



# Public Service Commission

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

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

**DATE:** MARCH 4, 1999

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

**FROM:** DIVISION OF AUDITING AND FINANCIAL ANALYSIS (MATHNOT, DM)  
LESTER, SLEMKEWICZ, MAUREY) JS EAD  
DIVISION OF ELECTRIC AND GAS (E. DRAPER, KUMMER, BREMAN, TEW) AS  
DIVISION OF LEGAL SERVICES (ELIAS) RUE

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

RECEIVED 11:00  
59 MAR - 4 11:00  
RECORDS AND REPORTING  
ALM

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

**AGENDA:** 03/16/99 - REGULAR AGENDA - PROPOSED AGENCY ACTION (ISSUES 1 AND 3 ONLY) - INTERESTED PERSONS MAY PARTICIPATE (EXCEPT ISSUES 2 AND 6)

**CRITICAL DATES:** NONE

**SPECIAL INSTRUCTIONS:** NONE

**FILE NAME AND LOCATION:** S:\PSC\AFA\WP\990250.RCM

### CASE BACKGROUND

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

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proposal to reduce its authorized ROE. Staff, OPC, and the Company agreed not to discuss the proposals and ideas shared at these meetings. Staff believes that the Commission should address GPC's regulatory assets, earnings, and authorized ROE.

On March 2, 1999, GPC filed a Petition for approval of an incentive revenue sharing mechanism. Issue 1 is staff's recommendation on the Petition.

Issue 2 is staff's recommendation to place revenue subject to refund, regardless of the Commission's decision on any other Issues. In Issue 3, staff proposes an incentive sharing plan. The Plan presented by Staff is a combination of concepts previously ordered by this Commission and not necessarily what Staff would recommend after a comprehensive hearing. If Issue 3 is not approved then staff recommends in Issues 4 and 5 that an earnings investigation be initiated and that GPC be required to file Minimum Filing Requirements. Issue 6, recommends that additional revenues be placed subject to refund pending a review of GPC's Contract Service Agreements.

**DISCUSSION OF ISSUES**

**ISSUE 1:** Should the Commission approve GPC's petition for approval of proposed plan for an incentive revenue sharing mechanism that addresses certain regulatory issues including a reduction to the Company's authorized ROE (Attachment C)?

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

**STAFF ANALYSIS:** On March 2, 1999, GPC filed a petition to implement a sharing plan and to address certain regulatory assets and its authorized ROE. The petition does not propose any rate reductions at the beginning of the sharing plan in order to target GPC's earnings at a specific ROE. In addition, staff believes that the Company's proposal does not adequately address its regulatory assets or its authorized ROE. Staff's analysis will first discuss general shortcomings of the proposal which are not even addressed by the plan and will then discuss the specific points in the plan.

The Company proposes to reduce its authorized ROE from 12.0% to 11.8% and then to share any earnings in excess of 12.8% on a 40%, 20%, 40% basis. 40% is to be retained by the Company. 20% is to be applied to the write off of certain regulatory assets and to the Property Insurance Reserve. 40% is to be refunded to customers through a credit. The Company reported achieved earnings of 12.99% ROE on its December 1998 Earnings Surveillance Report (ESR) and is projecting a 12.85% ROE for 1999. Both of these earnings amounts include a discretionary \$3 million accrual to the Property Insurance Reserve. Without these discretionary accruals, GPC would be earning in excess of its currently authorized ROE ceiling.

On page 7 of GPC's petition, the Company states that this type of incentive revenue sharing concept is similar to mechanisms previously approved by the Commission for Southern Bell and more recently by Georgia's PSC for Georgia Power Company. When this Commission approved the sharing plan for Southern Bell, it required rate reductions for each year of the plan to target rates at a rate setting point. The rate reductions were crucial to implementing the plan. This is discussed more fully in Issue 3. It is staff's understanding from discussions with the Georgia PSC staff that Georgia Power Company's rates were reduced to target earnings at some reasonable ROE. In addition, the Georgia Power plan requires a further rate reduction in 2000, and the write off of \$50 million of regulatory assets in 2000 and 2001 before any sharing occurs. GPC's petition does not propose any targeting of earnings at the

initiation of the plan. Granting GPC's petition would begin the incentive sharing plan at the Company's current level of earnings, which staff believes is already above both GPC's currently authorized ROE and an ROE based on current market conditions.

The specific points of GPC's proposal are included as Attachment C to this recommendation. Point 1 of the Company's plan is that it covers 1999, 2000 and 2001. Staff believes that three years for an incentive plan is reasonable only if all the other terms of the plan are reasonable. Staff does not believe that the other points of the plan are all reasonable and, as already discussed, implementing a plan without adjusting and targeting earnings initially is unreasonable.

Point 2 of the plan proposes a new authorized ROE of 11.8% with a range of 10.8% to 12.8%. In its petition, GPC states that it believes its ROE should be reviewed in light of its reliability and quality of service, its competitive rates, and its equity ratio. Regarding the quality and reliability of service, staff believes that these issues do not have a direct bearing on the determination of the cost of capital. GPC can be proud of its record on customer service, but customers should not have to pay a higher cost of capital for receiving such service. GPC should not be rewarded through a higher cost of capital for doing the job the public expects.

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

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

<b>Gulf Power Company's Equity Ratios, 1993-1998</b>						
Date	Sep. 30, 1998	1997	1996	1995	1994	1993
Percent	49.3	46.8	47.2	45.4	45.3	44.9
Source: Standard & Poor's Financial Statistics, September 30, 1998; Standard and Poor's Utility Credit Report, Gulf Power Company, June 1997						

GPC's equity ratio has ranged from 44.9% to 49.3%. This equity ratio is within the range of equity ratios for electric utilities with A+ bond ratings, and staff is not recommending the Commission consider adjusting GPC's equity ratio. A low equity ratio may need to be compensated with a higher ROE. However, GPC's equity ratio is not low when compared with other electric utilities with the same bond rating. Staff does not believe GPC's equity ratio justifies its currently authorized ROE of 12.0%, with an implied earnings ceiling of 13.0%, given current market conditions.

As discussed in Issue 4, staff believes GPC's currently authorized ROE of 12.0% is excessive given current market conditions. GPC's offer to reduce its authorized ROE by 20 basis points is not sufficient given the decline in interest rates and the allowed returns approved in other jurisdictions. For these reasons, staff believes GPC's proposal does not adequately address its authorized ROE.

Point 3 of the plan requests to place the third floor of the corporate office building and the related accumulated deferred return into rate base. Staff agrees with this point of the proposal as discussed in Issue 3.

Point 4 of the plan requests the Commission cease removing non-utility investment out of common equity. The current practice of removing non-utility investment from equity for surveillance purposes was approved in Order No. 23573 issued October 3, 1990 in GPC's last rate case. In this Order, the Commission stated:

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

The adjustment to remove non-utility investments from equity has been made in several cases. In the matter of GTE Florida, Inc. in Docket No. 920188-TL, the Commission's decision to remove non-utility investments from equity was approved in Order No. PSC-93-0108-FOF-TL issued January 21, 1993, affirmed on reconsideration in Order No. PSC-93-0818-FOF-TL issued May 27, 1993, and upheld on appeal to the Florida Supreme Court. GPC has not offered any competent evidence for why this treatment should be discontinued. For this reason, staff recommends the Commission reject this aspect of GPC's proposal.

Point 5 of GPC's proposal addresses the sharing point and sharing percentages, along with the disposition of any amounts to be shared. The Company proposes that it start sharing at 12.8% ROE, which is 100 basis points above its proposed midpoint ROE. In its petition the Company refers again to the Southern Bell decision by this Commission and states that the sharing point was set 125 basis points above the middle of the authorized ROE range. The Company has incorrectly interpreted the Southern Bell case. In the case of Southern Bell, the Commission did not set a traditional midpoint ROE with a normal range. The Commission determined a ROE rate setting point, then set the sharing point at only 80 basis points above the rate setting point and set a floor at 170 basis points below the rate setting point. Staff does not agree with the Company's proposal to begin sharing at 100 basis points above the ROE midpoint.

Staff does not disagree with the Company's proposed language in Point 6 which describes how earnings are to be measured each year. This is similar to language approved by the Commission in other dockets.

Point 7 of the proposal sets dates for the filing and review of the ESR. Staff does not believe this language related to the filing date of the ESR is necessary since the filing date of the ESR is set by rule. Staff does not believe that the requirement that FPSC Staff attempt to complete its audit, review and Staff Recommendation no later than June 1 adds any benefits to the plan. It may simply cause more disagreement over whether staff did or did not attempt to meet the June 1 goal.

Point 8 of the plan requires the Company to use the jurisdictional separations factors developed in its last rate case for its ESR. Staff believes that these factors may need to be updated to more accurately reflect current operations and the allocation of costs between the wholesale and retail jurisdictions.

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Point 9 addresses the treatment of any deferred revenues in the capital structure. It proposes to treat the deferred revenues in the same manner that the Commission approves in Docket No. 950379-EI for Tampa Electric Company. Staff does not object to this.

The most critical element in an earnings sharing plan is the resetting of rates at an appropriate ROE when the plan is initiated. GPC's proposal does not reset rates. If the Company's proposal is accepted, then GPC will earn above 13.0% ROE based on its 1999 budget. Staff recommends that GPC's petition should not be granted.

**ISSUE 2:** Should the Commission order GPC to place money subject to refund?

**RECOMMENDATION:** Yes. Pursuant to Section 366.071, Florida Statutes, the Commission should order GPC to place \$2,772,085 of annual revenue under corporate undertaking subject to refund, including interest, pending final disposition in this proceeding. Consistent with Section 366.071(2)(b), Florida Statutes, GPC is authorized to continue to collect the previously authorized rates, subject to the appropriate corporate undertaking. (MAILHOT, ELIAS)

**STAFF ANALYSIS:** On February 15, 1999, GPC filed its Earnings Surveillance Report (ESR) for calendar year 1998. The ESR indicates an achieved ROE of 12.99%. The Company's maximum authorized ROE is 13.0%.

Section 366.01, Florida Statutes, provides that: "the regulation of public utilities is declared to be in the public interest and this chapter shall be deemed to be an exercise of the police power of the state for the protection of the public welfare and all the provisions hereof shall be liberally construed for the accomplishment of that purpose." Section 366.06(2), Florida Statutes authorizes the Commission to, on its own motion, investigate the rates of a public utility and "determine just and reasonable rates to be thereafter charged." Section 366.071, Florida Statutes, specifically authorizes the Commission, on its own motion, to order an interim decrease upon a showing that "the utility is earning outside the range of reasonableness on rate of return. The statute further provides that rate of return "shall be calculated by applying appropriate adjustments consistent with those which were used in the most recent individual rate proceeding of the public utility." After making an adjustment consistent with Gulf's last rate proceeding, it appears that Gulf is earning outside its authorized range.

In the Company's last rate proceeding, Docket No. 891345-EI, GPC was allowed to record a fixed accrual amount of \$1.2 million annually to the reserve for storm damage. However, GPC was not allowed any flexibility in the amount accrued each year. By Order No. PSC 96-0023-FOF-EI, issued January 8, 1996, in Docket No. 951433-EI, the Commission approved an increase from \$1.2 million to \$3.5 million in the Company's annual accrual to the storm damage reserve and allowed GPC the flexibility to increase its annual storm damage accrual above its \$3.5 million minimum annual amount. The Company recorded additional storm damage expense during 1998, which resulted in reported achieved ROEs of 12.70% or less through



November 1998. In December 1998, the Company reversed much of the additional accrual recorded earlier in 1998, thereby increasing its achieved ROE to 12.99% in December. The net amount of additional expense accrual included in the December 1998 ESR is \$3 million. There is no requirement or assurance that the additional \$3 million accrual be recorded on an ongoing basis. No expenses of a discretionary nature, such as the portion of the storm damage accrual, were included in the calculation of Gulf's revenue requirement during its last rate proceeding. Therefore, staff recommends that it is appropriate, reasonable and consistent with the interim statute to exclude this item from the calculation of the interim amount. For the purpose of calculating the amount of revenue to place subject to refund on a prospective basis, staff recommends that an adjustment be made to the December ESR to remove the flexible expense accrual of \$3 million to the storm damage reserve.

By Order No. PSC-96-1219-FOF-EI, issued September 24, 1996, in Docket No. 960789-EI, the Commission allowed GPC to enter into Contract Service Agreements (CSA) which generally result in the Company giving discounts to customers that meet certain criteria. The Order required GPC to:

...include in its monthly surveillance reports, the difference between the revenues that would have been produced by Gulf's standard tariff rates and the revenues that are produced by each CSA. If the difference in revenues resulting from the CSAs causes Gulf's achieved jurisdictional return on equity to exceed the top of the Company's authorized range, we will review each CSA. These reviews will include our evaluation of whether Gulf's decision to enter into each CSA was prudent.

Based on the reported achieved ROE of 12.99% on the December 1998 ESR and the difference in revenues resulting from the CSAs, Gulf's achieved jurisdictional authorized ROE exceeds the top of the Company's authorized range. Consistent with the intent of Order No. PSC-96-1219-FOF-EI, staff recommends (in Issue 6) that an additional amount of revenue be placed subject to refund for these CSAs.

Staff believes that the Commission should place revenue subject to refund immediately, regardless of the Commission's decisions on other issues in this recommendation. Although staff believes that its recommendation in Issue 3 is a reasonable resolution to this proceeding, it is Proposed Agency Action and is subject to protest. If Issue 3 is approved by the Commission and

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is subsequently protested, the ratepayers are not protected during the interim until the Commission takes final action. If Issue 3 is approved by the Commission and is not protested, then staff expects to return to agenda with a recommendation to release the revenue subject to refund.

Staff recommends that the Commission order GPC to place \$2,772,085 of annual revenue under corporate undertaking subject to refund, including interest, pending final disposition in this proceeding. Staff's calculation of the amount is included in Attachment A. Consistent with Section 366.071(2)(b), Florida Statutes, GPC is authorized to continue to collect the previously authorized rates, subject to the appropriate corporate undertaking.

**ISSUE 3:** Should the Commission approve the plan listed in Attachment B?

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

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

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

In Order No. 20162, the Commission found that:

Traditional utility regulation has historically taken the form of rate of return regulation (ROR) by independent regulatory authorities such as this Commission. Under this approach, privately-owned utilities such as Southern Bell are given the opportunity to collect rates which will cover operating costs and earn a reasonable rate of return on property devoted to providing the regulated service. In recent years in Florida, the Commission has calculated a rate of return as a mid-point and generally allowed a 100 basis point zone of reasonableness around that point.

In our view, the disincentives of the present regulatory system are most likely to occur when the utility is earning at or near the top of its authorized range. Below this level, the company has the same incentive to raise productivity and offer new services as any other business. It is only when one sees no reward for doing what would otherwise be prudent that disincentives set in. No empirical evidence was offered to support the theory of disincentives under ROR regulation. However,

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

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

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

In item 2 of Attachment B, the staff has proposed certain returns on equity. The rate setting point of 11.2% is the ROE midpoint recently proposed by FPL and accepted by the Commission. The ROEs for the authorized floor, the point when sharing begins, and the point when sharing ends are each based on the Commission's decision in BellSouth relative to the rate setting point.

Item 3 of Attachment B addresses three regulatory assets on GPC's books. Staff recommends that each of these regulatory assets be written off in equal amounts per year during 1999, 2000, and 2001. The Commission previously approved the write off of the balance of the flow through portion of the FAS 109 regulatory asset and the balance of the loss on reacquired debt for Florida Power and Light.

Item 4 of Attachment B requires a credit to the customers. Staff has calculated the amount based on targeting the Company's earnings at 11.2% ROE, which is the rate setting point. In addition staff has included the effect of the write offs of the regulatory assets in item 3 of Attachment B.

Item 5 of Attachment B addresses earnings above the sharing point of 12.0% ROE. Consistent with the Commission's decision in BellSouth, staff is recommending a sharing of the earnings on a 60/40 basis in the ratepayers' favor. In the case of BellSouth, the Commission required additional rate reductions each year of the plan to account for accretion or the normal improvement in earnings and productivity. In this case, staff is not recommending that additional rate reductions or credits be implemented for 2000 and 2001, but that the same amount (\$7.6 million) of credit be applied each year. Staff is not certain of the amount of accretion or normal productivity gains that can be expected to occur. Therefore, staff is recommending a more conservative approach. The plan requires that additional amortization be recorded to the Property Insurance Reserve for 2000 and 2001 only if earnings exceed the 12.0% ROE sharing point.

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

Item 7 of Attachment B requires interest on any amounts to be credited to the ratepayers. For the purpose of calculating interest, any amounts to be credited to the ratepayers should be assumed to be earned equally throughout the year.

Staff recommends that the Commission approve the sharing of earnings plan in Attachment B for Gulf Power Company.

**ISSUE 4:** Should the Commission initiate a proceeding to investigate Gulf Power Company's earnings and authorized ROE?

**RECOMMENDATION:** Yes. If Issue 3 is not approved, staff believes that an investigation should be initiated and a limited proceeding hearing should be held to determine the appropriate ROE and range. (LESTER, MAILHOT)

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

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

In May 1993, when the Commission set GPC's current ROE of 12.0%, the monthly average yields on the 30-year treasury bond and A-rated public utility bond were 6.92% and 7.86%, respectively. As of January 1999, the yield on the 30-year treasury bond was 5.15% and the yield on the A-rated public utility bond was 6.97%. Staff believes this decline in interest rates indicates a corresponding decrease in the required return on common equity for electric utilities. These interest rates, GPC's authorized ROE, and the spread above the A-rated public utility bond are presented below.

<b>Analysis of Gulf Power Company's ROE and Concurrent Bond Yields</b>				
	Feb. 11 1999	January 1999	May 1993	October 1990
A-rated Public Utility Bond	7.08%	6.97%	7.86%	10.05%
30-year Treasury Bond	5.36%*	5.15%	6.92%	8.84%
Gulf's Authorized ROE	12.0%	12.0%	12.0%	12.55%
ROE Spread above A-rated Bond	4.92%	5.03%	4.14%	2.50%
Source for Bond Yields: Moody's Credit Perspectives * February 10, 1999				

In Docket No. 960502-GU, the Commission set City Gas' ROE at 11.3% in Order No. PSC-96-1404-FOF-GU, issued November 20, 1996. In Docket No. 980696-TP, the Commission set the ROE for BellSouth Telecommunications, Sprint, and GTE Florida at 11.5% in Order No. PSC-99-0068-FOF-TP, issued January 7, 1999. Staff believes that GPC has less risk than BellSouth, Sprint, or GTEFL. Staff's ROE models indicate a decline of approximately 95 basis points in Gulf's ROE from June 1993 to December 1998. The following table shows ROEs recently set by other state regulatory commissions:

S & P RATING	COMPANY	ORDER DATE	ROE	STATE
A-	AEP-Virginia Power	02/11/99	10.85%	Virginia
A+	Georgia Power Company	12/21/98	12.5%*	Georgia
AA	Northern States Power	09/17/98	11.90%	Wisconsin
A-	Empire District Electric	07/21/98	9.50%	Arizona
A-	Metropolitan Edison	06/26/98	10.00%	Pennsylvania
A+	Pacificorp	05/05/98	10.00%	Oregon
Source: Rate of Return Data Book, 3rd Qtr., 1998, 4th Qtr., 1998, Kan & Assoc. *The top of the range; sharing begins at this point.				

Compared with the decline in interest rates and the returns approved in other jurisdictions, GPC's currently authorized ROE of

12.0% appears excessive. Therefore, staff recommends the Commission hold a limited proceeding hearing to set the appropriate ROE for Gulf Power Company for all regulatory purposes.

According to its ESR for December 1998, GPC earned 12.99% for 1998. The utility's budget for 1999 indicates that it will earn a return of 12.85%. Staff has addressed GPC's earnings in Issue 2. If the Commission lowers GPC's ROE, the amount of overearnings will increase. A 100 basis point change in ROE for GPC equates to approximately \$6 million. Therefore, staff recommends that the Commission hold a limited proceeding hearing to determine a new ROE for measuring Gulf's earnings. After authorizing a new ROE, the Commission can determine if it needs to place additional funds subject to refund and its course of action.

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

Staff notes that in order to provide adequate protection for the ratepayers, the Commission should hold the limited proceeding on the appropriate ROE and its range expeditiously. Staff has reserved April 13, 1999, for this purpose. Staff believes a bench decision is warranted and the Commission should convene to determine if additional funds should be held subject to refund. Staff believes that due to the shortened time frame, only direct testimony should be filed by the parties.



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**ISSUE 5:** Should the Commission order GPC to file Minimum Filing Requirements (MFRs)?

**RECOMMENDATION:** Yes. If Issue 3 is not approved, staff recommends that the Commission order the Company to file MFRs, by June 15, 1999, using 1998 as the base year, and 1999 as the projected test year. (MAILHOT)

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

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

**ISSUE 6:** Should the Commission initiate a review of GPC's executed Contract Service Agreements (CSA) under its Commercial/Industrial Service Rider tariff (CISR)?

**RECOMMENDATION:** Yes. For the twelve month period ending December 31, 1998, GPC reported an achieved ROE of 12.99%. The top of GPC's currently authorized ROE range is 13.00%. The addition of the revenues that would have been produced by GPC's otherwise applicable tariff and the revenues that are produced under the CISR (revenue shortfall) cause GPC's ROE to exceed the top of its authorized range. Order No. PSC-96-1219-FOF-EI requires the Commission to review each CSA if the addition of the revenue shortfall causes GPC to exceed the authorized top of its range. In addition to the amount of revenue identified in Issue 2, the amount of the revenue shortfall over the top of the range should be held subject to refund pending the completion of the review. (E. DRAPER, SLEMKEWICZ)

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

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

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achieved ROE of 12.99%. The top of Gulf's currently authorized ROE range is 13.00%. The addition of the revenue shortfall causes Gulf to exceed the authorized top of 13.00%.

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

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DATE: March 4, 1999

**ISSUE 7:** Should Docket No. 990244-EI be closed?

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

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

**ISSUE 8:** Should Docket No. 990250-EI be closed?

**RECOMMENDATION:** No. Docket No. 990250-EI should not be closed. (ELIAS)

**STAFF ANALYSIS:** Docket NO. 990250-EI should remain open for the investigation of GPC's earnings and ROE.

<b>Gulf Power Company</b>		
<b>Year Ended December 31, 1998</b>		
NET OPERATING INCOME PER ESR		\$69,207,752
Staff Adjustments:		
Storm Reserve Accrual	\$3,000,000	
Income Taxes	<u>(1,157,250)</u>	
Total Adjustments		<u>1,842,750</u>
Adjusted NOI		<u>\$71,050,502</u>
RATE BASE PER ESR		\$861,807,776
Staff Adjustments:	<u>\$ 0</u>	
Total Adjustments		0
Adjusted Rate Base		\$861,807,776
ROR @ 13.00% ROE	x	<u>8.05%</u>
Maximum allowed NOI		69,375,526
Achieved NOI		<u>71,050,502</u>
Excess NOI		1,674,976
NOI Multiplier	x	<u>1.6550</u>
TOTAL REVENUE SUBJECT TO REFUND		<u>\$2,772,085</u>

1. This plan covers calendar years 1999, 2000 and 2001.
2. Effective January 1, 1999, the following returns on equity (ROE) are set for Gulf Power:
  - 9.5% - Authorized Floor
  - 11.2% - Rate Setting Point
  - 12.0% - Sharing Begins
  - 14.0% - Authorized Ceiling after Sharing

The 11.2% ROE will be used as the equity return for other purposes as well, including but not limited to the equity portion of JDIC and calculating Gulf's allowance for funds used during construction (AFUDC) rate.

3. Regulatory Assets -

- A. Effective January 1, 1999, Gulf Power will no longer accrue a deferred return on the cost of the third floor of the corporate office as authorized and identified in Order No. 23573 issued October 3, 1990 in Docket No. 891345-EI (Gulf Power's last full base rate adjustment proceeding). The accumulated balance of such deferred return together with the identified third floor investment amount shall be included in the Company's authorized jurisdictional rate base and be subject to depreciation and/or amortization for purposes of calculating the achieved jurisdictional return beginning January 1, 1999. The balance of deferred returns on the costs of the third floor of the corporate office (approximately \$2.9 million) and the deferred depreciation associated with the corporate office third floor will be fully amortized in equal amounts per year during 1999, 2000, and 2001.
  - B. The balance of the flow through portion of the FAS 109 regulatory asset (approximately \$1.7 million) will be fully amortized in equal amounts per year during 1999, 2000, and 2001.
  - C. The balance of the loss on reacquired debt (approximately \$18.9 million) will be fully amortized in equal amounts per year during 1999, 2000, and 2001.
4. Customer credit - Customer bills will be credited by \$7.6 million on an annual basis beginning July 1, 1999, through the environmental cost recovery clause. An additional credit of \$3.8 million will be made for the period January 1, 1999 to June

30, 1999. The Company shall file revised tariffs to reflect this credit, effective, July 1, 1999.

5. Sharing - After the close of each calendar year covered by this plan the amount of any actual revenues contributing to earnings above 12.0% ROE will be determined by the Commission. The ratepayers' share of revenues shall be refunded to Gulf's retail customers as a credit through the Company's fuel adjustment clause or in such other manner as may be approved by the Commission.
  - A. For calendar year 1999, the amount of any actual revenues contributing to earnings above 12.0% ROE up to a net earned jurisdictional return (after sharing) of 14.0% will be divided 60/40 in the ratepayers' favor. Any and all earnings over 14.0% after sharing will go to the ratepayers.
  - B. For calendar year 2000, the first \$3 million of revenues above 12.0% ROE will be added to the annual accrual to the Property Insurance Reserve. Any additional actual revenues contributing to earnings above 12.0% ROE up to a net earned jurisdictional return (after sharing) of 14.0% will be divided 60/40 in the ratepayers' favor. Any and all earnings over 14.0% after sharing will go to the ratepayers.
  - C. For calendar year 2001, the first \$6 million of revenues above 12.0% ROE will be added to the annual accrual to the Property Insurance Reserve. Any additional actual revenues contributing to earnings above 12.0% ROE up to a net earned jurisdictional return (after sharing) of 14.0% will be divided 60/40 in the ratepayers' favor. Any and all earnings over 14.0% after sharing will go to the ratepayers.
6. During 1999, 2000, and 2001, Gulf Power shall not have the flexibility, as approved in Order No. PSC 96-0023-FOF-EI, to increase its annual accrual to the Property Insurance Reserve above \$3.5 million, except as provided for in this plan.
7. Any revenues deferred pending Commission jurisdiction as to final disposition will accrue interest at the 30 day commercial paper rate as specified in Rule 25-6.109, Florida Administrative Code. Such deferred revenues will be assigned a cost rate in the determination of the cost of capital based on the rate used in the interest accrual for deferred balances consistent with the Commission's decision on this issue in Docket No. 950379-EI for Tampa Electric Company.

Gulf Power Company's  
Attachment "A"

The following is Gulf Power Company's proposal for addressing certain regulatory issues including a reduction to the Company's authorized return on equity ("ROE")<sup>1</sup>:

1. This plan covers calendar years 1999, 2000 and 2001.
2. Effective January 1, 1999, Gulf Power's authorized ROE will be established at a midpoint of 11.8% (reduced from 12.0%) for all regulatory purposes with an authorized range of 10.8% to 12.8%.
3. Effective January 1, 1999, Gulf Power will no longer accrue a deferred return on the cost of the third floor of the corporate office as authorized and identified by the Florida Public Service Commission in Order No. 23573 issued October 3, 1990 in Docket No. 891345-EI (Gulf Power's last full base rate adjustment proceeding). The accumulated balance of such deferred return together with the identified third floor investment amount shall be included in the Company's authorized jurisdictional rate base and be subject to depreciation and amortization for purposes of calculating the achieved jurisdictional return beginning January 1, 1999.
4. Effective January 1, 1999, Gulf Power's merchandising operations and any other non-utility investment excluded from the Company's jurisdictional rate base for surveillance purposes will be removed from the Company's capital structure on a pro rata basis (instead of totally from equity) in order to be consistent with the manner in which the Company actually finances such investments.<sup>2</sup>

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<sup>1</sup>The provisions of this proposal will not take effect unless and until approved by an order of the Florida Public Service Commission that becomes final and is not subject to further review. The foregoing statement is not intended to restrict the ability of any person having sufficient interest to seek initiation of a rate proceeding during the period covered by the plan.

<sup>2</sup>This item reflects the need to reassess the continued appropriateness of a decision reached nearly 10 years ago in Gulf's last rate case. This reassessment is of the same character as the reassessment reflected in item 3 above.



5. After the close of each calendar year covered by this plan, the amount of any actual revenues contributing to earnings above the revenue sharing point of 12.8% up to a ceiling on ROE of 14.3% (measured after sharing) for that calendar year will be divided into three shares on a 40%, 20%, 40% basis. These shares are to be distributed as follows:

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

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

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

Plan revenues will first be applied to amortize the remaining balance of Regulatory Asset A. Any remaining plan revenues will be used to supplement the \$3.5 million authorized annual accrual to Gulf Power's accumulated provision for property insurance ("Property Insurance Reserve") until a balance of at least \$12 million is achieved. If any additional plan revenues remain after Regulatory Asset A is fully amortized and a balance of at least \$12 million in the Property Insurance Reserve has been achieved, such remaining plan revenues will be applied first to amortize Regulatory Asset B and thereafter to amortize Regulatory Asset C. If any additional plan revenues remain after these two regulatory assets have been fully amortized, then such remaining plan revenues will be utilized first to further supplement the authorized annual accrual to the Property Insurance Reserve until a balance of at least \$25 million has been achieved<sup>3</sup> and thereafter to amortize any additional regulatory assets as may be approved by the Commission.

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<sup>3</sup>In Order No. PSC-96-1334-FOF-EI, the Commission established a target of \$25 million to \$36 million for Gulf Power's Property Insurance Reserve based on a study that had been requested by the Commission for its review.

In exchange for the foregoing, in recognition of the Company's superior performance on key customer service indicators noted in paragraph 3 of the petition, and as an incentive to achieve even further efficiencies in operations of the Company, the Company's shareholders will be entitled to receive the remaining 40% share of actual revenues contributing to earnings above 12.8% up to a net earned jurisdictional return of 14.3% (measured after sharing).

The full amount of any revenues contributing to earnings above a net earned jurisdictional return of 14.3% (measured after sharing) will be deferred for use as directed by the Commission. The Commission will retain jurisdiction over all such deferred revenues.

6. The calculations of the actual jurisdictional ROE for calendar years 1999, 2000 and 2001 will be on an "FPSC Adjusted Basis" using the adjustments approved in Gulf Power's last full base rate proceeding as amended by this plan. Except as noted in the preceding sentence, all actual reasonable and prudent expenses and investment related to Gulf's retail electric jurisdiction will be allowed in the calculation and no annualized or proforma adjustments will be made.
7. The calendar year surveillance reports for 1999, 2000, and 2001 on which the sharing calculations will be based will continue to be filed no later than February 15 of the year following each plan year and will be subject to audit by the FPSC Staff and true-up consistent with paragraph 6 above. The FPSC Staff will attempt to complete its audit, review and Staff Recommendation no later than June 1 following the close of the calendar year under review to facilitate the finalization of the sharing process.
8. The jurisdictional separation factors to be utilized in the surveillance report calculations referred to in paragraph 6 above will continue to be those developed in the cost of service study used in Gulf's last full base rate adjustment proceeding (Docket 891345-EI).
9. Any revenues deferred pending Commission approval as to final disposition will accrue interest at the 30-day commercial paper rate as specified in Rule 25-6.109, Florida Administrative Code. Such deferred revenues will be assigned a cost rate in the determination of the cost of capital based on the rate used in the interest accrual for deferred balances consistent with the Commission's decision on this issue in Docket No. 950379-EI for Tampa Electric Company.