



August 3, 1999

Ms. Blanca S. Bayo, Director
Division of Records and Reporting
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee FL 32399-0870

Dear Ms. Bayo:

RE: Docket Nos. 990250-EI and 990244-EI

Enclosed is an original and fifteen copies of Gulf Power Company's Response to Coalition's Petition on Proposed Agency Action to be filed in the above dockets.

Also enclosed is a 3.5 inch double sided, high density diskette containing the Response in WordPerfect for Windows 8 format as prepared on a Windows NT based computer.

Sincerely,

Susan D. Ritenour

<u>AFA</u>	<i>Revell</i>	Susan D. Ritenour
APP	_____	Assistant Secretary and Assistant Treasurer
CAF	_____	
CMU	_____	
CTR	_____	W
EAG	<u>3</u>	
LEG	<u>3</u>	Enclosures
MAS	<u>5</u>	
OPC	_____	
RRR	_____	CC: Beggs and Lane
SEC	<u>I</u>	Jeffrey A. Stone, Esquire
WAW	_____	
OTH	<i>T. Erdt</i>	

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Investigation into the earnings and)
 authorized return on equity of Gulf Power) Docket No. 990250-EI
 Company.)
 _____)

In re: Petition of Gulf Power Company for)
 approval of proposed plan for an incentive) Docket No. 990244-EI
 revenue sharing mechanism that addresses)
 certain regulatory issues including a reduction) Date filed: August 4, 1999
 to the Company's authorized return on equity.)
 _____)

GULF POWER COMPANY'S RESPONSE TO
COALITION'S PETITION ON PROPOSED AGENCY ACTION

Gulf Power Company ("Gulf Power", "Gulf", or "the Company"), by and through its undersigned counsel, hereby responds to the Petition on Proposed Agency Action filed on June 14, 1999 by the Coalition for Equitable Rates ("Coalition"), stating:

1. Gulf Power is without knowledge as to the membership of the Coalition and therefore cannot determine whether Coalition has sufficient authority or legally sufficient interest to petition for formal administrative proceedings to review Order No. PSC-99-1047-PAA-EI. Gulf Power does not have sufficient information about the Coalition or its membership to determine that any of Coalition's members pay Gulf Power for power at rates approved by the Florida Public Service Commission ("Commission") or that any of Gulf Power's ratepayers are actually represented by any of the members of Coalition. The Commission should address the allegations of paragraph 1 of Coalition's petition as an issue at hearing.

- 2. Gulf Power admits the allegations in paragraph 2 of Coalition's petition.
- 3. Gulf Power admits the allegations in paragraph 3 of Coalition's petition.
- 4. Gulf Power admits the allegations in paragraph 4 of Coalition's petition.

5. Gulf Power denies that its return on equity reached levels consistently at or near the top of its authorized range but admits the remaining allegations in paragraph 5 of Coalition's petition.

6. Gulf Power admits the allegations in paragraph 6 of Coalition's petition.

7. Gulf Power admits the allegations in paragraph 7 of Coalition's petition but states that the PSC Commissioners deferred the matter to allow all interested parties to meet in an effort to reach an acceptable settlement. Coalition was represented at the subsequent meetings between PSC Staff and Gulf.

8. Gulf Power denies the allegations in paragraph 8 of Coalition's petition. At the March 16, 1999 agenda conference, the matter was deferred to allow Staff, the Company and any other interested persons to continue to try to resolve the issues through negotiation. Gulf eventually modified its proposal in Docket No. 990244-EI by a filing on April 7, 1999 and the matter came back before the Commission at the April 20, 1999 agenda conference. Staff did not agree with Gulf's revised proposal and presented their own alternative in a written recommendation to the Commission.

9. Gulf Power denies the allegations in paragraph 9 of Coalition's petition. Order No. PSC-99-1047-PAA-EI was issued by the Commission after it rejected both Gulf's revised proposal and Staff's recommended alternative. The regulatory incentive plan contained in that Order was developed by the Commissioners themselves as a proposed agency action.

10. Gulf Power admits the allegations in paragraph 10 of Coalition's petition.

11. Gulf Power is without knowledge as to how Coalition received news of the Order under challenge but admits the remaining allegations in paragraph 11 of Coalition's petition.

12. Gulf Power admits that the Coalition's Petition on Proposed Agency Action was filed in a timely manner as required under Order No. PSC-99-1047-PAA-EI but denies the remaining allegations in paragraph 12 of Coalition's petition and requests the Commission to require Coalition to prove same at hearing.

13. Gulf Power is without knowledge and therefore denies the allegations in paragraph 13 of Coalition's petition and requests the Commission to require Coalition to prove same at hearing.

14. Gulf Power is without knowledge and therefore denies the allegations in paragraph 14 of Coalition's petition indicating that Coalition's members object to the Order under challenge and requests the Commission to require Coalition to prove same at hearing.

15. Gulf Power denies the allegations in paragraph 15 of Coalition's petition. Based on Gulf's projected earnings for 1999 using actual year to date data through June 1999 and projected data for the remainder of the year, Gulf's earnings would not exceed the top of a reasonable range for authorized return on equity. As a result, Gulf's rates would not be subject to reduction and thus the Order under challenge would not have the effect of a rate increase to Gulf's ratepayers. To the contrary, based on actual experience for 1999, the rate credits and other adjustments for 1999 contained in the Order under challenge, if implemented, could cause the Company's actual jurisdictional earnings for 1999 to fall below the ROE level at which Gulf's earnings were targeted by the Commission's calculation of credits to customers and other adjustments as part of the regulatory incentive plan set forth in Order No. PSC-99-1047-PAA-EI. Use of a proper ROE level based on current conditions for targeting earnings would not likely result in a decrease in Gulf's rates and may instead suggest that rates should in fact be increased.

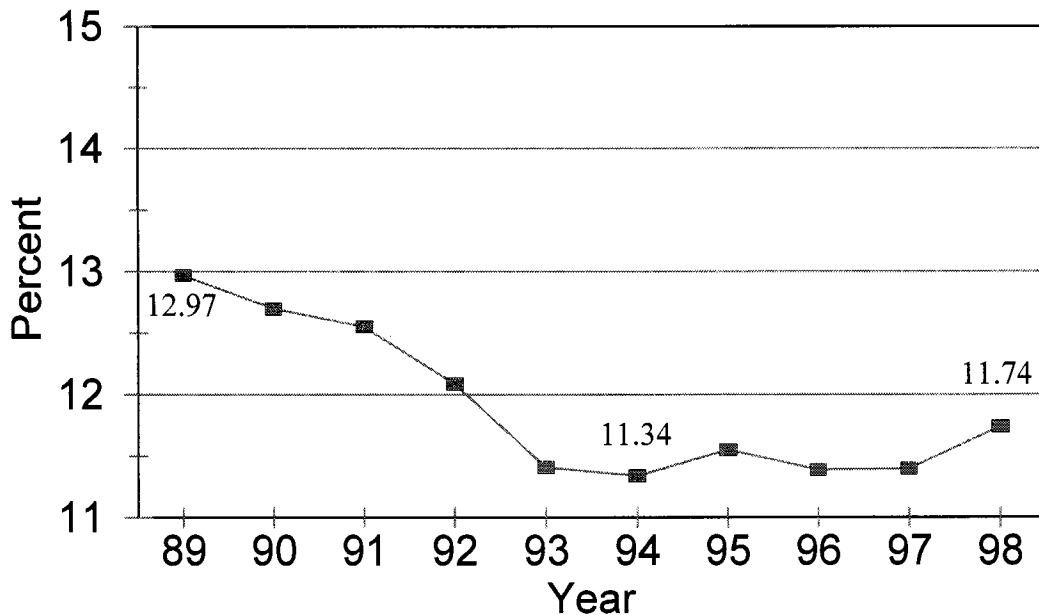
16. Gulf Power denies the allegations in paragraph 16 of Coalition's petition and requests the Commission to require Coalition to prove same at hearing.

17. Gulf Power denies the arguments raised in paragraphs 17 through 30 of Coalition's petition. As set forth in Attachment "D" to Gulf's Petition in Docket No. 990244-EI, differences between Gulf Power and other electric utilities subject to the Commission's jurisdiction in terms of leverage, electric rates, reliability, customer complaints and business risk justify differences in the authorized range on return on equity for Gulf from such other utilities. Based only on the differences between Florida Power & Light ("FP&L") and Gulf Power in the amount of leverage in their respective capital structures, the Commission is justified in setting Gulf's ROE at least 47 basis points higher than that set for FP&L. Gulf Power's 1997 equity ratio is 49 percent, compared to 63 percent for FP&L, a difference of 14 percentage points. The Commission has recently set a cap on the equity ratio of FP&L at 55.83 percent (after adjusting for off-balance sheet obligations). This figure was based on that utility's 1998 projected Rate of Return Report. Gulf's comparable equity ratio (adjusted for off-balance sheet obligations) is 49.08 percent, a difference of 6.75 percentage points. In the mid 1980s, the Florida Public Service Commission requested that Dr. Eugene F. Brigham (Public Utility Research Center at the University of Florida) conduct a study examining what impact the amount of leverage in a utility's capital structure had on its cost of equity. The June 30, 1986 study found that the cost of equity for an electric utility changed by an average of 12 basis points for each percentage point change in the common equity ratio for those companies within the 40 to 50 percent equity ratio range. In 1998, Dr. James H. Vander Weide, Professor of Finance and Economics at Duke University and President of Financial Strategy Associates also performed a study covering the same topic as the

June 30, 1986 study by Dr. Brigham. As shown in the affidavit set forth in Exhibit D-1 to Gulf Power's petition in Docket 990244-EI, Dr. Vander Weide concludes that for each one percent change in the leverage in an electric utility's capital structure, the cost of equity increases by approximately 7 basis points. Based on the separate studies conducted by Dr. Brigham and by Dr. Vander Weide, Gulf's authorized ROE should be adjusted 47 basis points higher than FP&L's just to account for the difference in equity ratios. [$(55.83 - 49.08) * 7 = 47.25$]

Contrary to the position taken by Coalition in its argument, the 11.5% ROE midpoint that would have been newly established for Gulf by the Florida Public Service Commission in Order No. PSC-99-1047-PAA-EI if the order had not been challenged is not out of line with authorized ROE's recently established by other commissions. According to a January 1999 report entitled "Major Rate Case Decisions January 1990 - December 1998" produced by Regulatory Research Associates, Inc. ("RRA"), equity returns authorized for electric utilities across the nation averaged approximately 11.7% in 1998 compared to 11.4% in 1996 and 1997. The ROE decisions summarized in the RRA report during the fourth quarter of 1998 averaged 12.03%. The following chart shows that the average authorized returns on equity established in 1998 have turned up when compared to the returns authorized during the 1993 to 1997 time frame.

ELECTRIC UTILITIES Average Authorized Return on Equity



Source: Regulatory Research Associates, Inc.

As likewise stated in Attachment "D" to Gulf's petition in Docket No. 990244-EI, it is also important to note the volatility in long-term interest rates. As noted in the petition dated March 2, 1999, the yield on 30-year treasury bonds was 4.72 on October 5, 1998 and increased by 93 basis points to 5.65 on February 25, 1999, less than five months later. Since that time, the yield on 30-year treasury bonds has increased even further to 6.12 on August 2, 1999.

Under present conditions the midpoint of a reasonable ROE range for Gulf Power could be higher than the 11.5% that would have been established by the Commission if its Order No. PSC-99-1047-PAA-EI had not been challenged. The Commission should take into account current circumstances when it establishes a new ROE range for Gulf Power as a result of these proceedings.

18. Gulf Power denies the arguments raised in paragraphs 31 through 35 of Coalition's petition. The target level of \$25 million to \$36 million for the Company's accumulated provision for property insurance ("Property Insurance Reserve") was approved by the Commission in Order PSC-96-1334-FOF-EI issued 11/5/96. That order was issued as a proposed agency action and followed Commission consideration of a study conducted by Gulf pursuant to an order by the Commission. Gulf's ratepayers were accorded the opportunity to examine the basis for adoption of the target level for the Property Insurance Reserve. Gulf's Property Insurance Reserve has been established and administered to be consistent with FPSC rules and orders. The Company's reserve is funded, and this cash is "isolated" from Gulf's other assets. The cash is not "incorporated into the overall cash flow" but is instead set aside in a separate investment account and is not used to meet daily cash requirements. Use of the Property Insurance Reserve mechanism ensures that the cost of property damages from storms and other causes is spread evenly over time. Otherwise, customers who endured a storm or other covered loss to the Company's property could be hit immediately with the entire cost. The Coalition's assertion that Gulf must earn \$1.60 in pretax income to add a dollar to the fund is also erroneous. It takes \$1 of revenue to cover \$1 of storm accrual for ratemaking purposes. The determination of the amount of cash for funding the reserve is calculated net of income taxes. For example, the balance in the reserve at 12/31/98 was \$1,605,160. The Company funded \$985,970 in cash, which is \$1,605,160 less the effective income tax of .38575. This is because storm or other such costs are deductible for income tax purposes in the year they are actually incurred. It is simply a timing difference for taxes. It would not be less costly to customers through "tax-deductible insurance premiums" or if the costs were recovered after the loss. In fact, the extremely high cost of

insurance to cover hurricane damages, if such coverage is commercially available, makes such an alternative prohibitively expensive.

19. Although not necessarily agreeing with the specific arguments raised in paragraphs 36 through 39 of Coalition's petition, Gulf does agree that it is not appropriate to accelerate the write-off of losses on reacquired debt.

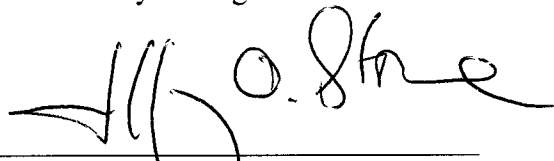
20. Gulf Power denies the arguments raised in paragraphs 40 through 42 of Coalition's petition that suggest earnings over a set amount after sharing should automatically be flowed through to customers. It indeed may be appropriate to continue the incentive features of the regulatory incentive plan adopted by the Commission by removing the cap on revenues that may be retained by Gulf's shareholders under the sharing plan. Under such circumstances, it would be appropriate to allow customers to receive their portion of shared revenues in the manner contemplated by the plan. If a cap on the level of revenues that may be retained by shareholders under the sharing plan remains, then it is entirely appropriate for the Commission to retain jurisdiction on all revenues above such point pending further review by the Commission to determine an appropriate disposition.

21. Gulf Power denies the arguments raised in paragraphs 43 through 45 of Coalition's petition. There is no "absence of direction" from the Commission as to how the customer portion of any shared revenues will be distributed. By directing Gulf to credit customers through the Environmental Cost Recovery Clause ("ECRC"), the Commission has indicated that the allocation is to be based in part on energy and part on demand. Use of the ECRC also addresses the issue of distributional inequities because the allocators used in the clause are based on the latest load research data available (which must be filed with the FPSC every two years) and are based on kWh projections for the upcoming period.

22. The list of issues to be addressed at the hearing in this docket that has been scheduled for January 25, 2000 should be worded in a neutral manner and should include an item to determine the effective date of the regulatory incentive plan that may result from the hearing process. Although the regulatory incentive plan proposed in Order No. PSC-99-1047-PAA-EI originally contemplated being in effect for three years beginning January 1, 1999, that period is no longer appropriate under current circumstances. Less than half of calendar year 1999 remains and therefore any meaningful opportunity to react to the incentives contemplated by the regulatory incentive plan proposed by the Commission in Order No. PSC-99-1047-PAA-EI has been lost to the Company. In addition, the Company's actual earnings for 1999 have fallen significantly below forecast levels through June 30, 1999, due to a shortfall in base rate revenues of approximately \$8 million. It would be fundamentally unfair and legally impermissible to impose the retroactive impacts of rate credits and other adjustments to 1999 earnings contemplated by the regulatory incentive plan proposed by the Commission in Order No. PSC-99-1047-PAA-EI at this point in time, let alone after a hearing that will not take place until the following year. The effective date rate credits or other adjustments to earnings such as increased expense accruals should be an issue for the hearing and should be on a prospective basis unless the parties stipulate otherwise.

WHEREFORE, Gulf Power Company respectfully requests the Commission to enter an order modifying the Order under challenge after hearing evidence on the issues including the effects of current and forecasted earnings. The Company further requests that this matter be heard by the full Commission pursuant to Rule 25-22.0355(4), Florida Administrative Code in accordance with the schedule set forth in the Case Assignment and Scheduling Record ("CASR") posted July 12, 1999.

Respectfully submitted this 3rd day of August 1999.

A handwritten signature in black ink, appearing to read "J.A. Stone", written over a horizontal line.

JEFFREY A. STONE

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to the Company's authorized return on equity.)
_____)

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a copy of the foregoing has been furnished this 3rd day of
August, 1999 by U. S. Mail to the following:

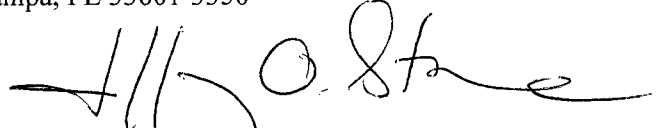
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