BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of **Investigation into the earnings and authorized return on equity of Gulf Power Company.** : **DOCKET NO. 990250-EI**

In the Matter of **Petition of 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.** : **DOCKET NO. 990244-EI**

PROCEEDINGS: **AGENDA CONFERENCE**
ITEM NO. 10

BEFORE: CHAIRMAN JOE GARCIA
COMMISSIONER J. TERRY DEASON
COMMISSIONER SUSAN F. CLARK
COMMISSIONER JULIA L. JOHNSON
COMMISSIONER E. LEON JACOBS, JR.

DATE: **April 20, 1999**

TIME: Commenced at 9:30 a.m.

PLACE: Betty Easley Conference Center
Room 148
4075 Esplanade Way
Tallahassee, Florida

REPORTED BY: KIMBERLY BERENS, CSR, RPR
FPSC Commission Reporter

PARTICIPATING:

DALE MAILHOT and PETE LESTER, FPSC Division of Auditing & Financial.

BOB ELIAS, FPSC Division of Legal Services.

JOE JENKINS, FPSC Division of Electric & Gas.

JEFF STONE, representing Gulf Power Company.

JOHN McWHIRTER, representing Florida Industrial Power Users Group, (FIPUG).

P R O C E E D I N G S

CHAIRMAN GARCIA: Mr. Mailhot, you want to tee up Item 10?

MR. MAILHOT: Sure. At the March 16th agenda, Staff brought a recommendation concerning a petition by Gulf Power Company for an incentive plan, and in addition, at that agenda, Staff had its own incentive plan. The Commission directed the Staff and the company and any interested persons to meet and try to resolve any differences. We met a couple of times and from those meetings, although we didn't resolve all our differences, we have a revised proposal from the company and a revised proposal from Staff. And the company's proposal is considered in Issue 1 and the Staff's proposal is in Issue 2. And I believe the company would like to speak.

CHAIRMAN GARCIA: Mr. Stone.

MR. STONE: Thank you, Mr. Chairman. I am Jeff Stone of the law firm of Beggs and Lane. I'm here today on behalf of Gulf Power Company. And I would like to go through our proposal and the revisions we made since we were here on March 16th.

In order to facilitate your review and our discussion, I have some handouts that I think will be helpful. One is a copy of our March 2nd filing that has the consecutive number sequence in the lower right hand corner from Page 1 through Page 27. That's the same thing that was handed out on March 16th.

The other document that's being handed out to you now is our April 6th filing. It consists of a letter in the first two pages, and then the next attachment to the letter is the red line strike out version of our revised Attachment A to our petition. It sets out our revised proposal. And I'd like to just walk you through that just briefly. You'll see the shading indicates additions and they're strike out to show the deletions from our original Attachment A which set out our proposal.

In Paragraph 2, you'll see that we have -- we have lowered our proposed ROE even further. Our currently existing ROE -- approved ROE is 12% midpoint and we have proposed to lower that 40 basis points to 11.6. There is some discussion in laying out all of that in Paragraph 2 of our revised Attachment A.

Paragraph 3 talks about an incremental increase to the property insurance reserve of $1 million dollars. And that would bring the total annual accrual to the property insurance reserve before sharing to $4.5 million on an annual basis for the three years covered by this plan.

In Paragraph -- new Paragraph 4, you'll see in the handout that we've given you is a discussion of a credit that we'd be providing to our retail customers for calendar year 1999. And that credit is a $3.7 million credit to customers and it would be issued under our proposal on a per kilowatt basis on the July bill to our customers. If there was any difference in the projections, that would be taken care of in a true-up mechanism that is provided there.

Paragraph 4 goes on on page -- the consecutive sequence there, Page 4, to talk about what would be done in the calendar year 2000. Again it's a $3.7 million credit. And, in this instance, we're talking about reducing the fuel and purchase power cost recovery factor. Since we don't have that information, we flow it into the determination of our factor come November.

And then for 2001, we have a little bit of a different twist on that $3.7 million credit. We have some concerns about the company's earnings in that last year of the three year plan and so what we're proposing is that we would recredit to customers in a fashion similar to what we proposed for the 1999 credit up to $3.7 million and that would be the first $3.7 million of revenues that contribute to earnings above the 12.2% earnings set point that we've been identified in Paragraph 2.

So basically the $3.7 million we talked about, it's automatic for years 1999 and 2000. But it's subject to earnings being available to support it for 2001.

The next area of change in our proposal is in Paragraph 6 and that's where we -- on our merchandizing program, we've talked about using a proxy as an alternative for the determination of how to remove our merchandizing operation for capital structure. And I'll go more into that later in my presentation.

But essentially what we're trying to identify is the type of operation that Gulf's merchandizing operation is, which is basically a financing operation.

Paragraph 7 is the sharing mechanism itself. Of course, it recognizes the reduction in our proposed ROE. The top of the range is where we start our sharing under our proposal and since we've lowered it more -- lowered it further than we had when we gave you our original proposal on March 2nd, you'll see that as a red line strike out there. And it makes reference to the incremental accrual to the property insurance reserve down there in the text on Page 5 of this red line strike out version.

The other changes noted are on Page 6, Paragraph 9, when we were trying to conform to what we understood Staff's concerns were about the reporting cycle. And then finally on Paragraph 10, which is on Page 7 of the red line strike out version of the April 6th filing, we talk about the company's going to commission an updated study to come up with the wholesale retail separation factors for use and surveillance report. And I just wanted to track you through our revision that was filed on April 6th.

The company formulated its original sharing proposal in order to address Staff's stated concerns regarding the level -- the current level of Gulf's authorized return on equity and the outstanding balance of certain regulatory assets. And our revised proposal continues to address the stated concerns in what the company believes is a reasonable manner and at the same time we have developed a mechanism that provides opportunities for significant benefits to customers and shareholders alike. I touched on it briefly, the significant change in our proposal where we talk about the $3.7 million credit to customers.

As I indicated, for 1999 that would be

passed to customers' bills in July. For Gulf's residential customers, based on the projected average residential energy use billing in July 1999, that would amount to 16 -- 16,019 kilowatt hours in that month and so the average credit would be about $5.94 in July.

As I go into my presentation, I want to point out that we have several people here from the company that when I get to a breaking point, they'll be available to answer questions if the Commission has any. And my comments right now will focus on four outline points.

I want to provide an overview, including a description of the plan; talk about our proposed ROE adjustment and the basis for our sharing percentage; and finally, our proposed treatment of the merchandizing operation.

As I mentioned, on the 16th of March, the foundation for the company's proposal is Gulf's sustained performance on three key indicators: Rates, reliability and the level of customer complaints. We believe our proposal properly takes into account significant differences between Gulf and other Florida electric utilities in regard to five years of data on these key indicators related to electricity prices, reliability of electric service and the number of justified customer complaints to this Commission. The data on these key indicators is shown in our petition on Attachment B, that's pages 11 to 12 of the March 2nd filing. And it shows superior performance by Gulf on a sustained basis with regard to prices to residential customers, regards to the number of minutes of interruption per customer per year, and regards to the incidents of customer complaints to the Commission.

Gulf's customers presently benefit from the fact that Gulf Power has the lowest electric rates in Florida among major utilities and among the lowest in the nation. Gulf's customers also benefit from the company's high reliability. And for the four major investor-owned utilities in Florida, Gulf has the lowest annual rate of justified customer complaints per thousand customers. Gulf's performance in these key areas reflects the company's long-term focus on issues related to customer satisfaction and value.

Gulf is highly ranked among leading electric utilities across the country in regards to customer satisfaction. As we stated on March 16th, we pointed your attention to Page 17 of our original petition which contained a table outlining the results of a recent benchmark study survey. Gulf's low rates, high reliability and high customer satisfaction clearly reflect management's focus on these key areas.

Again, Attachment C to our original petition, Pages 13 through 19, summarizes fuel cost initiatives, reduction initiatives, reliability and customer satisfaction initiatives undertaken by the company as part of this management focus.

These initiatives demonstrate that such outstanding results as shown in Attachment B did not occur by accident but instead are an indication that management's focus is working. As we pointed out on March 16th, despite combined effects of customer growth, inflation and several hurricanes since base rates were last set, Gulf's management has been able to find ways to consistently meet the expectations and needs of its customers through low rates, high reliability and high customer satisfaction. And at the same time, still satisfy its shareholders by achieving earnings near the top of the authorized range. And all of this is done with no increase in the company's base rates.

Our revised sharing plan starts from this positive starting point and builds towards something better in the future. It is important to note that Gulf's proposed plan incorporates a reduction to the company's authorized midpoint ROE of 40 basis points and this is retroactive to the first of the year. The reduction would change the midpoint from 12% to 11.6% and has a corresponding shift in the authorized range so that it would now be -- if approved, it would extend from 10.6% to 12.6% instead of the current 11% to 13%. And all of this is shown on page 3 of our April 6th filing in Paragraph 2.

Although important, the proposed ROE reduction is just one part of Gulf's overall sharing plan. Adoption of Gulf's sharing plan sends a proper signal to management and the company's shareholders. This incentive is designed to achieve good financial results while maintaining a high level of performance on the key customer service indicators of rates, reliability and customer satisfaction.

Briefly, the plan elements are, it's for three calendar years, 1999, 2000, and 2001 and that's in Paragraph 1 on Page 3 of our April 6th filing. It addresses two regulatory concepts established in Gulf's last rate case -- readdresses them. The third for deferred return and the effect of merchandizing operations on the company's capital structure. You'll find that treatment on Page 4 of the April 6th filing, Paragraphs 5 and 6.

And finally, the third plan element that we're focusing on is the sharing mechanism which allows earnings above the newly established top of the authorized range to operate to the benefit of customers and shareholders alike, both in the short term through the 40% credit to customers and the 40% credit to shareholders, and in the long-term, by using the remaining 20% to accelerate the amortization of three identified regulatory assets to lower base rates for the future and provide needed support to the property insurance reserve. That mechanism is detailed on Pages 5 and 6 of our April 6th filing in Paragraph 7.

We did meet since March 16th and we made an effort to come to an agreement, and you will note that the company has provided a significant credit to its customers in the form of $3.7 million to bring our projected earnings down to the revenue set point of 12.2%. But there are three major areas of disagreement between the company and the Staff. And these areas are of critical concern to Gulf's management and they're set forth in the company's revised proposal.

They are the ROE level, the sharing percentage and the treatment of Gulf's investment in its merchandizing operation.

Gulf's proposed ROE adjustment from 12.0%

midpoint to 11.6% midpoint is important. That is a significant reduction but it recognizes that ROE should not be set in a cookie cutter fashion. One size clearly does not fit all.

A hasty or ill-advised decision now, when capital needs for new generating capacity and other property additions are just around the corner, could cost Gulf's customers in the long run if rating agencies downgrade our credit worthiness out of concern about the regulatory environment created by FPSC actions.

It also -- a hasty or ill-advised decision, or dramatic decision and change in the ROE could send the wrong signal on opportunities for return on equity from this Commission, and could have far-reaching impacts on decisions regarding choices of where to invest equity capital.

COMMISSIONER CLARK: Let me just ask a question right on that point. How are you listed in the stock market? Are you Southern Company or are you Gulf?

MR. STONE: As far as Gulf's --

COMMISSIONER CLARK: Who raises capital? I guess that's a better way to put it.

MR. STONE: Common equity is provided to

Gulf from our parent, Southern Company.

COMMISSIONER CLARK: Okay. So Southern Company is the one that's traded, right?

MR. STONE: It's the one that's listed on the exchange, yes. Gulf is rated with regard to its debt individually. So we have our own credit rating.

COMMISSIONER CLARK: Okay. Thank you.

MR. STONE: In Attachment D to our petition, Pages 20 through 27, there is a detailed discussion of the basis for the ROE component of Gulf's proposal. And we discuss key points of difference between Gulf Power and other Florida electric utilities in terms of leverage, electric rates, reliability, customer complaints and business risk. I'd like to touch on some elements of that discussion for you today.

Relative differences in leverage between utilities justify relative differences in authorized ROE. I have a chart that we'd like to hand out that illustrates the dramatic difference in equity ratio that has developed between Gulf Power and FP&L over the past four years.

Although intuition leads us to the conclusion that differences in equity ratio reflect relative differences in risk, two separate studies conducted nearly 12 years apart establish this concept empirically for electric utilities. The two studies have been summarized in Attachment D to our original petition, on Pages 20 to 21. And they reach similar conclusions regarding the quantification of this difference. In Gulf's case, based on expert testimony before you by affidavit, the quantified difference is at least 47 basis points above the midpoint recently established for FP&L.

We also discussed trends and the comparative costs for kilowatt hour for Florida's electric -- Florida's electric utilities. We talk about the data of comparative reliability and we provide information regarding the customer complaints or satisfaction index and those are all on Page 21 of our original petition. And we submit to you that the data on these pages provide further grounds for appropriately exercising the Commission's discretion in setting Gulf's ROE at a higher level.

Although the ROE effects of the differences in these three areas are not specifically quantified in our proposal, the dramatic differences in performance between Gulf and other utilities, when combined with the 47 basis point difference associated with the difference in leverage, clearly justifies setting the midpoint for Gulf Power for the three years covered by the company's proposal at the level proposed by Gulf, 11.6%.

On March 16th I recited the basis for exercising discretion in this manner. It is found in the applicable statute and case law. Summaries of those matters are on Page 3 of our March 2nd filing.

I will not belabor the point further at this time except to say that the Commission clearly has the discretion to approve the ROE midpoint proposed by Gulf as an appropriate incentive reward for its outstanding achievement in the areas of customer rates, reliability of electric service and the low rate of justified customer complaints.

We submit to you that Gulf's sustained performance on these three key indicators are of sufficient magnitude that they should be recognized explicitly when establishing Gulf's authorized ROE. The differences between Gulf and other Florida electric utilities warrant the exercise of the Commission's discretion to establish a different higher midpoint than 11.0%.

The discussion in Attachment D also addresses differences in relative business risk faced by Gulf as compared to other Florida electric utilities.

As we mentioned on March 16th, Gulf faces more business risk than other electric utilities, in part due to our greater reliance on sales to the industrial sector and the dominant role of the U.S. military on the economy of the area in which we serve. These and other differences in relative business risk should also be reflected as differences in authorized ROE.

As we pointed out on March 16th, in order to evaluate the reasonableness of our proposed midpoint as a compromise settlement, Gulf examined recent trends in returns authorized for electric utilities across the nation. As part of Attachment D to our petition, Pages 22 to 23, using the consecutive numbering at the lower right-hand corner, we have included data from a January 1999 report. It's entitled, Major Rate Case Decisions, January 1990 to December 1998. It was produced by the Regulatory Research Associates or RRA.

And according to this report, equity returns authorized for electric utilities across the nation averaged approximately 11.7% in 1998 compared to 11.4% in '96 and '97. The ROE decision summarized in the RRA report during the fourth quarter of '98 averaged 12.03%. In fact, in nine of the cases for 1998 contained in the RRA report, the authorized ROE was established at or above 12.0%. Remember that's our current authorized midpoint.

When measured against these trends, our settlement proposal of 11.6%, a reduction from the 12.0% currently authorized and a further reduction from the 11.8% proposed on March 2nd, our 11.6% is clearly reasonable. This is especially so when you take into account that the proposal submitted by the company would operate retroactively.

The trend in ROEs recently authorized for electric utilities across the country on a going forward basis, suggests that the cost of equity capital for electric utilities is trending up. Forecasts show that rates for A-rated utility bonds and T-bills are expected to rise over the period covered by Gulf's proposal.

In fact, we'd like to hand out a chart that shows out selected financial information from 1990 to present including the T-bill rates, historical and projected, as well as the rates for A-rated utility bonds.

As you can see, based on the trends, now is not the time for a dramatic change in ROE for Gulf Power. The company's offered reduction of 40 basis points, as contained in Gulf's proposal and as part of the overall sharing plan, should be accepted as reasonable.

Turning now to the sharing plan itself. As we pointed out before, the existing regulatory framework provides a limited incentive for management to seek out and achieve efficiencies in operations. This limited incentive is provided by allowing shareholders to keep the increment in earnings above the authorized midpoint ROE up to the top of the authorized range. But our proposal builds on that and goes beyond by providing an appropriate incentive to seek out and achieve even greater efficiencies in order to grow shareholder value by entering into what we've labeled the sharing range above the top of the traditional zone.

We believe we struck an appropriate balance of customer and shareholder interest in our proposed sharing mechanism that allows both constituencies to receive and retain benefits resulting from added efficiencies.

Gulf's proposed allocation to shareholders under the sharing plan is important to the overall success of the plan and it's way it's contained in our proposal as an important element.

This share, 40%, is significant enough to get the attention of the company's shareholders and maintain their support of managements efforts to achieve further efficiencies without sacrificing the efforts that have led to outstanding accomplishments with regard to customer rates, reliability, and customer satisfaction as shown by the low incidents of justified customer complaints.

Furthermore, setting the shareholders allocation of the shared revenues at 40% is consistent with the Commission's established precedent. The Commission has approved a sharing mechanism for Southern Bell and TECO that provided 40% sharing to the shareholders.

As we've indicated, the allocation to shareholders must be large enough that it's not viewed by the shareholders as a mere token, but rather justifies their support of continuing management efforts. At the same time, we recognize that it has to be balanced with what the customers receive. We believe by striking the balance at 40% for both of these constituencies we have reached the proper balance point.

To build on the existing foundation it is important to add to whatever incentives exist within the traditional top of the zone framework. Gulf's proposal does this by adding an appropriate level of incentive based sharing opportunity that encourages efforts that may result in earnings above the top of the zone that can be appropriately shared, earnings that are essentially discouraged under the existing framework.

The third key point of difference that I wanted to describe for you is the merchandizing operation. The manner in which Gulf has been treated -- has been required to treat the capital structure of its merchandizing operation for surveillance purposes is not reasonable under the actual circumstances faced by Gulf. The company uses the -- Gulf's overall capital structure to support both utility and nonutility operations.

By taking the merchandizing operation out of the company's capital structure, based on 100% equity, we're unfairly penalizing the shareholders for this investment by forcing them to subsidize the retail jurisdiction. There simply is no empirical evidence to support the notion that Gulf's investment in its nonutility merchandizing operation has any impact on the company's overall cost of capital.

The company's merchandizing investment of

$14 million, the overwhelming majority of which is accounts receivable, simply pales in significance when compared to the $1.3 billion invested in the company overall. The merchandizing investment is such a small piece of the total that it is lost in the rounding. It, therefore, has no impact on the company's cost of capital. It is a mere fiction to act as though the merchandizing investment materially alters the company's risk profile. There simply is no evidence to suggest that Gulf's merchandizing investment has had any adverse impact on the cost to Gulf's retail electric customers.

COMMISSIONER CLARK: Mr. Stone, is that the test we've used in the past that it have no adverse impact?

MR. STONE: Commissioner, the way --

COMMISSIONER CLARK: Let me ask the question another -- what makes it different than what we decided in the last rate case?

MR. STONE: It was assumed in the last rate case that because it is perceived that the merchandizing operation has increased risk, that it must have some impact. But there was no evidence of that impact. In fact, the only evidence that was provided, was provided by Gulf and showed that there was no adverse impact.

COMMISSIONER CLARK: So you're saying we were wrong in the last case and we should change that now, not that the circumstances are different?

MR. STONE: Commissioner, that is correct. But I also point out that that's essentially what the Staff's concluded with regard to the third floor. And so, if we're revisiting the third floor decision, it -- we're basically asking the same type of re-review take place with regard to the merchandizing operation.

COMMISSIONER DEASON: Is Staff saying we were wrong on the third floor, that the opportunity is now present to cease accruing a regulatory asset and, in fact, try to reverse that accrual and get it off the books as rapidly as possible?

MR. STONE: They've not actually used the words that we're wrong, but certainly that is the effect of what we're doing.

This is a suitable breaking point in our presentation. As I mentioned at the beginning, we do have a number of people here from the company that are available to answer any questions you may have and certainly I will try to answer them as well. After we hear from other individuals, I would like an opportunity to make some further remarks in closing.

MR. McWHIRTER: Mr. Chairman and Commissioners, my name is John McWhirter and I'm here representing an industrial consumers group. Our group has not participated in these discussions from day one. We didn't know they were going on until Gulf filed its plan in March. After that time we were invited to participate and have participated.

At the outset, I'd like to pass on to you what Mr. Cresse told me and that is that Gulf is a very good utility company. It's very reliable. Its rates to the industrial consumer are less than the interruptible rates -- firm industrial consumer are less than the interruptible rates in other parts of the state. So why would we be here objecting and looking a gift horse in the mouth so to speak? Well, it's a matter of economics and it's a matter of money and it's a matter of proper regulatory philosophy.

Gulf has given you a plan and the Staff has given you a plan. The Gulf is Attachment A. The Staff's plan is Attachment B. I would like to proffer to you the FIPUG plan as Attachment C. And Gulf's plan is an 11 point plan. Staff has an eight point response with several subparts, and the FIPUG response is a simple six point plan.

First item would be that we would reduce base rates by $7 million a year. Item No. 2, Gulf has proposed that its ROE be 11.6%. Staff says it ought to be 11.2% or lower. I would suggest that the Commission adopt the return on equity that Florida Power & Light and the Public Counsel agreed upon in its recent rate confrontation at 11%.

The third item would be that all revenues that are 100 basis points in excess of the authorized 11.7 -- 11% return be refunded to customers.

The Commission has what it calls the range of reasonableness. You set a rate and you said the proper rate is 12% for this utility, but there's a range of reasonableness and you'll let it go up to 13% before you do anything about it. And the reason this case got started was, Gulf's 1998 revenues were over 13% when you take into consideration some things that were omitted from the Gulf presentation, which I'll go into in a minute.

So the third point is, that between 11 and 12, Gulf keeps the money. When it gets over 12, give it back to the customers. They're the ones that provided it.

Third -- the fourth point -- I combined with my -- oh, yeah. The fourth point is that as to this revenue between 11% and 12%, it would be retained by Gulf but it be retained as a fund entitled contribution and aide of construction against future anticipated storm damage.

Right now, you allow a storm damage reserve of 36 -- up to $36 million. We don't know exactly how that works and that needs some study, but I think if you treated these excess revenues in that fashion people would be properly accounted for.

COMMISSIONER CLARK: Mr. McWhirter, what is the point at which you start counting the revenues as excess? 12%?

MR. McWHIRTER: You talking about regulatory -- repeat the question. You know I'm hard of hearing.

COMMISSIONER CLARK: I guess your view that it should be retained for storm -- revenues be retained for storm damage --

MR. McWHIRTER: Future anticipated storm damage.

COMMISSIONER CLARK: And what revenues was that? Above what percent?

MR. McWHIRTER: That's between 11 and 12.

COMMISSIONER CLARK: So we --

MR. McWHIRTER: Earnings over 11% go to the first -- the first 1% goes to that storm reserve. Over 12%, which is 100 basis points over your authorized return, that would go to the customers.

COMMISSIONER CLARK: So you would eliminate the range of return?

MR. McWHIRTER: Beg your pardon?

COMMISSIONER CLARK: You would eliminate the range of return? You would set it at 11% and anything --

MR. McWHIRTER: Well, the range of return is merely used for surveillance purposes so that you know when something should be done. Revenues are volatile. They follow the weather and they follow other things. And as long as the revenues are within a range, you say, that's okay. And the revenues here are not within your authorized range. So what should you do?

Now, what we're doing here, the Staff and Gulf recommend that we freeze everything in stone for three years and so for the next three years we'll control. I'm suggesting that under a revenue cap procedure like we have, Gulf will be assured of getting its 11%, but over 11% it will get to keep the money and send it on to Southern Company like it does now, and over 12% the customers get some relief.

COMMISSIONER CLARK: Mr. McWhirter, I didn't understand your presentation as saying that. If you're saying the revenues over 11% have to be accredited to the storm reserve, then essentially I think what you're saying is, the top of the range is 11%.

MR. McWHIRTER: That's the authorized return.

COMMISSIONER CLARK: Yes.

MR. McWHIRTER: What do you do with money when it's more than you've authorized it to keep?

COMMISSIONER CLARK: But the point is, you're saying they can keep everything up to 11%. Above 11% -- above 11 to 12, they have to credit it to a specific account.

MR. McWHIRTER: It keeps that money, but that money is tagged.

COMMISSIONER CLARK: Okay.

MR. McWHIRTER: And it keeps the money. It can use it anyway it wants to, but it's tagged. If we have storm damage and they replace that storm damaged equipment, at that point in time the money they use that should have been in this reserve fund will be considered a contribution in aide of construction.

COMMISSIONER CLARK: So their earnings are --

MR. McWHIRTER: Similar to what you do in water and sewer companies. Yes.

COMMISSIONER CLARK: So their earnings -- what they're allowed to keep and have the discretion to do with as they please is 11%?

MR. McWHIRTER: Yes. Yes.

COMMISSIONER CLARK: Okay.

COMMISSIONER DEASON: Mr. McWhirter.

MR. McWHIRTER: Now --

COMMISSIONER DEASON: Mr. McWhirter.

MR. McWHIRTER: Yes, sir. I'm with you. I apologize.

COMMISSIONER DEASON: That's okay. I believe you indicated maybe in your presentation or response to a question that the company was guaranteed 11%?

MR. McWHIRTER: Yes.

COMMISSIONER DEASON: How is it in your proposal the company would be guaranteed 11%?

MR. McWHIRTER: I don't have any problem with giving it the same kind of guarantee that you do with environmental cost and the same kind of guarantee that you do with conservation investments. If it falls below 11%, go ahead and give them the guaranteed revenue. As you know, right now, 38% of all the revenues received by utilities are guaranteed revenues. It's not an opportunity to earn a return. And I won't go into that because you don't have time for it.

COMMISSIONER DEASON: Let me -- I want to clarify what you're proposing. If the company files a report with the Commission indicating that they earned 10% return on equity, then you think the company should be allowed to collect revenue through fuel adjustment or whatever mechanism, enough so that they would earn 11% on equity?

MR. McWHIRTER: I think if -- you need to address it the way you think appropriate to address it. But if we're restricting the company to the 11%, then I don't see any real problem with letting them earn 11%, provided that the investments are prudent and that you actually supervise the investments to ensure that they're --

COMMISSIONER DEASON: What happens -- there is no incentive to do anything to improve operations or be innovative or to be efficient, to cut costs or to try to increase sales because you're saying they're guaranteed 11 no matter what they do, but they're not going to get anything above 11 because if it goes above 11 we're going to take the first million -- I'm sorry -- the first 100 basis points and treat it as storm damage accrual and anything over 12 we're going to refund to customers.

MR. McWHIRTER: One of the benefits of being a monopoly and the only company that can provide service to customers is that you get an authorized return on your investment. That's one -- if you want the franchise and you want to have the monopoly rights, then you submit your operations to this regulatory body and this regulatory body doesn't need to give this kind of incentives that flow in a competitive industry to an industry that has essentially a guaranteed return, and here we're giving them a guaranteed 11% return. If they don't like this proposal, just as if they don't like the Staff's proposal, then they can ask for a hearing and we can deal with it at a hearing and the logic of the circumstances.

But we're in very serious times, as you well realize, far better than I do. And right now you're suggesting that we chisel something in stone for three years. If we're going to chisel it in stone, you need to truly evaluate and enunciate what your policies are with respect to what's going to happen the next three years. And I'm suggesting to you, and I will suggest it a little -- I want to hurry along because I know you have a crowded agenda. But I think this is a very interesting and a very extremely important topic. It's one of your best utilities without a doubt, but you're talking about regulatory philosophy.

The fifth item in our report is that the third floor, way back when, when you had a rate case, there was a determination that the $3.8 million that was spent to put in the third floor was excessive at the time, but sometime in the future it would be okay.

Well, since that time you've been booking a return on that. And that item now is a $3.8 million investment plus the $2.9 million or 47% interest on that initial investment. And I'm suggesting that that, instead of amortizing that investment over a three year period, that you put the $5.7 million in rate base and amortize it over the remaining useful life of that building.

Now, a few years ago the company spent $18.9 million to get better interest rates. They were able to refinance their debt. The company calls that a loss on refinanced debt. But, actually, over the length of the -- I'm sure they wouldn't have done it if they hadn't done a net present value study and concluded that over the term of the loan that

$18.9 million would be more than returned many times.

So the question is, should today's customers pay that in the next three years or so, or should the company amortize that over the remaining life of the indebtedness which you normally do with a mortgage with the Internal Revenue Service require you to do?

And I'm suggesting, as my last point, that this 8.9% spent to get a lower interest rate flow to the people who are going to benefit from the lower interest rate. Right now you're asking the customers to pay for it, but you're not giving the customers any benefit from the lower interest rate. So it doesn't make much sense. Let the people who benefit, pay for it.

Now, one of the problems with the man in the street and me, people that have fourth grade understanding like I do, is when you talk in percentages and mix percentages and dollars, you get kind of confused and you don't know what's going on.

So what I've done for you is I've taken the company's year-end surveillance report that was filed on February 15th, and it's the report that the Staff used to get its analyses. And I've translated the percentages that we're talking about here into dollars and I think -- what I'd like to do in the next three minutes is to analyze for you the dollar impact of the three proposals.

The first proposal is that the current authorized return, when we're doing our analysis, based upon Gulf Power's equity component, is $350 million in round numbers and it's entitled to a 12% return on that. That results in $42 million a year is what you authorized Gulf Power to earn.

Staff, Plan B, agrees with that and FIPUG agrees with that. So we're all in agreement that the current authorized return translated in dollars as though we were looking at a moment in time, December 31, 1998, the authorized return is $42 million.

Gulf says, here's what the return should be. Gulf says the return should be $44 million in cash. Staff says it should be $39 million because it's using a return of 11.2%.

(End of Tape 1, Side B.)

MR. McWHIRTER: What really happened was that instead of earning $42 million according to Gulf it earned $45 million. According to the Staff, Gulf earned $49.5 million plus. So it earned some seven and a half million dollars more than the authorized return. The difference is that in 1998 the Staff gives Gulf credit for $3.5 million going to the insurance reserve and Gulf took $6.5 million. FIPUG agrees with the Staff that the real earnings were $49.5 plus. So Gulf has got this money in its packet. Never recoverable from the customers. Okay.

What should we do about the excess in the future? Gulf says let's take $3.7 million of that $49 million and reduce rates. Staff says, take $7 million of that $49 million -- 49 and a half million dollars, which would bring Gulf back to $42 million, and reduce rates by that amount. FIPUG agrees with the Staff. We think $7 million rate reduction today is an appropriate amount under a settlement proposition. We think the amount is lower than that but what would happen is that would occur after a rate case and if you had a full rate case it would be a year before we would get any relief. So $7 million is appropriate in the short run.

So the next step is, what do we do with the money in excess of the amount that comes about with the new returns allowed? Gulf says it gets to keep the first $44 million, which is $2 million more. Staff says Gulf gets to keep $42.6 million. FIPUG says, Gulf can keep $41.9 million. Now, this is a 12% return on -- strike that. An 11% return on the equity component of the rate base.

Now, here's where we differ substantially with the Staff. Gulf says between $44 million and $51 million, customers will get 40% of the difference. So if it earns up to 14.2%, customers could get as much as $2.8 million more. So, Gulf would be earning $51 million and you would reduce that back to the 3.7 plus the 2.8 and it would get back, you know, somewhere in the mid 40's. Still far above the current authorized return.

What does the Staff say? The Staff says Gulf keeps the difference between $42 million -- $42.6 million and $49.6 million. Gets to keep it all. FIPUG, under its proposal, would say that anything over $40.19 million would go first to the insurance reserve and the balance to customers.

COMMISSIONER JACOBS: That's your 12%, Mr. McWhirter?

MR. McWHIRTER: Beg your pardon?

COMMISSIONER JACOBS: That's your 12%?. That number represents your 12%?

MR. McWHIRTER: Yes. Yes, sir. So that's a very simplistic approach which I've taken for you and put it in terms of dollars rather than mysterious -- not mysterious. But put it in percentage returns and then you have to go back and find some numbers and apply the percentages to them to see what's really happening. I tried to point out for you what's really happening. What makes sense. 11% return makes sense.

I was intrigued by the last handout that Gulf gave you and they justify -- they justify keeping the return high, based on what's going to happen in the bond market.

Now, the high point where it goes way up to 6.8% on the 30 year treasuries, that happens in the year 2001 so this is a projection. If you want to see where we are today, and you're making rates today, not in 2001, it's down here at the very lowest point on their exhibits.

Who is it that makes this projection? Well, it's Regional Financial Associates Inc. They may be a very fine firm. I'm not familiar with Regional Financial Associates Incorporated. But those are the kind of things that you would have if you had a hearing on what the appropriate return on equity would be. People like Regional Financial would come in and show what the projections are.

I'm suggesting to you that you do what is fair. What I propose to you, I think, is fair. If Gulf doesn't think it's fair, then it can come in and ask for a hearing. I think that's essentially the same thing that Staff has done. Staff has made a proposal to you. If Gulf doesn't think it's fair, then you don't implement it. Gulf comes in and asks for a hearing.

But what we've done is we have taken a moment in time in which some action will be taken and the action you take is -- the most important thing to FIPUG is your treatment of regulatory assets. And we think the regulatory asset treatment that has been given by Gulf and Staff is not rational in today's times. This money is extra money the utility gets and there's no evidence that this extra money is doing anything to benefit Florida ratepayers. It's going to flow up to Southern Company and Southern Company can invest it internationally with no protection for Florida ratepayers.

CHAIRMAN GARCIA: Thank you.

COMMISSIONER DEASON: I have one question. Mr. McWhirter, what was your sixth point? Number six? Was it concerning refinancing costs?

MR. McWHIRTER: $18.9 million was spent in order to get a lower interest rate. They call that loss on refinancing. I would suggest to you that 18.9% is an expenditure that was made in order to achieve a lower return over a longer period of time, and probably the net present value of that amount of money is far less than you're asking current ratepayers to pay. So I'm suggesting to you that you don't treat that as a regulatory asset, but that you just use your normal practice of plowing that into the debt component as an additional part of the debt.

COMMISSIONER DEASON: Thank you. Mr. Mailhot, how are we treating that currently?

MR. MAILHOT: How are we treating the loss on reacquired debt?

COMMISSIONER DEASON: Yes. Loss on reacquired debt.

MR. MAILHOT: Under Staff's proposal or --

COMMISSIONER DEASON: How is the company currently accounting for it and then how does Staff address it?

MR. MAILHOT: Okay. I believe the company amortizes it over the remaining life of the retired debt.

COMMISSIONER DEASON: So the company is currently doing what Mr. McWhirter says should be done?

MR. MAILHOT: That's correct.

COMMISSIONER DEASON: Okay. And does Staff address it at all in its proposal?

MR. MAILHOT: Yes. In Staff's proposal, if the company moves into the sharing range, a portion of that sharing would go to write off this loss more quickly.

COMMISSIONER DEASON: But only if the sharing range is reached?

MR. MAILHOT: That's correct.

COMMISSIONER DEASON: Okay. Thank you.

COMMISSIONER CLARK: Mr. McWhirter, you indicated that you thought that ROE should be the same as FP&L. And as I understood, I think what Staff was recommending, there ought to be some recognition of the fact that they carry less equity than FP&L. Do you have any response to that?

MR. McWHIRTER: Staff says that it should be 11.2 or lower. They selected 11.2 because it was a number that would move towards settlement. I don't think there's any magic in that number. They thought it should be lower as I understand their memorandum.

COMMISSIONER CLARK: Well, let me ask you this question. Do you think any adjustments should be made to recognize the fact that they carry lower equity?

MR. McWHIRTER: Yes. I agree that there is some differential in risk. I think the 11% that was chosen for Florida Power & Light was a settlement number that's higher than the current cost of debt. And I think this exhibit, if you cut it off at current times rather than projecting it to the future -- and what you do when you set rates is you look at historical plus a short projection to the future -- you'll see that the cost of debt have gone down, down, down, and it's now 5.5% on 30 year treasury.

COMMISSIONER CLARK: Then your position is that because some time has passed since we made a decision in FP&L -- I don't know how long that is. A month?

MR. McWHIRTER: I don't think you ought to look at FP&L. I think you need to look -- this whole thing --

COMMISSIONER CLARK: Let me ask you a question. You suggested that the ROE be the same as what we set for FP&L. I thought I heard you say that.

MR. McWHIRTER: Yes. That's a settlement number, yes. I'm not suggesting that's the right number, but I suggest to you that if you had a rate case it would be a lower number on current conditions and, therefore, that's a good settlement number. I think Gulf will buy off on it.

COMMISSIONER DEASON: But you referred us to one of Gulf's handouts. I assume you also received the handout entitled Equity Ratio Analysis?

MR. McWHIRTER: Yes.

COMMISSIONER DEASON: And according to this, Gulf is making the argument that their difference in equity ratio should justify a 47 basis point increase above whatever is appropriate for Florida Power & Light. Do you agree or disagree with this?

MR. McWHIRTER: Well, no. I don't.

COMMISSIONER DEASON: Don't agree.

MR. McWHIRTER: Well, the 6.75 is merely -- they subtracted 49% ratio from 55% ratio and then they multiplied it by 7. I don't know if that's some holy mystery number or if that is a number that is calculated based on what they think overall returns should be. Actually, it might be greater if you use 7.4.

But, all this stuff is fiction. The thing that is important to stockholders and investors is what's happening at Southern Company. And Southern Company is where the money comes in from investors. They're paying 8.32% for preferred stock. Well, those people are investors. Maybe there ought to be some kind of revision of that. Maybe they ought to borrow money at 6.6 and pay off the preferred stock if they can. That's imprudent in today's market, I'm pretty sure.

COMMISSIONER DEASON: Mr. Stone, let me ask you, and you may want to refer this to one of your experts. The factor of 7, which is applied to the 6.75 percent differential in equity ratio, how is that factor determined?

MR. STONE: I'll touch on that briefly, but I believe Mr. Scarbrough can elaborate on it. It was calculated -- the first time it was calculated was by Dr. Gene Briggum approximately 12 years ago. And he did it based on an empirical analysis of other utilities and their returns and examined the betas involved. Dr. Vander Wiede, as shown in his affidavit, has updated and done another study -- empirical study and he came up with that quantified difference based on empirical analysis in the marketplace. Not sure if Mr. Scarbrough has anything else he wants to add to that.

MR. SCARBROUGH: Mr. Stone, is exactly right. There was a study done by Dr. Gene Briggum through the Public Utility Research Center, University of Florida, and I understand it was at the request of this Commission. I haven't verified that, but that was 12 years ago. And then Dr. Vander Wiede, in recent testimony has -- has done a new empirical study on the same issue and that whole purpose was, what does the impact of leverage have on the cost of equity.

They both arrived at the same conclusion, that for every 1% increase in the leverage for electric utility, that the cost of equity should be increased by 7 basis points.

COMMISSIONER DEASON: What is Staff's viewpoint on that?

MR. LESTER: We constructed a leverage formula using our models. Same manner that we used -- for the water and wastewater leverage formula. And our conclusion to reach 11.2 midpoint is we basically are looking at the 11% for Florida Power & Light and then adding 20 basis points, which is appropriate given that leverage formula we used. I think Dr. Vander Wiede's 7 point proposal, that's just a conclusion that he reached in his study. I simply disagree. We're doing -- going with our leverage formula.

COMMISSIONER DEASON: So under our leverage formula there's basically about 20 points can be justified -- 20 basis points can be justified for the difference in equity ratio?

MR. LESTER: Yes, sir.

COMMISSIONER DEASON: Between Florida Power & Light and Gulf?

MR. LESTER: Yes, sir.

COMMISSIONER DEASON: Let me ask you this. What equity ratio did you use in your analysis? Was it as reported in financials or was it as adjusted by the PSC for eliminating the nonutility investment 100% from equity?

MR. LESTER: I'm using the 49% which is not adjusted for the nonutility investment.

COMMISSIONER DEASON: And it would be approximately 48% after that adjustment?

MR. LESTER: Yes, sir.

COMMISSIONER DEASON: Okay.

MR. LESTER: I believe it only makes a 4 basis point difference if you go down to the 48.

COMMISSIONER DEASON: In your leverage formula?

MR. LESTER: Yes, sir.

COMMISSIONER DEASON: If you assume the 7 was correct, then it would be -- it would be something greater than that? It would be about 7 basis points or how much would it be?

MR. LESTER: I believe only 3 or 4 basis points higher if you use the 48% equity ratio.

COMMISSIONER DEASON: Yeah, but what I'm saying is -- let me ask Gulf Power. Your analysis that you're using, your equity ratio analysis, I assume you're using your as reported equity ratio since you oppose the adjustment to remove it 100% from equity. So you're 49.8% does not reflect any adjustments to your equity ratio as a result of the nonutility investment?

MR. SCARBROUGH: No. That's the actual ratio.

COMMISSIONER DEASON: All the presentations are concluded; is that correct?

CHAIRMAN GARCIA: I believe so.

COMMISSIONER DEASON: Did Staff want to respond to anything Mr. McWhirter said or --

MR. MAILHOT: Yes. We have just one or two brief comments. In our initial recommendation and proposal that was presented at the March 16th agenda conference, Staff had crafted a plan based primarily on the Commission's prior decision in BellSouth with some modification to recognize what had been done in the Georgia Power case. And when we did that, we crafted what we thought was an appropriate plan at the time.

COMMISSIONER CLARK: Some recognition of what happened in the Georgia Power case.

MR. MAILHOT: Yes.

COMMISSIONER CLARK: Okay.

MR. MAILHOT: In terms of a couple of the components of the plan. So, primarily what was presented at that conference was a combination of the two plans. It was probably 90% Southern Bell and 10% Georgia Power.

And we thought that the plan we presented was reasonable in terms of setting up a three year plan and I think at the time, one of the most critical components of starting a plan is where you set the company's earnings to begin with, and in that recommendation we set the company's earnings at 11.2% return on equity.

COMMISSIONER CLARK: Can I interrupt you a minute?

MR. MAILHOT: Yes.

COMMISSIONER CLARK: Just what exactly -- did I miss it in the Staff's write-up about what part you sort of developed in light of the Georgia Power decision?

MR. MAILHOT: Well, essentially, it was one component of the plan that had to do with productivity factors. In BellSouth's plan, the way the plan worked was the productivity factors were assumed for the next -- each of the next multiple years in the plan. BellSouth was required to reduce rates, for example, in years two and three of the plan regardless of earnings, you know, whether earnings improved or, you know, went down hill. No matter what, they had to reduce rates in the subsequent years of the plan.

In Georgia Power's case, what happened was, the company only had to -- the productivity factor only kicked in if the company's earnings hit a certain level. Okay. And the way that worked was in Georgia Power's plan, if the company earned 12.5% return on equity in years two and three --

COMMISSIONER CLARK: Go slower. Go slower. Say that again.

MR. MAILHOT: Okay. In years two and three of the Georgia Power plan, if the company's earnings got to 12.5% return on equity, the first $50 million above that 12.5% had to go -- was not shared. It essentially went 100% towards writing off regulatory assets.

What that does, essentially, is that the company doesn't start sharing until they actually improve earnings above the sharing point.

COMMISSIONER CLARK: All right. So the assumption being that that would be a productivity factor.

MR. MAILHOT: Essentially that's the way it works. Okay. And that, in a sense, is more conservative because if the company didn't earn 12.5 then they wouldn't have to put anything towards regulatory assets, any additional money. As opposed to like in the BellSouth case --

COMMISSIONER CLARK: Where no earnings is taken out.

MR. MAILHOT: Right. Even if earnings went down they still had to reduce rates.

COMMISSIONER CLARK: Okay.

MR. MAILHOT: So that was kind of one of the features that we incorporated from the Georgia plan.

COMMISSIONER CLARK: And that's -- is that what we incorporated in our plan?

MR. MAILHOT: Yes, we did. It's not specified as a productivity factor, but it's part of the plan. It's part of our plan.

COMMISSIONER CLARK: And that is the reference to -- I'm looking at the chart somebody developed.

MR. MAILHOT: Yes. On Item 5.

COMMISSIONER CLARK: Item 5. That means -- what does that mean?

MR. MAILHOT: Okay. Staff's plan, in our revised proposal, in the current recommendation, there's a productivity factor included where, essentially, if the company earns 12.2% then the first $2 million above that level goes into the storm damage reserve.

COMMISSIONER DEASON: Before any sharing begins?

MR. MAILHOT: Before any sharing begins. But if the company doesn't reach 12.2%, then they don't have to do anything.

Anyway, our revised plan, Staff has moved essentially from targeting earnings at 11.2% return on equity, which we thought was appropriate, you know, based on the Commission's prior decisions, to targeting earnings at 11.8%. Now, this is 60 basis points above where we think earnings should be targeted. And you can ascribe that 60 basis points, you know, to a number of reasons. I mean, you can say it's for compromise. You can say it's for, you know, the company's -- you know, all the reasons the company's pointed out they should be rewarded. I mean, for whatever reason, you know, we are setting or targeting earnings above what we think, you know, would actually be appropriate in our proposal.

The only other thing I'd like to say is, you know, you already brought up is, the productivity factor. In the plans that have been approved in the past productivity factor is an integral part of the plan. And the company hasn't proposed anything in that area. They don't even mention it as, you know, any kind of a difference between Staff and the company. We think it's important to include a productivity factor in any plan.

One other thing the company mentioned is the treatment of nonutility and the third floor. The company's indicated that those two things, you know, that we're just revisiting both of them and that there is no difference between them.

Staff would say that, you know, since the last rate case the treatment of the third floor was determined I think at that time to be essentially nonused and useful. Staff this year reviewed the use of the third floor. Sent an auditor over there to physically inspect the third floor. And although it may be questionable as to whether it's 100% used and useful at this point in time, Staff believes that it is being used in large part, and so we think that there is a change in circumstances since the time of the last rate case involving the third floor.

So, we see that item as being significantly different than the treatment of the nonutility. There -- I don't think we believe there is any real change in circumstances since the last rate case. And I think that's all. Do you have anything else?

MR. LESTER: If I could just respond briefly to the ROE concerns. The company raised the concern of business risk and in the last utility credit report that Standard Reports issued for Gulf, which would be in November of '97, they said that Gulf Power's heavy concentration on the residential class mitigates concerns regarding the company's dependence on military and cyclical demand. Also regarding --

COMMISSIONER CLARK: I'm sorry. Would you read that again and who is it from?

MR. LESTER: This is from Standard Reports from the utility credit report. The sentence is, "Gulf Power's heavy concentration on the residential class mitigates concerns regarding the company's dependence on military and cyclical industry related demand." It goes on to say, "the presence of the contracts with military customers, as well as projected growth in the military employment and load through the year 2001, also offsets those concerns."

You can go through these reports and pick out, you know, anything you want to favor sometimes. But I think what it's trying to say is that the company has enough of a residential base to offset any concerns regarding, you know, Gulf's having the military base as its customers.

COMMISSIONER CLARK: Do we know what portion of their revenues come from the military base or --

MR. LESTER: I believe it's about 15% from military and industrial.

COMMISSIONER CLARK: And what -- what additional residential percentages is somewhat dependent on the 15%?

MR. LESTER: It would be somewhat interrelated, yes. But they're also forecasting a growth in military employment, in a sense.

MR. STONE: Commissioner Clark, with regard to the reliance on the industry and military, at Page 22 of our filing on March 2nd, there is some discussion of that. And it talks in some detail about the numbers. It may not be precisely the number that you were looking for as an answer, but it does give some numbers about percentage of our sales. It's interesting to note that Gulf's reliance is far different than the other utilities in Florida on the military and on industrial sales. And that was the difference we were trying to point out with regard to the differences in relative business risk.

COMMISSIONER DEASON: Mr. Stone, though, you have no nuclear generation, correct?

MR. STONE: This is true.

COMMISSIONER DEASON: Let me ask Staff a question, and here once again, I'm referring to the side-by-side comparison which Staff prepared. And it's Item 3 which looks at the means of getting the earnings down to a targeted level. And, of course, Staff's target is 11.8 and the company's target is 12.2. So I realize there is a difference there.

But Staff's is recommending that regulatory assets be written off at $2.26 million a year. And that includes, according to the information that I have, the inclusion of the third floor and rate base and the depreciation and amortization of that. Also, accelerated recovery of the regulatory asset associated with that, and FAS 109 cost, for a total of $2.26 million, is that correct?

MR. MAILHOT: Yes.

COMMISSIONER DEASON: Okay. The -- describe for me the FAS 109 cost and why that needs to be included in a rapid recovery?

MR. MAILHOT: What that is, is essentially before -- I'm not a tax expert. But before we went to full normalization, certain tax items were flowed through to the benefit of the customers and when we went to full normalization, those flow through of prior benefits now must be collected from current customers, so it's essentially -- this is one of those cases where prior customers benefitted years ago and the way it's being recovered currently is, over the remaining life of property, and it has anywhere from probably a 10 to 15 years future recovery period.

This item in particular, the Commission approved for accelerated recovery for FP&L. As an item -- essentially it's a past cost that's currently being collected from ratepayers.

So we think it's appropriate since there is no -- since it's a past cost it should be recovered as quick as possible.

COMMISSIONER DEASON: Do these amounts appear as a debit balance, deferred taxes?

MR. MAILHOT: The regulatory asset does.

COMMISSIONER DEASON: Yes. So by writing these off, you remove that which, in essence, has the net effect of reducing the company's rate base in the long run?

MR. MAILHOT: Right.

COMMISSIONER DEASON: Okay. Now, describe to me why you've chosen to accelerate the recovery of the regulatory asset associated with the third floor up front and delay recovery of the loss on reacquired debt until there are earnings available to do that? You had to draw the line somewhere?

MR. MAILHOT: Yes. And these were small items that, you know, seem to have a long life. I mean, if you were to use the remaining life of the third floor it would be spread out over probably 25 years as the remaining life. The same thing with the tax item. It has, you know, a 10 to 15 year remaining life and it's, you know, like I said, that's definitely a past cost.

So, I mean, these are small items that, you know, we thought were appropriate to deal with as quick as possible.

COMMISSIONER DEASON: How much is the loss on reacquired debt? I think Mr. McWhirter quoted $18.9 million?

MR. MAILHOT: It's approximately that at the end of last year.

COMMISSIONER DEASON: And right now that's being recovered over the life of the debt issued?

MR. MAILHOT: I believe it's the life of the old debt, the debt retire.

COMMISSIONER DEASON: The debt that was retired?

MR. MAILHOT: Yes.

COMMISSIONER DEASON: And how many years is that doing that?

MR. MAILHOT: I would say on average that's probably in the neighborhood of 12 to 15 years.

COMMISSIONER JACOBS: Going to the question Mr. McWhirter raised on the ceiling, we have historically had a 13 as a ceiling for them, right? And the proposal here is that that be 14.2; is that correct?

MR. MAILHOT: Yes.

COMMISSIONER JACOBS: With the caveat of the sharing after 12.2?

MR. MAILHOT: Right. That's correct.

COMMISSIONER JACOBS: And essentially what we do when we give them the target of 11.8 is we give them kind of a jump start on that, don't we? We kind of say, you know, you're earnings are going to be able to start off at a point larger than we think the midpoint is, is that correct?

MR. MAILHOT: That's correct. That's about 60 basis points above where we think rates should be targeted.

COMMISSIONER JACOBS: Okay.

MR. MAILHOT: Or at least in our previous recommendation.

COMMISSIONER JACOBS: Now, there was some statistics cited here which would indicate that -- I think the number that was 11 -- I think the point was going to the midpoint. I may be mistaken, but I think that there was some data which was presented and I'm trying to -- the chart. That's what it was. Which would indicate that companies were having midpoints -- I'm sorry. It was in the file. That's what it was. It was at Page 23. 23 of the filing. What's your response to this data in comparison to what your recommendations are?

MR. LESTER: I think I just disagree. I looked at my chart, which would be on Page 11, I believe.

COMMISSIONER JACOBS: Right.

MR. LESTER: And, I mean, we've assembled the returns using a reporting service and then we've added the top two based on news reports. Those are the reports that we're finding in terms of around the country. I'm not sure of their source of data. Now we, obviously, conflict.

COMMISSIONER JACOBS: Okay.

COMMISSIONER CLARK: I just want to be clear. On your chart, which shows your revised plan and Gulf's revised plan, with respect to, you set the rates at 11.8%, would that be correct? Or do the rates get left where they are?

MR. MAILHOT: In Staff's plan, earnings get targeted at 11.8%.

COMMISSIONER CLARK: Okay. So the rates stay where they are?

MR. MAILHOT: It's partly through just a credit on the bill and partly through write-offs.

COMMISSIONER CLARK: Okay. And as I understand it, under 3(A) and (B), those things get done regardless of where the earnings are?

MR. MAILHOT: In Staff's plan?

COMMISSIONER CLARK: Yes.

MR. MAILHOT: Yes.

COMMISSIONER CLARK: And the same is true for Gulf, except when you get down to the year 2001. Then it has an earnings test.

MR. MAILHOT: Right.

COMMISSIONER CLARK: Okay.

COMMISSIONER DEASON: Commissioners, I think that we've got to answer a basic question. And that is, do we want to try to come out with a proposal. We've got Staff's proposal. We've got the company's proposal. We've got Mr. McWhirter's proposal. They're all different. Some things are alike. Some things are different.

I guess the question is, do we want to come out with our own proposal, in effect. Issue that as PAA and basically test the waters with it and see if anybody wants to protest it. Obviously, if it's protested, it goes away. And, I assume at that point then, we could either litigate that PAA or simply just decide to go to a rate case. That would be our options, Mr. Elias?

MR. ELIAS: Yes.

COMMISSIONER DEASON: Okay. I'm of the opinion that we should try our own proposal, issue it as a PAA and see what the reaction is. It may be protested, and that's fine if it is. It may be that nobody is happy with it but everybody can live with it and say, we can go forward from this. And that's what I'd like to attempt to do.

And it seems to me that if we're willing to do that, one of the -- the key factors we've got to decide before we decide any of the other particulars -- and there are a number of things that we need to address. But the key factor we need to decide up front is the targeted rate of return we're going to use. We need to set a floor and a midpoint. We also need to set a target earnings level to currently set at this time.

And also if we think that there should be some type of sharing, which I think there is, I think it provides the correct incentives, what that sharing point is going to be. And I think that we've got to agree on that before we even get to all of the particulars because if we can't agree on that, there is no need even talking about all of the particulars.

So, just for trying to throw something out and see if we can reach any type of consensus on this, I'd be willing to suggest, and open it up to discussion, but my suggestion would be that we would establish a floor of 10.5%, a midpoint of 11.5%. We would target our rates or to set earnings at 12.0%. We would initiate sharing at 12.5%. And that sharing would cease at 14% at which time any earnings in excess of that would be determined by the Commission in the future, but it would be utilized by the

Commission either as refunds or as write-off of regulatory assets. But we could -- if we find ourselves in that position, which I think would be a fortunate position to find ourselves in, we can deal with that at that time.

COMMISSIONER CLARK: Second.

CHAIRMAN GARCIA: If there is no discussion, we have a motion and a second. All those in favor signify by saying aye.

COMMISSIONER JACOBS: The midpoint again was?

CHAIRMAN GARCIA: Midpoint was --

COMMISSIONER DEASON: Midpoint was 11.5 but we would target earnings. I want to make it clear. We would target earnings at 12% which is above the midpoint. It's halfway between the midpoint and the high end. And the reason that I'm suggesting that is, first of all, as Staff has indicated and I think some of the parties, we're here in an attempt to reach an agreement. And there's a little bit of negotiating factors involved. And while we don't negotiate, our Staff does and Mr. McWhirter is involved in those things.

I think that, given the performance of this company, the fact that their rates are low, customer satisfaction is high, customer complaints are low, reliability is high, that -- and that this would, if it is issued and it is not protested, it would negate the need for a rate proceeding, which means that we would capture the benefits of this proposal retroactive to the beginning of the year. If we go to a rate proceeding, we're looking at least eight months or longer from now before we capture any benefits.

So there's kind of a sharing so to speak of the benefits. We also avoid a rate proceeding and the rate case expense associated with that. I think this company's rate case expense the last time they filed a rate case was somewhere in the neighborhood of $1 million. So, it's just kind of a massage factor to recognize all of those things.

COMMISSIONER JACOBS: Can I ask a question real quickly? Basically to Staff. First of all, let me say this. I agree in concept of where you're going. I think there is an indication that this company has operated effectively. My concern is that we're essentially giving them a productivity incentive that is not real quantified, not very well quantified.

And my thought is, and the question I have for Staff is, how does this relate to the idea of giving them -- versus the 11.2, giving them the 11.5?

How -- is there any correlation to that, to whether or not there is a productivity factor or not? Are they different concepts or do they play into one another or not?

MR. LESTER: The idea of a productivity factor is really separate from, you know, where you set rates or what your authorized ROE is. They're somewhat related, but they're separate too.

COMMISSIONER JACOBS: Okay. So, there is no -- we wouldn't do anything if we were to do one versus the other? They're totally different -- different atmospheres. And the reason I'm thinking that is at least there you have something that you can begin to say, we're giving this company this addition because we -- of this factor. That's the only thing I'm searching for.

COMMISSIONER CLARK: I think, if understood the motion from, and the explanation from Commissioner Deason is, we're recognizing some -- the positives things of that company; low rates, low customer complaints. And, in my view, recognizing the relatively lower amount of equity. What was the third thing?

COMMISSIONER DEASON: Low customer complaints, high reliability and low rates.

COMMISSIONER CLARK: That was it. High reliability.

COMMISSIONER DEASON: Lower equity ratio.

COMMISSIONER CLARK: I think those factors indicate setting the midpoint at a higher level. And I would point out that we have been quick to penalize this company when they don't live up to those productivity issues.

COMMISSIONER DEASON: Let me also indicate that if we were in a rate proceeding and if by just some chance we were to determine that 11.5 is the correct amount, we would set rates at 11.5, but we also would put a whole -- 100 basis points on the upper end of that and we would allow the company to earn up to 12.5 and would not say anything to the contrary. We'd say those are still reasonable earnings.

Under this proposal, we would be setting rates at 12.0 and allowing the company to earn up to 12.5, which is only a half a percentage point or 50 basis points. Whereas, when we normally set rates, if we were in a rate proceeding, it would be 100 basis points on that end. So, here again, it's kind of --

COMMISSIONER CLARK: You mean where sharing begins.

COMMISSIONER DEASON: Yes. Sharing begins at 12.5. They can still have bottom line earnings above 12.5 because there is a sharing percentage which we will address later on. But I would also point out that that only begins if there are efficiencies or enhanced revenues or reduced costs or something happens and there are going to be additional benefits for customers too, and that that's what incentives are all about is to provide an incentive to management, hopefully customers are made better off by those incentives.

COMMISSIONER JACOBS: And that's exactly the point. I was pursuaded by Mr. McWhirter's point that if there are going to be efficiencies gained then they ought to flow through. I don't want to belabor it, if that's not a way of doing this. I agree in concept with the idea that there are things here that the company can be regarded on. I'm searching for a way to make that a bit more quantified. But if we can't do that then I'm --

CHAIRMAN GARCIA: All right. We have a motion and a second.

COMMISSIONER CLARK: Well, let me -- you made a motion on the ROE and that's not really a motion on any of the issues, so do we need to wait or are you moving that --

COMMISSIONER DEASON: You know, we may want to look at this as a package. If we can all kind of agree that at least that's a framework that we can look at. Because to me that's the key, is to determine an ROE before you start looking at any particulars. And I'm willing to do it either way.

COMMISSIONER CLARK: Well, I guess I'm willing to second a motion that uses those parameters with respect to the ROE and sharing and then moving Staff's recommendations on the write-off of the assets, the credits to the customers, with the understanding that it gets adjusted by the new sharing points.

COMMISSIONER DEASON: Okay. So are you moving now to Item 3 on the side-by-side comparison?

COMMISSIONER CLARK: I guess what I'm suggesting is -- yeah, I guess I am moving to Item 3.

COMMISSIONER JACOBS: And the number that we're going to set them at is what again?

COMMISSIONER CLARK: I'm okay with Staff's recommendations with respect to 3, 4, 5 and 6, but with the new proposals on the ROE.

MR. MAILHOT: We need a little bit of clarification because --

COMMISSIONER DEASON: The numbers are going to change because you get a new target point.

COMMISSIONER CLARK: Yes. The actual figures will change as a result of the different ROEs.

COMMISSIONER DEASON: And I guess that was going to be my next question as to, if we target earnings at 12% as opposed to the Staff's recommended 11.8, obviously, you cannot do everything Staff is recommending in Items 3(A) and 3(B). There's got to be something that's got to be reduced to make up that 20 basis points differential.

And I guess my question to Staff is, is there still adequate earnings available to achieve the $2.26 million and the $3.5 million first year accrual to storm damage reserve, which is your Part A? Is there sufficient earnings to do that before we look at credit on the bills?

MR. MAILHOT: Yes. The difference, if I understand your proposal, is to target earnings at 12%?

COMMISSIONER DEASON: Correct.

MR. MAILHOT: Okay. This analysis here is based on targeting earnings at 11.8%. The dollar difference between those two is $1.2 million.

COMMISSIONER DEASON: $1.2 million per year.

MR. MAILHOT: Per year. So, for example, I mean on this schedule, if you wanted to --

COMMISSIONER DEASON: So the $7 million, in essence, would become what, $5.8 million as opposed to 7?

MR. MAILHOT: That's correct.

COMMISSIONER DEASON: And under your rational then that the first year accrual to the storm damage would be half of the 5.8 which would --

MR. MAILHOT: You could do it that way. That's a way to do it.

COMMISSIONER CLARK: Wait a minute. I'm misunderstanding. I thought there was also going to be a credit on the customer's bill and what I understand is in 1999 the credit would -- recognizing the fact that it's $1.2 million less, it would be -- is it $2.3 million?

COMMISSIONER DEASON: What happens there -- what Staff has done is they've done their regulatory asset write-off of $2.26 million. Then they've taken what is left over and put that as customer credits. But they recognize that the 1999 customer credit will only be for a half of a year. So they've taken the other half of the year and recommended that it be recognized as an accrual to the property insurance reserve.

COMMISSIONER CLARK: Okay.

COMMISSIONER DEASON: And if you reduce the $7 million per year by $1.2 million you're down to 5.8.

(End of Tape 2, Side A.)

(Beginning Tape 2, Side B.)

MR. MAILHOT: That would be consistent with the current recommendation.

COMMISSIONER JACOBS: Do we -- is it possible to keep that customer credit close to the existing number? I'm thinking rather than having the credit, you'd keep that at three maybe and then do the other to the --

COMMISSIONER DEASON: Well, to achieve that you would have to basically reduce your $2.26 million write-off of regulatory assets, and that basically consists of three things, which is the inclusion of the third floor and rate base and the associated depreciation and amortization of that; the accelerated amortization of the regulatory asset associated with the third floor; and the FAS 109 write-off.

CHAIRMAN GARCIA: With the motion, where is that credit now under your motion?

COMMISSIONER DEASON: Under my motion the credit would be $5.8 million a year. Well, I guess I haven't really made a motion. I'm trying to clarify. But following Staff's rational, if you make the assumption you still want $2.26 million a year in regulatory asset write-offs, then the only other alternative would be to reduce the customer credit from $7 million to $5.8 million.

MR. MAILHOT: That's correct for 2000 and 2001. Staff's assumption here is that the credit is a monthly credit. But I mean, you could make it a once a year credit which was the company's proposal. I mean, in the sense of, I think they were planning on crediting the customer's bill all in one month of the year and if you do it that way, then you can just pick a dollar amount for 1999.

COMMISSIONER DEASON: But then you forego any accrual to the property insurance reserve.

MR. MAILHOT: Yes. That's the trade-off in 1999, would be between the property insurance reserve and the credit.

COMMISSIONER DEASON: And I think it's important -- I know the company is proposing $1 million a year for three years or a total of $3 million up-front increase in the property insurance reserve. Our Staff's recommending $3.5 million but, of course, that was with an 11.8% targeted earnings level.

I would hate to forego -- I think that that's something that we need to do up front so -- you know, if we want to modify this some, I guess, we can tinker with it, but I think it's important to have an accrual somewhere in the neighborhood of $3 million over this period of time to the property insurance reserve.

CHAIRMAN GARCIA: Okay.

COMMISSIONER DEASON: So if we need a motion, -- I would move that we adopt Staff's recommendation for Item 3 in a side-by-side comparison except that the credits be reduced from $7 million to $5.8 million and that 1999 would be half of that as a customer credit and the other half of the $5.8 million would be booked into the property insurance reserve.

CHAIRMAN GARCIA: Right. And then you -- with the midpoint and the ROE that you -- with everything else that you stated.

COMMISSIONER DEASON: Right. That's correct.

CHAIRMAN GARCIA: So we understand the motion. Susan got a call from the Governor. He agrees also. So we've got a motion and a second. All those in favor signify by saying aye. Aye.

COMMISSIONER DEASON: Aye.

COMMISSIONER JOHNSON: Aye.

COMMISSIONER JACOBS: Aye.

COMMISSIONER CLARK: I apologize.

COMMISSIONER DEASON: We also need to address --

COMMISSIONER CLARK: What did we decide just now?

COMMISSIONER DEASON: You voted for it. You don't know?

CHAIRMAN GARCIA: You seconded it.

COMMISSIONER CLARK: I did not say aye, actually. Or if I side yes, I would be answering --

CHAIRMAN GARCIA: No. It was exactly what you had stated to tie in the Staff's proposal with Commissioner Deason's numbers.

COMMISSIONER CLARK: Okay. I just -- I think that's the correct thing to do. I just wanted to ask, where are we on the storm damage amount? Do we have in mind a figure that we think is appropriate to accrue to and how close are we?

MR. MAILHOT: Well, as far as I know, in the actual reserve, I think there is between $1 million and $2 million.

COMMISSIONER CLARK: That's all that's there?

MR. MAILHOT: Yes, as of the end of last year.

COMMISSIONER DEASON: And we've targeted somewhere in the neighborhood of $25 million to even perhaps $30 million --

COMMISSIONER CLARK: Okay.

MR. MAILHOT: It's kind of controversial what the target is, but it's pretty large.

COMMISSIONER CLARK: Okay.

CHAIRMAN GARCIA: Okay. You wanted to make a second motion.

COMMISSIONER DEASON: Well, we need to address the sharing percentages. There are some differences between our Staff and Mr. McWhirter and the company.

I would simply suggest that we would just do it one-third, one-third, one-third, with the shareholders receiving one-third of any sharing, regulatory assets receive one-third, and then credits to customers would receive one-third. But -- and I'm open to negotiation.

COMMISSIONER CLARK: Well, I guess the only thing that concerns me there is I think we need to get the storm damage --

COMMISSIONER DEASON: Well, we're going to address that in the productivity factor to some extent, I think. Maybe we need to do those jointly because Staff's productivity factor takes $2 million a year up front before sharing begins, in essence, and puts that into storm damage. I keep calling it storm damage reserve. I think it's property insurance reserve is the correct terminology, but we know what we're talking about.

COMMISSIONER CLARK: Okay. So what you're saying is that that is not included in the regulatory assets?

COMMISSIONER DEASON: Well, for the years 2000 and 2001, that's correct. It's not part of regulatory assets. Well, it is too. Once we get sharing, Staff has identified the deficiency in the property insurance reserve as something that needs to be addressed with the sharing percentage that we determine when earnings exceed the 12.5%.

COMMISSIONER CLARK: Let me state it back to you. As I understand it, once we hit the sharing, an automatic $2 million goes to the storm damage?

MR. MAILHOT: Right.

COMMISSIONER CLARK: And after that you would go to the sharing of one-third, one-third, one-third.

COMMISSIONER DEASON: Well, Staff has identified a number of items that they think need to be addressed when we reach sharing. One of those is storm damage and another thing is the loss on reacquired debt, correct?

MR. MAILHOT: Yes.

COMMISSIONER DEASON: But you've got certain thresholds in there and you identify what triggers what and I don't really have a problem with what you're recommending, but we should remember though that Staff's recommendation on Item 5, the productivity factor, if we reach sharing, $2 million per year would go into the storm damage reserve before you get your one-third, one-third, one-third or 40, 30, 30, whatever you come up with.

COMMISSIONER CLARK: I guess I'm still not understanding it.

COMMISSIONER DEASON: Okay.

COMMISSIONER CLARK: The sharing -- when does the sharing start? When you hit --

COMMISSIONER DEASON: For 1999, it would -- sharing would begin at 12.5%.

COMMISSIONER CLARK: All right. What about

2000 and 2001?

MR. MAILHOT: In 2000 and 2001, when earnings get to 12.5%, the next $2 million of earnings --

COMMISSIONER CLARK: Okay.

MR. MAILHOT: -- goes to the storm damage reserve.

COMMISSIONER CLARK: All right.

MR. MAILHOT: As the productivity factor.

COMMISSIONER CLARK: And they the sharing begins?

MR. MAILHOT: Right.

COMMISSIONER CLARK: Then after that point it's one-third -- you're proposal is one-third, one-third -- okay.

COMMISSIONER DEASON: My proposal is one-third, one-third, one-third. But here again, that's --

COMMISSIONER CLARK: Regulatory assets back to customers and 33 to the company.

MR. MAILHOT: Correct.

COMMISSIONER CLARK: Okay. I'm okay with that.

CHAIRMAN GARCIA: That's a second.

COMMISSIONER CLARK: Yep.

CHAIRMAN GARCIA: We have a second. All those in favor signify by saying aye. Aye.

COMMISSIONER DEASON: Aye.

COMMISSIONER CLARK: Aye.

COMMISSIONER JOHNSON: Aye.

COMMISSIONER JACOBS: Aye.

CHAIRMAN GARCIA: Very good.

COMMISSIONER DEASON: I would move Staff on Item 5, productivity factor.

COMMISSIONER CLARK: Second.

CHAIRMAN GARCIA: There being no objection, show that approved.

COMMISSIONER DEASON: I would move Staff on Item 6.

COMMISSIONER CLARK: Second.

CHAIRMAN GARCIA: There being no objection, show that approved.

COMMISSIONER CLARK: So that for -- we would move Staff on Issue 1.

MR. MAILHOT: Okay.

COMMISSIONER DEASON: We would be denying Gulf's proposal.

COMMISSIONER CLARK: With respect to 2, we would move Staff as modified by those individual votes?

COMMISSIONER DEASON: Yes.

CHAIRMAN GARCIA: Correct. Do you want to show that like that, Mr. Elias, then? Show it moved and seconded --

MR. ELIAS: As modified.

CHAIRMAN GARCIA: No objection as modified.

COMMISSIONER JACOBS: Did it say what the floor was? Do we need to?

MR. ELIAS: There are other issues in this recommendation that need to be --

CHAIRMAN GARCIA: Okay.

COMMISSIONER CLARK: All right. And Issue 3 and 4 are now moot.

CHAIRMAN GARCIA: Right.

COMMISSIONER DEASON: Until we determine if there is a protest or not.

COMMISSIONER CLARK: Right. Issues 3, 4 and 5 actually.

COMMISSIONER DEASON: No, I think Issue 5 is an independent issue, I believe. At least my discussions with Staff they've indicated that's their belief.

COMMISSIONER CLARK: Okay. So we move Staff on --

COMMISSIONER DEASON: Move Staff on 5.

CHAIRMAN GARCIA: Is there a second?

COMMISSIONER DEASON: Well, Mr. Jenkins have something to say about that?

MR. JENKINS: Yes. I was sort of hoping that the outcome of this negotiation would be to resolve that docket with some of the agreements or some of the sharing. I can't give you the number because it's confidential, but it's not a large number.

COMMISSIONER DEASON: What is Gulf's position on Issue 5, the initiation of a review of the contract service arrangement?

MR. STONE: Commissioner, we are prepared to help the Commission in its review. We are confident we'll be able to justify that the actions taken in those contracts were prudent and within the concept approved by the Commission for our pilot program. We believe you will agree with that. We believe there will be no money subject to refund.

CHAIRMAN GARCIA: So let's keep it on that track, then.

COMMISSIONER DEASON: You're agreeing it should be done independent of whatever we do here?

MR. STONE: If that's the pleasure of the Commission, we're prepared to help with that.

CHAIRMAN GARCIA: Very good. We had a motion. I believe Susan moved it and Commissioner Deason seconded it. There being no objection, show Item 5 approved -- Issue 5 approved.

COMMISSIONER CLARK: I move Staff on Issue 6 and 7.

CHAIRMAN GARCIA: Issue 6 and 7.

COMMISSIONER DEASON: Second.

CHAIRMAN GARCIA: Second. There being no objection, show those approved. Very good.

COMMISSIONER DEASON: Just ask the parties to look at the PAA order and I know nobody is going to be happy with that, but just weigh that against going to a rate case.

CHAIRMAN GARCIA: I want to thank the company and Staff for working through this as well as Mr. McWhirter. Thank you.

(Thereupon, the proceedings on Item 10 were concluded)

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STATE OF FLORIDA)
: CERTIFICATE OF REPORTER
COUNTY OF LEON)

I, KIMBERLY K. BERENS, CSR, RPR, Official Commission Reporter,

Do hereby certify that I stenographically transcribed the said proceedings from tape recordings delivered to me by Commission Staff.

DATED this 22nd day of April, 1999.

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