclusion with respect to**
2 **Mr. Larkin's calculation of these plant items?**
3 A. It is obvious that Mr. Larkin's calculation of plant
4 balances, without proper consideration of the
5 forecasted level and timing of construction
6 expenditures, plant additions and retirements,
7 cost-of-removal and salvage, does not result in
8 reasonable or accurate projections for
9 plant-in-service, accumulated depreciation, or
10 depreciation expense. The Company's projections,
11 adjusted to reflect the revised costs related to Plant
12 Scherer Unit 3, are more accurate, and properly reflect
13 Gulf's 1990 test year amounts.
14
15 Q. **Is Mr. Larkins's adjustment to income taxes related to**
16 **interest synchronization accurate?**
17 A. No. First of all, Mr. Larkin has included the wrong
18 amount for the interest deduction, per Company filing,
19 on his Schedule HL-11. He used the jurisdictional
20 interest per books amount of $30,871,000 from MFR
21 Schedule C-44. The correct amount to use is the
22 jurisdictional synchronized interest of $32,045,000
23 used by the Company in its interest synchronization
24 calculation as shown on Schedule 15 of my prefiled
25 direct testimony. This would result in a

1 decrease in interest of $2,734,000 on Schedule HL-11
2 based on Mr. Larkin's revised rate base.
3 The second error related to interest
4 synchronization is the direction of the adjustment to
5 income taxes. A reduction in rate base results in a
6 reduction in interest as shown on Schedule HL-11. A
7 reduction in the interest deduction should result in an
8 increase in income taxes. However, on page 2 of
9 Mr. Schultz's Schedule HWS-1, income taxes have been
10 reduced by the $587,000 calculated by Mr. Larkin, not
11 increased as they should be. The correct adjustment
12 for interest synchronization based on Mr. Larkin's
13 revised rate base is to increase income taxes by
14 $1,029,000 ($2,734,000 shown above x .3763), not to
15 decrease income taxes by $587,000.
16
17 Q. **Mr. Larkin has made an adjustment to remove the**
18 **capitalized portion of the cancelled Southern Company**
19 **Services (SCS) building. Is this appropriate?**
20 A. No. The correcting entry to expense the cancellation
21 costs related to the SCS building was recorded in
22 May 1989. The financial forecast used in developing
23 the 1990 test year included actual data through
24 August 1989, therefore, the correcting entry has been
25 properly reflected in the test year plant data and no

1 adjustment is required.

2

3 Q. **Mr. Larkin has proposed disallowance of the insurance**
4 **reserves included in Other Property and Investments**
5 **until the Company can show the benefit to ratepayers of**
6 **these reserves. Please explain the purpose of these**
7 **reserves.**

8 A. The Southern electric systems' Public Liability and
9 Directors & Officers Liability insurance coverages are
10 obtained through four captive insurers:
11 1. Associated Electric & Gas Insurance Services
12 (AEGIS),
13 2. Energy Insurance Mutual (EIM),
14 3. XL Insurance Company (XL), and
15 4. ACE Insurance Company (ACE).
16 It should be noted that these insurers are not pure
17 captives, i.e., they were not created for the sole
18 purpose of underwriting the risks of The Southern
19 Company and its subsidiaries. In each instance, the
20 captive is an association or group captive established
21 by a group of companies to underwrite their collective
22 risks. AEGIS and EIM provide coverage only to electric
23 and gas utilities. XL and ACE provide coverage on a
24 multi-industry basis, primarily to Fortune 500
25 companies.

1 Southern and Gulf's initial involvement with
2 captives began on August 21, 1984, when we joined
3 AEGIS. In conjunction with the August 21, 1985 renewal
4 of the system public liability policy, a competitive
5 bid was solicited from the commercial market. American
6 Reinsurance Company/Reliance of Illinois offered a
7 premium quotation of $5,200,000 for a policy limit of
8 $5,000,000 in excess of a $1,000,000 deductible. AEGIS
9 quote for broader coverage with a policy limit of
10 $20,000,000, subject to a $1,000,000 deductible, was
11 $2,112,600. The coverage was awarded to AEGIS. These
12 premium quotations were for the system as a whole and
13 the cost was allocated pro rata among the system
14 companies. We continued to purchase excess Public
15 Liability insurance, with limits above the AEGIS
16 policy, and our Directors & Officers Liability
17 insurance from the commercial insurance market until
18 1986.
19 Southern joined EIM, XL and ACE in 1986. These
20 captive insurers were created in direct response to the
21 insurance market crisis occurring at that time. The
22 commercial insurance market was extremely restricted,
23 terms of coverage were unreasonable and, where coverage
24 was available, pricing was exorbitant. We simply could
25 not fill our insurance requirements, at any

1 reasonable price, with coverage available from the
2 commercial market. The captives offered the only
3 viable alternative and resulted in a significant
4 savings in insurance premiums.
5
6 **Q. Is Mr. Larkin's adjustment to reduce fuel inventories**
7 **appropriate?**
8 A. No. He has based his adjustment on an inappropriate
9 interim adjustment. Additionally, the interim test
10 period is not representative of the 1990 test period,
11 and as discussed by Mr. Parsons in his prefiled direct
12 testimony, Gulf's test year requested fuel inventory
13 levels are reasonable and appropriate.
14
15 **Q. Mr. Larkin has proposed a reduction in plant materials**
16 **and operating supplies of $2,307,000. Is this**
17 **appropriate?**
18 A. No. He based his adjustments on the actual 13-month
19 average for the period ending February 28, 1990, which
20 is not representative of the test period. Just using
21 actual balance as of February 1990, with no additional
22 increase, would result in a significant reduction in
23 his adjustment. The forecasted increases in our
24 inventory balances are reasonable and necessary due to
25 increasing costs, and the constantly increasing

1 investment in additional electric facilities required
2 to serve our customers. Gulf's projections for 1990
3 are reasonable, and are a more accurate estimate of the
4 test year inventory requirements; therefore, no
5 adjustment is appropriate.
6
7 Q. **Is Mr. Larkin's adjustment to exclude Other Accounts**
8 **Receivable from rate base appropriate?**
9 A. No. These receivables include the amounts due the
10 utility upon open accounts, other than the amounts
11 related to associated companies and from our electric
12 customers. The majority of these receivables are for
13 pole attachment rentals (invoiced to non-associated
14 companies) for which the revenues have been recorded in
15 other operating revenues (Account No. 454-100). The
16 remaining miscellaneous accounts pertain to pole/line
17 damage claims and other miscellaneous utility
18 billings. All of these amounts are properly included
19 in rate base.
20
21 Q. **Mr. Larkin has also excluded $136,000 of prepayments**
22 **identified as other. Please explain what these "other"**
23 **prepayments are.**
24 A. Gulf's forecast of prepayments were prepared in four
25 categories. Specific individual estimates were made

1 for insurance, EPRI dues, and pensions. All "other"
2 prepayments were estimated based on a three year
3 historical average. These "other" prepayments are
4 primarily comprised of prepaid licenses for motor
5 vehicles, prepaid taxes, prepaid city and county
6 occupational licenses, and prepaid registrar transfer
7 and fiscal agent fees. The Company's estimate is
8 reasonable, and should be included in rate base.
9
10 Q. **Mr. Larkin has excluded $30,000 related to**
11 **"miscellaneous" deferred debits from working capital.**
12 **Is this appropriate?**
13 A. No. This amount is a conservative estimate for the
14 numerous miscellaneous charges that are always present
15 in deferred debits which cannot be specifically
16 identified in advance. The analysis, which Mr. Larkin
17 states included no balance in the account for the
18 actual month's of January through August 1989, is
19 Gulf's budget workpaper utilized for the forecasted
20 amounts, not an analysis including actual. The actual
21 amounts for January through August 1989 averaged in
22 excess of $100,000. The Company's estimate is
23 reasonable, and is properly included in working capital.
24
25 Q. **Is Mr. Larkin's adjustment to remove the Caryville**

1 Subsurface Study from working capital appropriate?

2 A. No. As discussed by Mr. Parsons, the Caryville
3 generating site and related costs are properly included
4 in rate base.

5

6 Q. **Should unamortized rate case expense be included in**
7 **Working Capital?**

8 A. Yes. This Commission recognizes that rate case
9 expenses are a legitimate cost of doing business, and
10 are, therefore, recoverable costs. Since the
11 Commission required a two year amortization in our last
12 two cases, we have included one-half of the expenses in
13 1990, and the remaining half in 1991. The unamortized
14 balance in deferred debits is properly included in
15 working capital, since these unrecovered costs do not
16 earn a return. Not allowing a return on the amortized
17 balance would unfairly penalize the stockholders for
18 complying with state regulations and the Commission's
19 rules and filing requirements.

20

21 Q. **Are Mr. Larkin's proposed adjustments to allocate the**
22 **63 mw of Plant Scherer (available to serve the**
23 **territorial customers) to the Unit Power Sales (UPS)**
24 **jurisdiction appropriate?**

25 A. No. Mr. Larkin states that his adjustment is based on

1 Dr. Rosen's testimony recommending that the 63 mw of
2 Plant Scherer capacity be allocated to UPS. I was
3 unable to find that recommendation in Dr. Rosen's
4 testimony. Dr. Rosen does recommend disallowing the
5 63 mw of Plant Scherer, but does not propose imputing
6 fictional UPS sales for the test period. Mr. Larkin's
7 proposed calculations not only disallow the 63 mw of
8 Plant Scherer, but also imputes additional investment
9 and expenses to UPS, related to the transmission and
10 general functions, based on the UPS allocations. The
11 transmission and general plant investment and expenses
12 recovered from the UPS customers are not directly
13 related to Plant Scherer, but are the allocated costs
14 which are credited to the retail customers. Were the
15 Commission to remove the Company's total investment in
16 Plant Scherer from rate base, as well as the associated
17 expenses, then the total impact of the Plant Scherer
18 UPS sales should likewise be removed. If the retail
19 jurisdiction is not going to bear the burden of any of
20 the Plant Scherer investment made for their benefit,
21 they should certainly receive none of the benefits
22 accruing from the UPS sales. While we have not, and
23 see no need to make a precise calculation of the impact
24 of Plant Scherer on the retail jurisdiction, when the
25 credits from the UPS sales, and the Intercompany

1 Interchange Contract (IIC) are excluded, the retail
2 revenue requirements for Plant Scherer, including the
3 transmission line rentals and production related A & C,
4 are approximately $2 million. However, the 63 mw of
5 Plant Scherer is currently available to serve our
6 territorial customers and no adjustment is
7 appropriate. Mr. Larkin's adjustments are
8 inappropriate, overstated, and inconsistent with
9 Dr. Rosen's recommendation.
10
11 Q. **Is Mr. Larkin's discussion and recommendation regarding**
12 **the use of the 1/8 of O & M (Cash Work Capital) for UPS**
13 **appropriate?**
14 A. No. This commission requires that working capital be
15 calculated using the balance sheet approach. Gulf's
16 system or total company working capital and each
17 jurisdiction (retail, wholesale, and UPS) has been
18 calculated in accordance with this methodology,
19 resulting in the appropriate retail working capital
20 utilizing the balance sheet approach. Each of these
21 jurisdictions has numerous differences in required
22 ratemaking calculations, but for retail ratemaking, all
23 calculations are done in accordance with Florida
24 requirements. To pick and choose different
25 calculations and amounts when and if it is advantageous

1 is inconsistent and inappropriate. As noted above, the
2 retail jurisdiction is already receiving significant
3 benefits related to the UPS sales calculated in
4 accordance with retail ratemaking requirements, and no
5 additional adjustments are appropriate.
6
7 Q. Should the net overrecoveries of fuel and conservation
8 expenses be included in the calculation of working
9 capital?
10 A. No. The Company is required to return any
11 overrecoveries to the ratepayers with interest, and
12 conversely, the Company is allowed to recover any
13 underrecovery from the ratepayers with interest.
14 Therefore, following the Commission's guidelines that
15 working capital excludes all accounts or items on which
16 a return is earned or paid, both the over and under
17 recoveries should be excluded from working capital.
18 The Commission staff has defended including the
19 overrecoveries in working capital on the basis that the
20 inclusion of any net overrecoveries of fuel and
21 conservation expense in the working capital allowance
22 has the effect of requiring the stockholders to pay the
23 interest on these overrecoveries. It is further
24 contended that if the net overrecoveries are excluded
25 from the working capital allowance calculations, it is

1 the ratepayers who must pay interest to themselves.
2 This is not correct. In determining the amount for the
3 fuel factor in the following recovery period, the
4 budgeted fuel expense for the period is reduced by the
5 prior overrecoveries <u>with interest</u>. This reduces the
6 fuel revenues to be recovered from the ratepayers by
7 the actual overrecovery, and the interest is paid to
8 the customers through a reduction in their electric
9 bills. The Company does not actually write them a
10 check for interest, but does reduce their future bills
11 for both the overrecovery and interest. Therefore, the
12 customers do not pay the interest to themselves, but
13 instead they receive credit for the interest through
14 reduced billings.
15 Including overrecoveries in working capital not
16 only requires the stockholders to pay the interest
17 through a reduction in the fuel component of the
18 customers bill, but would also compensate the customer
19 at the overall rate of return, which includes equity
20 returns. Not only is the stockholder paying twice, but
21 a short-term interest rate is not comparable to our
22 overall rate of return. As stated in Order No. 9273
23 (Docket No. 74680-EI), the Commission established the
24 interest provision to counter any incentive to bias the
25 projections in either direction. The Company agrees

1 with the intent and purpose of this provision. Both
2 the Company and ratepayer are properly compensated for
3 over/under recoveries in the fuel and conservation
4 dockets through the interest provisions. Therefore,
5 both over and under recoveries should be excluded from
6 working capital.
7
8 Q. **Are the temporary cash investments projected by the**
9 **Company reasonable and needed for the provision of its**
10 **regulated utility service?**
11 A. Yes. The Company's forecasted temporary cash
12 investments are essentially all of its available
13 working funds used for making disbursements. Beginning
14 in 1988, Gulf consolidated its disbursement accounts
15 maintained with several banks into one controlled
16 disbursement account. This has enabled the Company to
17 invest <u>all</u> idle cash until the checks are presented for
18 payment. The change to this controlled disbursement
19 account has resulted in improved banking services,
20 reduced the cost of our banking activities, allowed
21 optimization of the use and control of available cash,
22 and resulted in overall savings to the Company and
23 ultimately the ratepayers.
24
25 Q. **How should the temporary cash investments be removed**

1 **when reconciling rate base and capital structure?**
2 A. The Company has removed temporary cash from rate base
3 (working capital) and has adjusted it out of the
4 capital structure on a pro-rata basis in accordance
5 with the Commission's treatment in our last rate case.
6 As stated above, these funds are essentially all of
7 Gulf's available cash. The 13-month average amount of
8 $6,399,000 (per MFR B-2a) is approximately 10 percent
9 of our average monthly disbursements. In fact, the
10 Company is projecting to borrow funds during five
11 months of the test period. Unquestionably, these funds
12 are required and necessary in providing utility
13 services for our customers.
14 The Company has always maintained that these funds
15 are a legitimate working capital requirement and should
16 be included in working capital, and the related
17 earnings generated by these funds used to offset the
18 revenue requirements. This position is supported by
19 Staff's witness, Mr. Seery, in his direct testimony on
20 page 20. If the Commission decides to leave temporary
21 cash in working capital, the earnings on these funds
22 are projected to be $506,000 as shown on Schedule 3,
23 page 15 of 16 of my prefiled direct testimony.
24
25 Q. **Mr. Shultz has proposed disallowing the $223,000 in**

1 **expense related to bank fees and lines of credit**
2 **charges. Should any portion of this amount be**
3 **disallowed from base rates?**
4 A. Absolutely not. These costs are directly attributable
5 to the Company's utilization of a controlled
6 disbursement account and the payment of fees for
7 certain lines of credit with area banks. This has
8 resulted in a <u>reduction</u> in our banking costs, cash
9 required for working capital, and the revenue
10 requirements requested in this case.
11 Mr. Schultz's conclusion on page 57 of his direct
12 testimony, that this expense should be borne by the
13 stockholders of the Company since they clearly derive
14 the benefits is totally ludicrous, and could not be
15 further from the true impact on the Company's
16 stockholders. As stated by staff witness, Mr. Seery,
17 in his direct testimony on page 20:

18 In general, short-term investments can be expected to earn less than the utility's overall cost of
19 capital. Therefore, a blanket policy of excluding temporary cash investments from rate base could
20 result in an asset, potentially necessary for the provision of regulated service, earning less than
21 a fair rate of return.

22 Mr. Shultz's conclusion would result not only in
23 excluding temporary cash investments from working
24 capital, but that the stockholders should also pay all
25 banking fees and charges. These banking fees are a

1 legitimate and necessary expense required in the
2 provision of utility services, therefore, the Company
3 should be allowed to recover these costs from the
4 ratepayers.
5
6 Q. **Does this conclude your testimony?**
7 A. Yes, it does.
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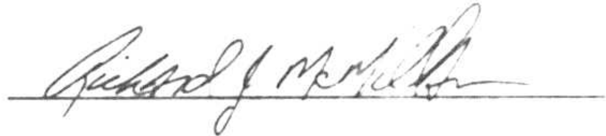
AFFIDAVIT

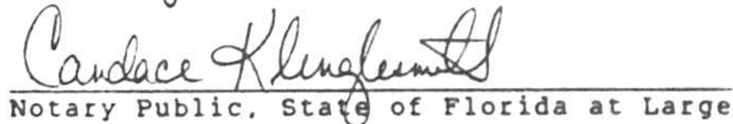
STATE OF FLORIDA)
)
COUNTY OF ESCAMBIA)

Docket No 891345-EI

Before me the undersigned authority, personally appeared Richard J. McMillan, who being first duly sworn, deposes and says that he/she is the Supervisor of Financial Planning 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 11th day of May, 1990.



Notary Public, State of Florida at Large

My Commission Expires: MY COMMISSION EXPIRES MAY 18, 1991