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ORIGINAL

GULF POWER
A SOUTHERN COMPANY

October 29, 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 No. 990001-EI

Enclosed are an original and ten copies of the rebuttal testimony of M. W. Howell to be filed in the above docket.

Sincerely,

Susan D. Ritenour

Susan D. Ritenour
Assistant Secretary and Assistant Treasurer

lw

Enclosures

cc: Beggs and Lane
Jeffrey A. Stone, Esquire

AFA Vandiver
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EAG Bohrmann
LEG 1
MAS 3+og
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SEC 1
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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

IN RE: Fuel and Purchased Power Cost)
Recovery Clause with Generating)
Performance Incentive Factor) Docket No. 990001-EI
)

Certificate of Service

I HEREBY CERTIFY that a true copy of the foregoing was furnished by hand delivery or the U. S. Mail this 29th day of October 1999 on the following:

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ORIGINAL

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 990001-EI

FUEL COST AND PURCHASED POWER COST RECOVERY CLAUSE

PREPARED REBUTTAL TESTIMONY

OF

M. W. HOWELL

FUEL COST RECOVERY
JANUARY 2000 – DECEMBER 2000

CAPACITY COST RECOVERY
JANUARY 2000 – DECEMBER 2000

NOVEMBER 1 ,1999

GULF POWER
A SOUTHERN COMPANY

GULF POWER COMPANY

Before the Florida Public Service Commission
Rebuttal Testimony of
M. W. Howell
Docket No. 990001-EI
Date of Filing: November 1, 1999

Q. Please state your name, business address and occupation.
A. My name is M. W. Howell, and my business address is One Energy Place, Pensacola, Florida 32520. I am Transmission and System Control Manager for Gulf Power Company.

Q. Have you previously testified before this Commission?
A. Yes. I have testified in various rate case, cogeneration, territorial dispute, planning hearing, need determination, fuel clause adjustment, and purchased power capacity cost recovery dockets. I have prefiled direct testimony in this proceeding dated October 1, 1999.

Q. What is the purpose of your rebuttal testimony in this proceeding?
A. The purpose of my testimony is to respond to portions of the direct testimony offered respectively by Judy G. Harlow of the Florida Public Service Commission (FPSC) Staff, Kent D. Taylor of the Florida Industrial Power

Users Group (FIPUG), and David E. Dismukes of the Citizens of the State of Florida (Citizens) in connection with the issue in this proceeding regarding the 20 percent (%) shareholder incentive for economy sales.

Q. What general concerns do you have regarding the testimony you are addressing in this rebuttal?

A. In general, the witnesses are proposing that this Commission accept their troubling thesis that the 20% shareholder incentive currently associated with economy energy sales does not provide an inducement or incentive for utilities to continue their efforts to maximize economy sales. Their thesis is in conflict with the basis characteristics of human nature and business practices. An incentive is just that - it provides a motivation to behave in a certain way. In other words, incentives are effective mechanisms to encourage the performance of desired actions. For example, this Commission has for years continued an incentive mechanism in the fuel cost recovery clause known as the Generation Performance Incentive Factor.

The witnesses for Staff, FIPUG and Citizens have all confused the concept of an incentive. They would have the Commission believe that as long as a utility is motivated in general terms to keep its rates to retail customers low, additional direct incentives supporting the goal of lowering customer costs are inappropriate. The fallacy in their thesis is that they deem the general motivation to keep rates low to be equivalent in impact to the more focused incentive provided by the 20% shareholder incentive currently associated with economy energy sales.

I certainly agree that utilities today have an incentive to keep rates as low as reasonable. But if an additional incentive is provided, human nature and all business practices dictate that there will be a response to the additional incentive. In the case of the 20% shareholder incentive associated with economy energy sales, the response takes the form of increased effort to maximize these sales. Conversely, removal of an existing incentive will send a signal that the utility resources devoted to this activity are not as important to the Commission today as they once were.

The second general concern I have is that the witnesses sponsored by Staff, FIPIG and Citizens have either misunderstood or mischaracterized the relationship of today's more competitive market with the need for an incentive. They assert that the more competitive market negates the need for an incentive. I submit that the opposite is true. The only reason a more competitive wholesale market exists today is that the sellers have a direct incentive to make these sales. That direct incentive is the opportunity to make a profit. In fact, for any of the new non-utility players in the wholesale arena, profit is the only reason driving these sales. They certainly are not motivated to keep prices low simply for the sake of low prices. I assert to you that if these new players knew they would not make any profits from their efforts, they clearly would not be in the game. The primary driving force behind the more competitive market in Florida today is the opportunity for increased profits. If profits are OK for non-regulated players who find ways to increase sales, then it hardly seems fair to deny a portion of the profit margin to regulated utilities.

Q. Are there specific concerns you have about the Staff's reasons for elimination of the 20 percent stockholder incentive?

A. Yes. The testimony stated that the 80/20 incentive encouraged utilities to **more aggressively** (emphasis added) participate in the economy market. This statement underscores my previous point that regardless of what other motivations may exist, an added incentive will affect behavior, in this case motivating utilities to more aggressively pursue economy sales. The testimony goes on to summarize changes that have occurred in the electricity business since the incentive was originally offered, asserting that these changes negate the need for the incentive, but ignoring the more important and correct characterization that these changes cannot change fundamental laws of behavior.

The testimony states that because the FERC has recently required unbundling of operations and marketing, that Florida utilities now have a marketing department to handle transactions. Carefully avoided is the point that if utilities have any added incentive to make sales, it will be just that - an added incentive, which will increase sales, and likely provide lower rates to the retail customer, because giving them 80% of a larger pie is better than 100% of a smaller pie. In fact, if the incentive were removed, then utilities would have an incentive to shut down these marketing departments whose operating costs would represent a drain on profits. This is clearly an example of how the general motivation to keep rates low is not necessarily equivalent to the direct incentive associated with the opportunity to share the profits on economy sales. Whatever benefits are associated with near-term economy sales may be lost to ratepayers due to the change in focus that would come with the loss of the direct incentive.

Q. Are you saying that if the direct incentive were removed, a utility might lose its motivation to make these sales?

A. Absolutely not. Clearly, a utility has a motivation to keep rates low, and it will certainly pursue some level of sales absent a direct shareholder incentive. But today's market requires knowledge of market prices and conditions that only comes from spending dollars and effort to acquire that knowledge. Without the direct incentive, a utility is de-motivated to expend the money and resources to more aggressively pursue sales. Without that incentive, these costs come straight out of operating profits. This is not a desirable situation when we are in competition with players who keep all the profits. It becomes increasingly difficult to justify programs when only indirect incentives are associated with successful efforts.

Q. What additional concerns do you have?

A. The Staff testimony also seems to conclude that the existing 80/20 incentive does not "appear to be necessary in order to encourage economy sales" for <u>all Florida utilities</u> just because FPL and FPC do not apply the 20% stockholder incentive to their off-broker economy sales. Gulf Power Company (Gulf) contends there are many financial and operating considerations each utility must make in order to best determine how and when to participate in the economy sales market, as well as how to treat the gains. A predominant seller has a lot to lose if the incentive were eliminated. A predominant buyer is basically indifferent.

The conclusion of the testimony is that removal of the stockholder incentive is necessary to alleviate a perceived "disparity in the application of the shareholder incentive" which is apparently occurring in Florida because Gulf and TECO apply the 80/20 mechanism to all of their economy sales. This is not the only way to eliminate this perceived disparity. The Commission could either order FPL and FPC to apply the incentive to all of their economy sales, or, even better, make it optional if the utilities apply it.

Gulf does not agree that things that are different among the utilities necessarily represent disparities. They are correctly characterized as simply differences. The utilities have differing levels of cost in their various areas of operations, very different customer programs based on other driving differences, different pool and dispatch operations, and particularly, differences related to whether they are predominantly a buyer or a seller in the market. To characterize these as disparities would not be correct - they are just differences.

Q. What concerns do you have about FIPUG's testimony on the use of incentives in a competitive setting?

A. The testimony completely avoids use of the term "incentive," rather stating that a utility should manage all aspects of their business in return for regulated returns. This seems to contradict Staff's position, which asserts that there is now more of a competitive environment. The testimony does not address the nature of or need for incentives in a competitive environment. And, clearly, without incentives, no unregulated players will enter the market. Neither, then, should a regulated utility be expected to operate without reasonable incentives.

Q. What about FIPUG's comments related to risk?

A. The testimony states that the utility experiences no risk related to these sales, that there is no entrepreneurial aspect to the sale of the power. While this may be true in the theoretical world, which assumes full knowledge of all inputs, it does not apply to Gulf in the real world. When demand is high and supply is low, the market becomes fast-paced and intense. Costs and selling prices may be constantly changing as different units become available and needs of purchasing utilities change. We do not always know exact costs until after the sale is committed. If there were not some profit incentive for us to make sales where the margin is tight, we might easily forego opportunity that was not a clear-cut winner. That would likely result in far fewer overall sales, giving the customer less overall benefit, since he would be getting 100% of a small number rather than 80% of a larger number.

The testimony also seems to rebut the testimony of Staff in stating that increased competition within the state of Florida doesn't change FIPUG's position because Florida utilities are not in jeopardy of losing retail customers as a result of the increased competition. This statement on competitive options runs counter to one of the reasons for elimination of the incentive given by Staff and Citizens.

Q. What concerns do you have about the Citizens' testimony regarding the competitive nature of the wholesale market?

A. The testimony states that a more competitive Florida market today sends signals to market participants which should be enough to encourage taking advantage of all available market opportunities. This ignores two important points in making that assertion. First, the market is more competitive because there are now more participants, all of whom are driven by a profit motive, and their incentive to make these sales is profit. It is particularly noteworthy that the non-utility participants keep 100% of the profits, not just 20%.

If we remove the incentive which is currently available to utilities to make these sales, we are creating an uneven playing field. The change in policy would serve to discourage utilities from taking reasonable risks in making sales, resulting in lower shared profits for our customers. It has nothing to do with an incorrect theory of utilities' ability to manipulate their economy sales.

Additionally, the increased competition will have the effect of driving down what prices would otherwise be. As prices drop, so do the profit margins on the sales. If any incentive to make these sales were eliminated, then utilities would have a counter incentive to not offer sales that might marginally bring a profit. They would then forego these marginal sales, and the customer would likely lose.

Q. Are all the generating assets that make these sales in the rate base supported by retail customer rates?

A. Perhaps for other Florida utilities, but certainly not for Gulf. As part of the Southern electric system power pool, Gulf participates with the other Southern operating companies in making economy sales, and economy sales are made out of the generation assets of all five operating companies. Even if Gulf's generating units were not the units that pick up generation in a given period to make the economy sales, we would still get our share of profits, since the gain on these sales is split among the Southern operating companies, regardless of which units actually made the sale. In other words, under the present system, Gulf's customers receive a portion of the profit on economy sales produced by generating units that are not in Gulf's rate base. This participation in the Southern electric system power pool highlights a significant difference between Gulf and the other Florida utilities.

Q. What about Citizens' testimony regarding bulk power efficiencies?

A. The discussion of bulk power efficiencies shows a misunderstanding not only of system operations, but also the cost accounting involved in economy transactions. First, the assertion is that economy sales' effect of increasing capacity utilization will increase overall operating efficiencies by reducing average system heat rates, whereas the opposite is really true. Most economy sales occur when loads are high and capacity is short. It is the more efficient units that operate to serve base load, and the less efficient units that are called on in times of high demand. Increasing the demand on our generating units through economy sales will call on more generation from the less efficient units, raising average system heat rates. Also, the testimony is void of any reference to the relationship between average and incremental system heat rates, which is the true measure of the value of economy sales.

The testimony then makes the remarkable statement that "these increased efficiencies gains" can be flowed through to shareholders. And all this is in the framework of the argument against retaining the 80/20 incentive. If, in fact, 100% of the gain is passed to the customer as proposed, then there is ZERO gain left to be passed to the stockholder. What is also missing from the discussion is that if utilities have an additional profit incentive to make sales in a competitive market where prices are tight, there is a huge additional incentive to reduce overall costs to make all generation more competitive. This benefits the customer on every kilowatt-hour generated, not just the relatively small portion that makes up off system sales. In other words, elimination of the direct incentive currently associated with economy sales may result in a reallocation of resources, because the general motivation to keep rates low in the long term may become more dominant.

Q. What about the discussion on name recognition?

A. The testimony throws out a novel theory that increased name recognition will be an incentive for utilities to engage in wholesale sales. This position confuses utilities' efforts at name recognition with how the bulk power market really operates. Any market player is well aware that the Southern Company, FP&L, FPC, and TECO are known by all in the market, with a proven reputation to deliver what is promised. The competitive electricity market is interested primarily in only two things - deliverability and price. The Florida utilities have the deliverability reputation. But if, in any hour, they are not competitive on price, then they do not get the business, their customers do not get the 80% savings, and every customer in Florida loses to unregulated players who profit from the lost opportunity of the regulated utility.

Q. Should the Commission eliminate the 20 % shareholder incentive?

A. No. The Commission should not take any action to remove or reduce the existing direct incentives to utilities for participating in this market. By establishing the existing 20% direct shareholder incentive, the Commission recognized the need for and overall benefit of increased sales of economy energy. The competitive market changes that have recently occurred have only increased the importance of this incentive to encourage electric utilities to continue participation in this market, to give Florida's retail customers an opportunity to receive greater near term benefits than if this incentive were removed.

Q. Does this conclude your testimony?

A. Yes.

AFFIDAVIT

STATE OF FLORIDA)
)
COUNTY OF ESCAMBIA)

Docket No. 990001-EI

Before me the undersigned authority, personally appeared M. W. Howell, who being first duly sworn, deposes, and says that he is the Transmission and System Control Manager of Gulf Power Company, a Maine corporation, that the foregoing is true and correct to the best of his knowledge, information, and belief. He is personally known to me.

M. W. Howell

M. W. Howell
Transmission and System Control Manager

Sworn to and subscribed before me this 29th day of October, 1999.

Rollanda R. Cothran

Notary Public, State of Florida at Large

Commission No.

My Commission Expires

ROLLANDA R. COTHRAN
MY COMMISSION # CC 697386
EXPIRES: February 26, 2002
Bonded Thru Notary Public Underwriters