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March 20, 2002

Ms. Blanca S. Bayo, Director
Division of the Commission Clerk and Administrative Services
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee FL 32399-0870

Dear Ms. Bayo:

RE: Docket No. 010949-EI

Enclosed are an original and fifteen copies of Gulf Power Company's Post-Hearing Brief to be filed in the above docket.

Also enclosed is a 3.5 inch double sided, high density diskette containing the Brief in Adobe Acrobat 4.0 format as prepared on a Windows NT based computer.

Sincerely,

Susan D. Ritenour

Susan D. Ritenour
Assistant Secretary and Assistant Treasurer

lw

Enclosures

cc: Beggs and Lane
Jeffrey A. Stone, Esquire

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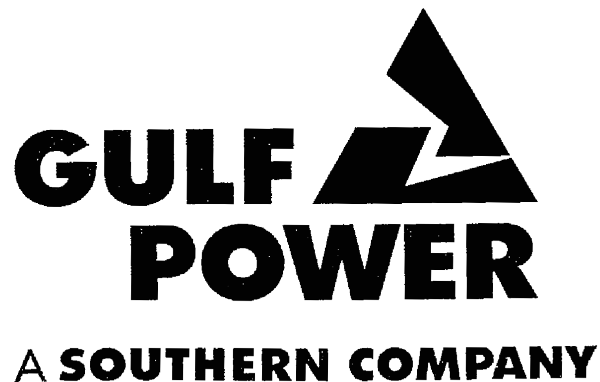
BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 010949-EI

POST-HEARING BRIEF
OF
GULF POWER COMPANY



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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

IN RE: Petition of Gulf Power Company for an increase in its retail rates and charges.	Docket No. 010949-EI Date Filed: March 20, 2002

GULF POWER COMPANY'S
POSTHEARING BRIEF AND STATEMENT OF ISSUES AND POSITIONS

Gulf Power Company ("Gulf Power", "Gulf", or "the Company"), by and through its undersigned attorneys, files the following as its posthearing brief and posthearing Statement of Issues and Positions in this proceeding before the Florida Public Service Commission ("Commission") pursuant to Order No. PSC-02-0219-PHO-EI and Rule 28-106.215, Florida Administrative Code.

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GENERAL DISCUSSION:

Gulf Power Company's current rates and charges will not provide Gulf a reasonable opportunity to earn a fair and reasonable rate of return for the period June 2002 through May 2003 and beyond. Gulf filed this case seeking an annual increase in its rates and charges of approximately $69.9 million to begin on the anticipated commercial in-service date of Smith Unit 3, a 574 megawatt gas fired combined cycle generating unit currently under construction at Gulf's Smith Plant located outside of Panama City, Florida. The most reasonable period on which to base new rates and charges for Gulf is June 2002 through May 2003 which corresponds to the first 12 months following the anticipated commercial in-service date of Smith Unit 3. Since the anticipated commercial in-service date of Smith Unit 3 is on or before June 1, 2002, this period also corresponds with the first 12 months following the anticipated expiration of the stipulation and settlement approved by the Commission in Order No. PSC-99-2131-S-EI. As a result, the chosen test period appropriately corresponds to the first 12 months new rates resulting from this case will be in effect.

Gulf initiated this case on September 10, 2001 with the filing of the Company's petition, direct testimony and schedules containing the Commission's minimum filing requirements ("MFRs") for electric utility rate cases. Based on the data in Gulf's MFRs, the Company's adjusted 13-month average jurisdictional rate base for the period June 1, 2002 through May 31, 2003 (the "May 2003 projected test year") is projected to be $1,198,502,000; and the jurisdictional net operating income is projected to be $61,378,000 using the rates currently in effect. The resulting adjusted jurisdictional rate of return on average rate base is projected to be 5.12%, while the return on common equity is projected to be 4.43% for the May 2003 projected

test year. Such a return is so low that it would severely jeopardize the Company's ability to finance future operations. The continued compulsory application of Gulf's present rates and charges after the commercial in-service date of Smith Unit 3 will result in the unlawful taking of the Company's property without just compensation, resulting in confiscation of the Company's property in violation of the guarantees of the state and federal constitutions.

The management and employees of Gulf have worked diligently to enable the Company to keep its rates low in spite of escalating costs, significant growth in customers to be served, and increased reliability requirements and other customer expectations caused by the widespread use of computers and other technology. The Company has succeeded in these efforts through a deliberate and intense effort to increase the productivity and efficiency of all programs and operations. The Company's success in this regard is demonstrated by the fact that the growth of Gulf's Operating and Maintenance ("O & M") expenses since the 1990 test year applied in Gulf's last rate case through the May 2003 projected test year in this case is less than the compound growth rate for customers and inflation. This has resulted in Gulf's projected O & M expense for the May 2003 projected test year being under the Commission's Benchmark by $3.7 million. Without the addition of Smith Unit 3, Gulf's projected O & M expense for the test year would have been $7.1 million under the benchmark. Although Gulf is projected to serve a customer base that will have grown by approximately 32 percent since the 1990 test year, it will do so in the May 2003 projected test year with nearly 10 percent fewer employees than in the 1990 test year.

Despite these successful efforts on the part of Gulf's management and employees to control and reduce expenses, the addition of the Smith Unit 3 generating capacity and increased

O & M expenses associated with continuing to provide reliable service to Gulf's customers make the filing of this request for rate relief necessary. Although the addition of Smith Unit 3 with the associated O & M expenses is the primary driver behind Gulf's need for rate relief in this case, there are other significant factors that have increased the cost of providing electric service since Gulf's last rate case, Docket No. 891345-EI. These other significant factors include: the addition since 1990 of more than (1) 100,000 new customers; (2) 1400 miles of new distribution lines; and (3) 90 miles of new transmission lines; the replacement and repair of an aging electrical infrastructure; and the increased O & M costs associated with aging generating plants.

As a provider of retail electric service to the people of Northwest Florida, Gulf is obligated by statute to provide such service in a reasonable, "sufficient, adequate, and efficient" manner. Gulf has a similar obligation to provide its shareholders with a reasonable and adequate return on their investment. Without the revenue increase requested, Gulf cannot meet its obligations to either constituency in the long run. If Gulf is rendered unable to meet its obligations to the customers and shareholders due to inadequate rates, both stakeholder groups will suffer. Gulf's customers will suffer from less reliable service and eventually higher costs of electricity, while its shareholders will suffer from an inadequate and confiscatory return on investment and will seek other places to invest their money. For these and other reasons detailed in the testimony and exhibits of Gulf's witnesses, Gulf is respectfully requesting an increase in rates and charges that will produce an increase in total annual revenues of at least $69,867,000 before adjustments as detailed in the Company's positions on the issues listed below.

DISCUSSION OF SPECIFIC ISSUES:[1]

ISSUE 1: Is Gulf's projected test period of the 12 months ending May 31, 2003 ("May 2003 projected test year") appropriate?

**
SUMMARY:

Yes. Gulf's new combined cycle unit at Plant Smith is expected to be in commercial operation on or before June 1, 2002. The chosen test year is representative of Gulf's expected future operations after Smith Unit 3 is in service and is the first full year that new rates will be in effect.

**

DISCUSSION:

The projected test year of the 12 months ending May 31, 2003 is appropriate. A test year is used to establish a consistent time period to examine rate base, revenues and expenses, capital structure and cost of capital for purposes of setting rates that will be in effect in the future. As such, the test year selected should be representative (after any necessary adjustments) of future operations of the company.

The major factor driving Gulf's need for a rate case at this time is the addition of Smith Unit 3, which is expected to begin commercial operation on or before June 1, 2002. [Bowden, R. 57; Labrato, R. 609] There is an immediate need for rate relief beginning with the commercial in-service date of that unit. Of the $69.9 million request for rate relief, approximately $48 million is associated with Smith Unit 3. [Labrato, R. 608-609]

[1] The listing of issues and position summaries that follow in this section is also intended to serve as Gulf Power's posthearing Statement of Issues and Positions required by Order No. PSC-02-0219-PHO-EI.

Gulf selected a projected test year ending May 31, 2003 because it is representative of Gulf's future operations after Smith Unit 3 is in-service. It will also be the first year that the new rates will be in effect. [Labrato, R. 608-609] In addition, each of Gulf's witnesses with functional responsibility over the Company's various O & M activities necessary to reliably serve Gulf's retail customers has testified under oath based on their expertise and experience in these functional areas. Each witness has assured the Commission that the projected test year amounts in their respective areas of responsibility are necessary, reasonable and prudent expenses that are representative of the levels that will be spent in periods following the test period. As such, the May 2003 projected test year is more representative than any possible historical test year.

The Commission approved a projected test year in Gulf's last rate case. [Order No. 23573] The Commission likewise approved projected test years in the last rate cases for the other major investor-owned electric utilities, Florida Power & Light Company [Order No. 13537 in Docket No. 830465-EI], Florida Power Corporation [Order No. PSC-92-1197-FOF-EI in Docket No. 910890-EI], and Tampa Electric Company [Order No. PSC-0165-FOF-EI in Docket No. 920324-EI].

The Office of Public Counsel ("OPC") took the prehearing position that Gulf's projected test year is not appropriate, yet OPC offered no other proposed test year and did not object to numerous Commission-approved stipulations that established rate base, revenue and expense amounts based on the projected test year. Although OPC witness Schultz did express concern regarding the level of detail provided in the MFRs and the budget process used to project test

year amounts, and indicated that he might make additional recommendations based upon his review of outstanding discovery requests [Schultz, R. 796-801], no additional or changed recommendations were ever forthcoming.

Mr. Schultz's concerns are unfounded for at least three reasons. First, it is not clear that Mr. Schultz even understood what test year the Company is using. At the time of the hearing, he appeared to be laboring under the misimpression that Gulf had requested a historical test year, adjusted for known changes, rather than the projected test year it in fact was using. [Schultz, R. 832] Second, as discussed in Issue 40 below, Gulf's budget process provides a sound basis to project revenues, expenses and capital expenditures up to and including the projected test year. Third, Mr. Schultz's concern regarding the level of detail in the MFRs ignores the fact that MFRs establish the information that an electric utility must file to initiate a rate case proceeding and to make a prima facie showing of a need for rate relief. As issues develop, more detailed information on areas of concern to Staff and intervenors is provided through the normal discovery process. MFRs simply are not designed to anticipate and answer every detailed question that a party may have.

In summary, Gulf's May 2003 projected test year is representative of the Company's future operations, and the data included in the test year is based on reliable and credible projections. Therefore, the May 2003 projected test year provides the appropriate basis for setting rates in this case.

ISSUE 2: Stipulated

ISSUE 3: Should Gulf be required to establish a mechanism that would provide for a payment or credit to retail customers if frequent outages occur?

**

SUMMARY:

No. Gulf has demonstrated its commitment to providing reliable electric service and superior customer service. Such a mechanism could result in an electric utility focusing on one very narrow component of reliability to the exclusion of other equally important components. In addition, the proposed mechanism is one-sided and acts more as a penalty mechanism than an incentive mechanism.

**

DISCUSSION:

Gulf should not be required to establish a mechanism that would provide a payment or credit to retail customers if frequent outages occur. In the case of Gulf, the proposal by Staff witness Breman to penalize the Company in the event the percentage of its Customers Experiencing More than Five Interruptions ("CEMI5") exceeds 2% appears to be a solution in search of a problem.

Gulf's overall distribution reliability is good. [Breman, R. 867] There were no customer complaints about reliability during the Commission's two service hearings in this case. To the contrary, each of Gulf's customers at the two service hearings that had any comments at all about the Company's quality of service, only had good things to say in that regard. In addition, it has been over three and a half years since Gulf has had a reliability related infraction; and Gulf ranks high overall in customer value surveys, including high marks in handling emergencies, responding quickly to problems, and restoring service quickly after an outage. [Fisher, R. 1021-1022] Ninety-three percent of customers in the Public Confidence Survey replied that Gulf provides reliable service. [Fisher, R. 1020]

Gulf's CEMI5 was 2.1% for 2000 and only 1.0% for 2001. [Fisher, R. 1020-1021; Exhibit 52, Schedule 6] This compares favorably to other Florida investor-owned utilities ("IOUs"). [See Exhibit 46 at JEB-1, Figure 5, as corrected by Breman, R. 864] Gulf's average customer minutes of interruption (measured by the System Average Interruption Duration Index, or "SAIDI") for the year 2001 was 78.55, which is well below the last published national average, and represents a 19% reduction from the previous year. [Fisher, R. 1020, 1027] Mr. Breman suggested that his proposal would provide Gulf a greater incentive to spend maintenance dollars on activities such as tree trimming [R. 893] and suggested that use of a CEMI5 based standard would help address the issue of geographic areas where customers are experiencing many interruptions. [Breman, R. 872] In the view of Gulf's management, it is inappropriate to focus on only one measure, such as CEMI5, for testing whether Gulf's management is focusing the Company's spending on the right activities. Management must have the discretion to respond to changing circumstances and allocate available financial resources to areas that allow the Company to meet the needs of all its customers. The mechanism proposed by Mr. Breman, because of its narrow focus, may have the effect of impeding the sound exercise of management discretion by substituting the impact of a single arbitrary indicator over the reasoned judgment of Gulf's management.

In describing the history of the Commission's focus on distribution reliability, Mr. Breman acknowledged that heightened attention in recent years was due to a high incidence of complaints for other IOUs, not due to complaints regarding Gulf. [Breman, R. 868, 884-886] While Mr. Breman stated that one reason for his proposal was to ensure that distribution

reliability does not decline between rate cases, he conceded that he had no evidence that Gulf has suffered such a reduction in reliability. Since data became available in 1997, Gulf's distribution reliability has generally improved. [Breman, R. 871, 877-878, 886-887] Gulf's management has a demonstrated history of responding appropriately to the needs of its customers under changing circumstances. The new or expanded programs identified in this rate case provide prime examples of the proactive response of Gulf's management to changing conditions.

In summary, the record contains no evidence that Gulf has a problem with distribution reliability that needs to be addressed through a penalty mechanism. To the contrary, Gulf's customers currently enjoy good distribution reliability, and there is no reason to believe that this level of performance will deteriorate in the future. As stated by Gulf's witnesses, the Company's reliability of service to its customers is of high priority to management. Gulf's management has identified a need for additional resources to ensure continued reliable service to Gulf's customers. This case was filed in part to secure the resources necessary to ensure that the Company is able to continue providing highly reliable electric service. Gulf will continue to focus on providing reliable service because it is in the customers' best interest and is integral to Gulf's business goals. [Fisher, R. 1021] Punitive measures such as that proposed by Mr. Breman are neither necessary nor appropriate for Gulf Power Company.

In any event, the particular mechanism proposed by Mr. Breman should not be adopted in this proceeding. First, customers will naturally experience some variations in reliability over time, since reliability is a function of many variables, which are under various degrees of the electric utility's control. It is not appropriate to make refunds to customers based solely on the

level of a single indicator such as CEMI5, which could be greatly affected by weather and other conditions beyond Gulf's control. [Fisher, R. 1019, 1021; see Breman, R. 882] Using such a single indicator in a penalty context could cause the Company's focus to shift away from other broader recognized and more appropriate measures. [Fisher, R. 1027] Second, there is no reasoned basis in the record to establish any particular compliance level of CEMI5, much less the 2% level suggested by Mr. Breman. [Fisher, R. 1023] Third, the mechanism proposed by Mr. Breman does not contain any incentive or "carrot," only a financial penalty or "stick." It penalizes the company for not meeting one particular standard, with no opportunity for reward. [Fisher, R. 1024-1025; Breman, R. 881-882; Labrato, R. 1099] If the Commission were to adopt an incentive program, it should look at the overall quality of service instead of looking at only one particular standard. [Labrato, R. 1100, 1102; see Issue 34]

Finally, the IOUs have been working with the Commission staff in Docket No. 011351-EI on proposed rule amendments to address reliability reporting and other concepts. The rulemaking docket is a more appropriate forum in which to attempt to develop fair standards and to ensure that any reliability targets which may be established are cost-effective. [Fisher, R. 1022-1023, 1025] It is particularly appropriate to defer to that rulemaking docket when the record in this case demonstrates that Gulf does not have a utility-specific distribution reliability problem.

ISSUE 4: Stipulated

ISSUE 5: Stipulated

ISSUE 6: Should an adjustment be made to production related additions included in Plant in Service?

**

SUMMARY:

No. The Commission approved a stipulation to include Smith Unit 3 without adjustment. The other production related additions included in plant-in-service for Gulf's projected test year are reasonable, prudent, and necessary and should be allowed. These additions, which are detailed in Mr. Moore's testimony and exhibits, are necessary to effectively maintain Gulf's existing fleet of generating units such that Gulf can continue to provide low cost, reliable generation to its customers.

**

DISCUSSION:

No adjustment should be made to the production related additions included in plant-in-service. Gulf has supported those additions with detailed construction budget information and no party presented evidence to question any specific capital project. Gulf's management has testified under oath that these additions are reasonable expenditures, necessary to ensure continued reliable service to the Company's retail customers.

The plant-in-service balance, combined with the CWIP balance, at the end of the May 2003 projected test year reflects total production plant additions of $251,069,000 since December 31, 2000. [Exhibit 30, Schedule 2] Adjustments were made for rate-making purposes to exclude amounts recovered through the environmental cost recovery clause ("ECRC"), to exclude amounts related to Unit Power Sales ("UPS") from Plant Scherer, and to properly reflect the jurisdictional portion of the plant. [Moore, R. 410; Labrato, R. 617; Exhibit 37, Schedule 6]

The total additions of $251,069,000 are comprised of $238,060,000 of additions during the 17-month period January 2001 through May 2002 and $13,009,000 of additions during the

projected test year. [Exhibit 30, Schedule 2] Approximately 75% of the total amount is related to Smith Unit 3, which must be fully included in plant-in-service pursuant to a stipulation approved by the Commission at the beginning of the final hearing. [Stipulation No. 9] The projects comprising the remaining 25% of the additions since December 31, 2000 are listed on Schedules 9 and 10 of Exhibit 32.

As testified by Mr. Moore, Gulf's Vice President of Power Generation and Transmission, the capital projects included in the construction budget are designed to improve heat rate, prevent forced outages, improve plant efficiency, or otherwise help ensure the availability of efficient, low-cost generation to Gulf's customers. [Moore, R. 410-411] In order to ensure that capital dollars are spent wisely, Gulf uses the Project Evaluation and Prioritization System ("PREPS") model to determine the economic viability of all proposed capital projects. Ordinarily a project is required to provide a minimum benefit-to-cost ratio of 1.2, and a payback of less than five years. [Moore, R. 411] Each project in the construction budget is assigned to a project manager who has start-to-finish responsibility for project implementation. Total capital project expenditures and budget variances are monitored on a monthly basis and quarterly explanations are required for all budget variations that meet specified variance criteria. [Moore, R. 411-412] This planning and monitoring process demonstrates Gulf's commitment to undertaking only those projects, which will provide benefits to its customers.

Gulf's capital budget process is highly accurate. Production related construction expenditures for calendar 2001 totaled $199.9 million, which is within 0.5% of the original budget for that year. [Moore, R. 981-982; Exhibit 50, Schedule 6]

OPC took the position in the prehearing order that "a number of [production-related] budget items appear to be overstated." This position reflected the testimony of Mr. Schultz, who at the time his testimony was filed was still planning to review additional discovery responses in order to determine whether to recommend an adjustment to plant-in-service. [Schultz, R. 793] Presumably Mr. Schultz's discovery review revealed no necessary adjustments, since he identified none at the hearing and counsel for OPC did not conduct cross-examination on any of the capital expenditure issues.

ISSUE 7: Should an adjustment be made to transmission and distribution related additions included in Plant in Service?

**

SUMMARY:

No. The transmission and distribution related additions included in plant-in-service for Gulf's projected test year are reasonable, prudent, necessary and should be allowed. These amounts, which are detailed in the testimony and exhibits of Mr. Howell and Mr. Fisher, are necessary to serve new customers, meet additional load growth from existing customers, and replace deteriorating facilities.

**

DISCUSSION:

No adjustment should be made to the transmission and distribution related additions included in plant-in-service. Gulf has supported those additions with detailed information about the nature of the projects and no party presented evidence to question any specific transmission or distribution project. Gulf's management has testified under oath that these additions are reasonable expenditures necessary to ensure continued reliable service to the Company's retail customers.

The plant-in-service balance, combined with the CWIP balance, at the end of the May 2003 projected test year reflects total transmission additions of $56,035,000 and total distribution additions of $95,418,000 since December 31, 2000. [Exhibit 30, Schedule 2]

The transmission plant additions are comprised of $48,530,000 of additions during the 17-month period January 2001 through May 2002, and $7,505,000 of additions during the projected test year. [Exhibit 30, Schedule 2] As testified by Mr. Howell, Gulf's Transmission and System Control Manager, the total construction costs for the 17-month period included $10 million for the Smith Unit 3 step-up substation and interconnection facilities, and $3.4 million for minor upgrades to the Smith-Highland City, Callaway-Highland City, and Smith-Greenwood 115 kV transmission lines in order to accommodate Smith Unit 3. [Howell, R. 515, 516] Mr. Howell's testimony describes the other major projects completed during 2001 and projected through May 2003, and his exhibit includes a detailed list of these projects, their status, and their estimated completion dates. [Howell, R. 514-516; Exhibit 53, Schedule 1] These transmission expenditures are necessary to serve new customers; to strengthen the transmission system to meet additional demand resulting from load growth; and to replace damaged, worn out, or obsolete facilities. As such, all of these transmission projects are necessary to serve the current and future needs of Gulf's customers. [Howell, R. 515-516, 1065]

In order to ensure that transmission dollars are spent wisely, long range planning studies are typically performed annually to determine what future transmission system improvements will be needed in the coming ten year period. Once a future deficiency is identified, alternative improvements are evaluated and the most cost-effective solution is recommended for inclusion in

the budget. All transmission capital projects are further reviewed every year before they are either added to or retained in the budgeting process. Construction expenditures are managed by awarding contracts for equipment, material and major transmission lines on a competitive basis in order to ensure the lowest installed cost to Gulf's customers. [Howell, R. 516-517, 520-521]

The distribution plant additions are comprised of $57,113,000 during the 17-month period January 2001 through May 2002, and $38,305,000 of additions during the projected test year. [Exhibit 30, Schedule 2] As testified by Mr. Fisher, Gulf's Vice President of Power Delivery and Customer Operations, the total construction costs for the 17-month period include two major construction projects necessary to meet peak summer load conditions. The remaining expenditures are necessary to serve new customers, meet additional load growth from existing customers, and replace deteriorating facilities. The funds will be used to purchase and install poles, wire, cable, transformers, capacitors and other distribution equipment and material. [Fisher, R. 441] The specific items included in the plant additions from January 1, 2001 through the end of the projected test year are detailed on Schedules 2 and 3 of Exhibit 52. All of these projects are necessary to provide reliable service to Gulf's customers. [Fisher, R. 1010]

Although OPC's prehearing position challenges the entire amount of transmission and distribution plant added since December 31, 2000, Mr. Schultz testified only that he had made no determination as to whether an adjustment to the transmission and distribution capital amounts was necessary and would be doing so only after reviewing additional discovery responses. [Schultz, R. 792-793] Clearly Mr. Schultz's discovery review revealed no necessary

adjustments, since he identified none at the hearing and counsel for OPC did not conduct cross-examination on any of the transmission or distribution capital expenditure issues.

ISSUE 8: Should an adjustment be made to general plant related additions included in Plant in Service?

**

SUMMARY:

No. The general plant additions included in plant-in-service for the projected test year are reasonable, prudent and necessary and should be allowed. The majority of these expenditures, which are described in the testimony of Mr. Fisher and Mr. Saxon, are to provide for improvements to buildings and land, as well as the purchase of automotive equipment, including mechanized line and service trucks, as well as telecommunications, computer and other equipment.

**

DISCUSSION:

No adjustment should be made to the general plant additions included in plant-in-service. Gulf has provided an adequate description of and justification for such additions and no party has presented evidence to question any specific general plant addition.

The plant-in-service balance, combined with the CWIP balance, at the end of the May 2003 projected test year reflects total general plant additions of $11,369,000 since December 31, 2000. [Exhibit 30, Schedule 2] These are comprised of $5,256,000 of additions during the 17-month period January 2001 through May 2002, and $6,113,000 of additions during the projected test year. [Exhibit 30, Schedule 2]

The majority of these expenditures are for improvements to buildings and land, as well as the purchase of automotive equipment including mechanized line and service trucks. [Fisher, R. 441-442] These expenditures are reasonable, prudent and necessary to provide reliable

service to Gulf's customers. [Fisher, R. 442, 1010] Another portion represents investment in telecommunications, computer and other equipment. These expenditures are reasonable and prudent and are well within the normal range of spending for these types of items. [Saxon, R. 356, 965, 972] Detail on the specific expenditures making up the general plant additions is provided on Exhibit 49, Schedule 1 and Exhibit 52, Schedules 4 and 5.

As in the case of production additions and transmission and distribution additions, Mr. Schultz proposed no specific adjustment to general plant additions and counsel for OPC conducted no cross-examination on these amounts.

ISSUE 9A: Should the deferral of the return on the third floor of the corporate offices be allowed in rate base?

**

SUMMARY:

Yes. In Gulf's last rate case, the Commission allowed Gulf to earn a deferred return on the third floor investment in anticipation of future recovery. The third floor is fully utilized and the deferred return should be allowed in rate base. The deferred return balance as filed in the MFRs should be reduced by $693,000 jurisdictional to reflect the impact of the additional amortization that was booked during 2001 pursuant to the revenue sharing stipulation.

**

DISCUSSION:

The deferred return on the third floor should be allowed in rate base. In the last rate case, the Commission excluded from rate base both the investment related to the third floor of the corporate office building and the associated accumulated depreciation. The Commission did, however, allow Gulf to earn a deferred return on this investment at a rate equal to the allowance for funds used during construction ("AFUDC"). [Order No. 23573 at page 9] The decision to

allow a deferred return reflects an expectation by the Commission that recovery of these carrying costs would be allowed at an appropriate time in the future. [Labrato, R. 656-658; 1097] Gulf has accounted for the third floor investment for surveillance and financial reporting purposes in a manner that is consistent with the Commission's decision. Based on this accounting, investors and the financial community were aware that this return was being deferred and would be recovered at some future point. [Labrato, R. 658-659] By Order No. PSC-99-1047-PAA-EI, issued on May 24, 1999, in Docket No. 990250-EI, the Commission approved placement of the deferred return and the investment in the third floor within Gulf's retail rate base, and authorized a three year amortization period for the accumulated balance of the previously deferred return. Although that approval was later withdrawn when the proposed agency action order itself was withdrawn as part of the stipulation approved by Order No. PSC-99-2131-S-EI, the Commission's decision in favor of moving this investment and the associated deferred return into rate base was not directly challenged. As discussed in Issue 9B, the third floor is fully utilized and should be included in rate base. It is, therefore, appropriate at this time to include the balance of the deferred return in Gulf's rate base. [Labrato, R. 619-620]

The balance of the deferred return has changed since the MFRs were filed. Under the revenue sharing stipulation approved by the Commission in Order No. PSC-99-2131-S-EI, Gulf was authorized, at its discretion, to amortize up to $1,000,000 a year of the deferred return during the time the plan is in effect. [Order No. PSC-99-2131-S-EI at pages 2, 17] Gulf subsequently amortized $1,000,000 in each of the years 2000 and 2001. Since the 2001 amortization had not been booked at the time the MFRs were filed, the deferred balance used to set rates in this case

should be reduced by $693,000 jurisdictional ($855,000 system) to a 13-month test year average of $1,652,000 jurisdictional ($2,037,000 system). [Labrato. R. 1096; Exhibit 54, Schedule 1] As discussed in more detail in Issue 72, the deferred balance at the beginning of the test year should be amortized over three years. [Labrato, R. 1096; Exhibit 54, Schedule 1] As noted earlier in the discussion of this issue, before proposed agency action Order No. PSC-99-1047-PAA-EI was later withdrawn as part of a stipulation settling other issues, the Commission had approved amortization of what was then a larger deferred balance over a three-year period.

ISSUE 9B: Should the third floor of the corporate offices be allowed in rate base?

**

SUMMARY:

> Yes. In Gulf's last rate case, the Commission ordered the Company to remove the cost of the third floor from rate base, but allowed the Company to earn a deferred return on that investment in anticipation of future recovery. The third floor is fully utilized and the investment, as well as the deferred return, should be allowed in rate base.

**

DISCUSSION:

The third floor of the corporate office should be allowed in rate base. The rate base amounts related to this investment in the projected test year consist of $3.8 million of plant-in-service and $338,000 of accumulated depreciation. These are the amounts deferred by the Commission in Gulf's last rate case for future recovery by the Company. [Labrato, R. 619]

The Company currently utilizes 100 percent of the 52,000 square feet of space on the third floor. The third floor, which consists of unfinished space, is primarily used for records retention, spare office furniture, miscellaneous supplies, and other storage for the print shop,

safety and health, and power delivery functions. It also contains a workshop for building maintenance. The investment made in the third floor was a prudent investment decision, which has allowed for convenient, secure and humidity-controlled storage space for items that are used in the corporate office. Gulf's ratepayers receive a benefit from the Company's use of the third floor for storage and maintenance. If this space were not available, Gulf would be required to build or lease additional space to perform these functions. [Labrato, R. 619, 644, 646, 1097]

In 1999, the Commission audit staff toured the third floor and concluded that over 90% of the 52,000 square feet of space was utilized. As noted in the discussion of Issue 9A, the Commission initially approved placement of the third floor investment in Gulf's retail rate base starting in 1999. [See Order No. PSC-99-1047-PAA-EI, which was later superseded by a settlement stipulation approved in Order No. PSC-99-2131-S-EI] The Commission audit staff in the current case again toured the space and concurs with the utility's statement that the third floor is used and useful for utility operations. [Bass, R. 907; Exhibit 47 at Disclosure No. 2 on page 8] As a result, no rate base adjustment to the Company's filing in this case is necessary or appropriate.

ISSUE 10: Stipulated

ISSUE 11: Dropped

ISSUE 12: What are the appropriate adjustments, if any, that should be made to Gulf's test year rate base to account for the additional security measures implemented in response to the increased threat of terrorist attacks since September 11, 2001?

**

SUMMARY:

A $683,000 adjustment ($714,000 system) should be made to increase rate base for the May 2003 projected test year to reflect the impact of investments in additional security measures implemented in response to the increased threat of terrorist attacks since September 11, 2001.

**

DISCUSSION:

Jurisdictional rate base should be increased by $683,000 to reflect the impact of investments made in response to the increased threat of terrorist attacks since September 11, 2001. As shown on Confidential Exhibit 7 at Staff Interrogatory No. 238, page 2, this rate base amount represents additional production plant and general plant-in-service, net of accumulated depreciation. No intervenor took a position on this issue, and there is no evidence in the record that questions the amount of Gulf's request.

ISSUE 13: Should the capitalized items currently approved for recovery through the Environmental Cost Recovery Clause be included in rate base for Gulf?

**

SUMMARY:

No. The Company filed its case assuming that the capitalized items currently approved for recovery through the Environmental Cost Recovery Clause ("ECRC") would continue to be recovered through the ECRC. The ECRC factors approved by the Commission for 2002 were calculated consistent with this assumption. The impact on customers is essentially the same whether the costs are recovered through base rates or through the ECRC.

**

DISCUSSION:

The capitalized items currently recovered through the Environmental Cost Recovery Clause ("ECRC") should continue to be recovered through that mechanism and should not be included in rate base in this proceeding. There is no basis in the record to support changing the mechanism by which these costs are currently recovered. The Company filed its case assuming that the capitalized items currently approved for recovery through ECRC would continue to be recovered through that mechanism, and the ECRC factors approved by the Commission for 2002 were calculated consistent with this assumption. The impact on customers is essentially the same whether the costs are recovered through base rates or through the ECRC.

This issue was retained in the case by OPC. According to its prehearing position, OPC believes that capital items are "more appropriately" recoverable in base rates and states that Section 366.8255(5) "suggests their incorporation into base rates during a rate case." As indicated in that position, OPC regards this as a legal and policy issue and therefore presented no witness on the topic.

Gulf submits that OPC has misread the statute and mischaracterized this issue as solely one of law and policy. First, the statute not only permits the recovery through the ECRC of capital investments incurred in complying with environmental laws or regulations, it also suggests that ECRC is the preferred recovery mechanism. In this regard, Section 366.8255(2) provides in part that:

> If approved, the commission shall allow recovery of the utility's prudently incurred environmental compliance costs. . .through an environmental compliance cost recovery factor that is separate and apart from the utility's base rates. An adjustment for the level of

> costs currently being recovered through base rates or other rate-adjustment clauses must be included in the filing. (Emphasis added.)

This language contemplates that the ECRC will include all environmental costs that are not already being recovered through base rates at the time a petition is filed to recover particular costs through the clause.

In addition, Section 366.8255(5), cited by OPC in its prehearing position, provides that:

> Recovery of environmental compliance costs under this section does not preclude inclusion of such costs in base rates in a subsequent rate proceeding, if that inclusion is necessary and appropriate; however, any costs recovered in base rates may not also be recovered in the environmental cost-recovery clause. (Emphasis added.)

While this section does not foreclose the inclusion of environmental compliance costs in base rates in a rate proceeding, such inclusion is permitted only if "necessary and appropriate." Whether the inclusion of such costs in base rates is "necessary and appropriate" is at least in part a question of fact. Since OPC elected to put forward no evidence, and no policy testimony, as to why it is either necessary or appropriate to include any of these capital costs in base rates, the record contains nothing that would support a change in the current status quo.

ISSUE 14: Dropped

ISSUE 15: Stipulated

ISSUE 16: Is Gulf's requested level of Plant in Service in the amount of $1,966,492,000 ($2,015,013,000 system) for the May 2003 projected test year appropriate?

**

SUMMARY:

No. The requested level of plant-in-service should be adjusted by $926,000 to a new total of $1,967,418,000 on a jurisdictional basis (or by $961,000 to $2,015,974,000 on a system basis) to reflect the increased investment associated with additional security measures discussed in Issue 12 and the capitalization of underground cable injection costs discussed in Issue 64.

**

DISCUSSION:

This issue is primarily a fall-out of Issues 6 to 15. As demonstrated by Gulf's discussion of those issues, an adjustment should be made to increase Gulf's requested level of plant-in-service by $774,000 (jurisdictional) to reflect the investment associated with the additional security measures undertaken in response to the increased threat of terrorist attacks since September 11, 2001. [See Issue 12; Confidential Exhibit 7 at Staff Interrogatory 238, page 2] In addition, as discussed in Issue 64, Gulf is prepared to capitalize its cable injection costs. This results in a $152,000 increase in plant-in-service.

ISSUE 17: Stipulated

ISSUE 18: Is Gulf's requested level of accumulated depreciation in the amount of $854,099,000 ($876,236,000 system) for the May 2003 projected test year appropriate?

**

SUMMARY:

No. The requested level of accumulated depreciation should be reduced by $926,000 ($960,000 system) to reflect the stipulation to a longer depreciable life for Smith Unit 3, the effect of Gulf's recommended adjustments related to additional security measures, and capitalization of cable injection costs.

**

DISCUSSION:

The test year average jurisdictional balance of accumulated depreciation should be reduced by $926,000 to $853,173,000. The major portion of this change is the result of a stipulation, which increased the depreciable life of Smith Unit 3 to 25 years and reduced the accumulated depreciation for the test year by $1,019,000 ($1,057,000 system) for purposes of this rate case. [Stipulation for Settlement of Depreciation Issues, page 6] Except for that change, and any fall-out change resulting from other issues, the stipulation accepted the depreciation rates and dismantlement accrual as filed by the Company in this docket and Docket No. 010789-EI. [Stipulation, pages 6-7] The Commission approved that stipulation at the start of the hearing. [R. 12-15]

The reduction associated with Smith Unit 3 is offset in part by additional accumulated depreciation of $91,000 (jurisdictional) associated with investment in additional security measures (see Issue 12) and additional accumulated depreciation of $2,000 (jurisdictional) associated with Gulf's proposal to capitalize, rather than expense, cable injection costs (see Issue 64). [Confidential Exhibit 7 at Staff Interrogatory 238, page 2]

ISSUE 19: Stipulated

ISSUE 20: Stipulated

ISSUE 21: Stipulated

ISSUE 22: Stipulated

ISSUE 23: Stipulated

ISSUE 24: Should any adjustment be made to Gulf's fuel inventories?

**

SUMMARY:

No. Gulf's requested fuel inventory is reasonable, prudent and in the best interest of Gulf's customers. Gulf's inventory management policy balances the cost of replacement fuel and/or energy against the carrying cost of inventory. Any reduction in the allowed inventory would result in higher fuel cost and could impair the reliability of Gulf's generation. The inventory requested in this case, including in-transit, is $3 million lower than the amount allowed in Gulf's last rate case.

**

DISCUSSION:

No adjustment should be made to Gulf's fuel inventories. The amount requested to be included in working capital for fuel inventory, including in-transit fuel, is a reasonable and prudent amount, which is necessary to ensure that Gulf's customers receive reliable service at the lowest possible cost. [Moore, R. 415, 999]

Gulf has requested total fuel inventory of $42.4 million for the May 2003 projected test year. This includes $29.4 million for fuel stock and $13.0 million for in-transit fuel. [Moore, R. 412] This request is $3 million below the amount approved by the Commission in Gulf's last rate case. This reduction is the result of Gulf's proactive approach to efficiently manage its fuel inventory. This reduction has been achieved even though Gulf's current request includes

$2.1 million for natural gas related primarily to Smith Unit 3, a fuel, which was not included in inventory in the prior case. [Moore, R. 418-419]

Gulf's policy for coal inventory is to maintain plant inventory at levels sufficient to safeguard against disruptions in supply and inconsistencies in the delivery of coal due to weather conditions and other factors affecting the transportation sector. The determination of an appropriate inventory level makes use of computer models, which evaluate the economics of being forced to procure coal in the spot market versus the costs associated with carrying various levels of inventory. The model results are considered in light of specific plant logistics and other market intelligence to set inventory target levels. This analysis resulted in target levels for the May 2003 projected test year of approximately 40 normal full load (NFL) days for Gulf's barge-served coal plants and 20 to 37 NFL days for its rail-served plants. [Moore, R. 412-413] The requested average inventory level of 36 NFL days translates to approximately 52 days "projected burn days," which is less than the projected burn allowed in the last rate case. [Moore, R. 983, 986] Because Gulf pays its coal suppliers upon shipment, the working capital request also includes $13.0 million for in-transit coal. This amount takes into account the time involved in transporting coal to the plant sites, which ranges from approximately 10 days for Illinois Basin coal under favorable weather conditions to over a month for some offshore coal supplies. [Moore, R. 414, 985]

Gulf's current policy is to maintain a certain portion of its natural gas requirements in storage to provide for pipeline balancing (which is necessary to avoid economic penalties associated with large swings in daily and hourly demands) and to protect against natural gas

supply interruptions. The current target level is ten NFL days (or approximately 17.5 projected burn days) for Smith Unit 3 and approximately ten projected burn days for Plant Crist. In addition to coal and natural gas, Gulf also maintains a modest amount of distillate oil inventory. [Moore, R. 414-415]

OPC witness Schultz recommended an $8,130,000 reduction to Gulf's fuel inventory based on his calculation of an adjusted average inventory level for the year 2000 and a 20% reduction in in-transit coal. [Schultz, R. 793-794] This proposed adjustment is flawed for a number of reasons, including:

(1) Mr. Schultz arbitrarily chose to base his recommendation on actual inventory levels during the year 2000, which he erroneously believes is the test year for this case. He made no investigation to determine if 2000 was a representative year, even though he recognized that fuel inventories during 2000 were lower than in both 1999 and 2001. [Schultz, R. 832-834] In fact, year 2000 is not representative. Gulf's inventory levels dropped significantly in the last quarter of 2000 due to very early and prolonged winter conditions, unprecedented high natural gas prices, and the resulting increase in demand for coal-fired generation. This increased demand came at a time when winter conditions affected both coal production at the mines and coal deliveries. As a result, Gulf's inventories reached unusually low levels during late 2000. [Moore, R. 985] Since then, Gulf has prudently rebuilt its inventory levels. By May 2001, the inventory level was well above the average amount included in Gulf's test year request. [Moore, R. 986]

(2) Mr. Schultz inexplicably adjusted the year 2000 average to include coal for Smith Unit 3, even though it is a natural gas fired unit which does not burn coal. [Schultz, R. 834-835]

(3) Mr. Schultz improperly removed $2.6 million of coal for Plant Scherer even though no coal for that plant was included in the base number to which he applied the adjustment. [Schultz, R. 837-838]

(4) After making a 20% reduction in Gulf's requested coal inventory level, Mr. Schultz then made a similar 20% adjustment to the requested in-transit amount. [Schultz, R. 794, 835] This reflects his lack of knowledge of how coal-fired power plants operate. The purpose of in-transit coal is to assure an adequate supply of coal to meet burn requirements. In order to maintain a desired stockpile level, the average daily amount of coal delivered must approximate the burn. [Moore, R. 987] The amount of in-transit coal is thus a direct function of the average daily burn and the average transit time. Regardless of the stockpile level, if the amount of in-transit coal is less than the average amount burned, the stockpile will be exhausted. [See Schultz, R. 835-837]

The effect of Mr. Schultz's proposed adjustment would be to reduce inventory levels to an average of only 24.8 NFL days. This would be a dangerously low target level for Gulf. It would provide very little reserve for coal supply interruptions. Such a low level could result in reliability issues, or the required purchase of high-cost off-system replacement energy, if Gulf were again to face the type of supply reductions and delivery delays that were encountered in 2000. [Moore, R. 985-987, 999]

In summary, the fuel inventory requested by Gulf is a prudent amount and is designed to achieve an optimum fuel level which balances the carrying cost of fuel stockpiles against the risks associated with interruptions in fuel supply. [Moore, R. 986-987, 999]

ISSUE 25: Is Gulf's requested level of Working Capital in the amount of $67,194,000 ($69,342,000 system) for the May 2003 projected test year appropriate?

**

SUMMARY:

No. The requested level of working capital should be reduced by $693,000 to $66,501,000 on a jurisdictional basis (or by $855,000 to $68,487,000 on a system basis) to reflect a change in the balance of the deferred return on the third floor of the corporate office.

**

DISCUSSION:

This issue is a fall-out of Issues 9A and 24. As demonstrated by Gulf's discussion of those issues, the only adjustment that should be made to Gulf's requested level of jurisdictional working capital is a reduction of $693,000 (to $66,501,000) to reflect a change in the balance of the deferred return on the third floor of the corporate office building. [See Issue 9A]

ISSUE 26: Dropped

ISSUE 27: Is Gulf's requested rate base in the amount of $1,198,502,000 ($1,227,644,000 system) for the May 2003 projected test year appropriate?

**

SUMMARY:

No. The requested rate base should be revised to $1,199,661,000 on a jurisdictional basis to reflect the impact of the: (a) adjustment to working capital from changes in the deferred return on the third floor of the corporate office; (b) adjustments to plant-in-service and accumulated depreciation due to additional security measures; (c) adjustment to accumulated depreciation resulting from the stipulation reducing depreciation for Smith Unit 3; and (d) capitalization of cable injection costs.

**

DISCUSSION:

This issue is primarily a fall-out of Issues 6 through 26. As demonstrated in Gulf's discussion of those issues, adjustments to jurisdictional rate base result from (a) the adjustment to working capital for the reduction in the balance of the deferred return on the third floor of the corporate office, (b) the adjustments to plant-in-service and accumulated depreciation due to additional security measures, and (c) the adjustment to accumulated depreciation resulting from the Commission-approved stipulation reducing depreciation for Smith Unit 3.

In addition, as discussed in Issue 64 relating to cable inspection expense, Gulf is willing to accept the Staff's position that the cost of the cable injection program should be capitalized rather than expensed. If this proposal is approved by the Commission, jurisdictional rate base will increase by $150,000. This is the net of the capital investment ($152,000 jurisdictional) and the increased balance of accumulated depreciation ($2,000 jurisdictional).

These changes are summarized in the following table:

Summary of Rate Base Adjustments to MFRs
($000's)

Rate Base Components	(1) Jurisdictional Rate Base Per MFRs	(2) Adjustments	(3) Adjusted Rate Base (1) + (2)	(4) Basis for Adjustment
Plant-in-Service	1,966,492	926	1,967,418	See Issues 12, 16 and 64 (Note 1)
Less: Accumulated Depreciation and Amortization	854,099	(926)	853,173	See Issues 12, 18 and 64 (Note 2)
Net Plant-in-Service	1,112,393	1,852	1,114,245	--
Plant Held for Future Use	3,065	0	3,065	Stipulation 13
Construction Work in Progress	15,850	0	15,850	Stipulation 11
Net Utility Plant	1,131,308	1,852	1,133,160	
Working Capital Allowance	67,194	(693)	66,501	See Issues 9A and 25 (Note 3)
Total Rate Base	1,198,502	1,159	1,199,661	--

Note 1: Includes additional investment related to additional security measures and cable injection.

Note 2: Includes effect of investments related to additional security measures, cable injection, and change in depreciation rate for Smith Unit 3.

Note 3: Includes effect of change in balance of deferred return on third floor.

ISSUE 28: Dropped

ISSUE 29: What is the appropriate amount of accumulated deferred taxes to include in the capital structure?

**

SUMMARY:

The appropriate amount of accumulated deferred taxes is $121,587,000 jurisdictional ($124,565,000 system) for purposes of calculating the weighted average cost of capital. This amount has been revised from the jurisdictional amount $121,471,000 as originally filed to reflect the revised reconciliation of rate base and capital structure discussed in Issue 31.

**

DISCUSSION:

The appropriate amount of accumulated deferred taxes to include in the jurisdictional capital structure for the June 2002 through May 2003 test year is $121,587,000. This amount was derived by first calculating the unadjusted total company amount of $164,672,000, shown as line items "deferred taxes" and "regulatory tax assets/liabilities" on Mr. Labrato's Exhibit RRL-1, Schedule 18, page 2, and on the revised Schedule 18, page 2, filed as Exhibit 2 to Mr. Labrato's deposition. [Exhibit 37 and Exhibit 11, respectively] The unadjusted total company amount was derived by calculating the 13-month average of the projected balances shown on Schedule 3 of Exhibit RRL-1. [Exhibit 37] Adjustments were then made to the total company amount to remove the deferred taxes specifically identified with unit power sales contracts, which was explained in the response to Staff's Interrogatory No. 131, and to remove the appropriate portion of other rate base adjustments which were made on a pro rata basis over all sources of capital. [Exhibit 3, pages 29-30] The rate base adjustments discussed in Issue 27 were also allocated to deferred taxes on a pro rata basis. The resulting total adjusted deferred taxes of $124,565,000 were then allocated to the retail and wholesale jurisdictions to derive the jurisdictional amount of $121,587,000. [Labrato, R. 627-629]

ISSUE 30: What is the appropriate amount and cost rate of the unamortized investment tax credits to include in the capital structure?

**
SUMMARY:

The appropriate amount of unamortized investment tax credits is $16,601,000 jurisdictional ($17,007,000 system) and the appropriate cost rate is 9.48% for purposes of calculating the weighted average cost of capital.
**

DISCUSSION:

The appropriate amount of unamortized investment tax credits to include in the jurisdictional capital structure for the June 2002 through May 2003 test year is $16,601,000. This amount has been revised from the jurisdictional amount of $16,584,000 as originally filed to reflect the revised reconciliation of rate base and capital structure as discussed in Issue 31. The appropriate amount of unamortized investment tax credits of $16,601,000 (jurisdictional) was derived by first calculating the unadjusted total company amount of $22,113,000, as shown on Mr. Labrato's Exhibit RRL-1, Schedule 18, page 2, and on the revised Schedule 18, page 2, filed as Exhibit 2 to Mr. Labrato's deposition. [Exhibit 37 and Exhibit 11, respectively] The unadjusted total company amount was derived by calculating the 13-month average of the projected balances shown on Schedule 3 of Exhibit RRL-1. [Exhibit 37] Adjustments were then made to the total company amount to remove the investment tax credits specifically identified with unit power sales contracts, which was explained in Staff's Interrogatory No. 131, and to remove the appropriate portion of other rate base adjustments which were made on a pro rata basis over all sources of capital. [Exhibit 3, pages 29-30] The rate base adjustments discussed in Issue 27 were also allocated to unamortized investment tax credits on a pro rata basis. The

resulting total adjusted unamortized investment tax credits of $17,007,000 was then allocated to the retail and wholesale jurisdictions to derive the jurisdictional amount of $16,601,000. [Labrato, R. 627-629]

The appropriate cost rate of unamortized investment tax credits for purposes of calculating the weighted average cost of capital is 9.48%. The investment tax credit cost rate has been revised from 9.70% as originally filed to reflect the changes in amounts and rates of the long-term debt and preferred stock sources of capital. [Exhibit 11, pages 27-30] The weighted cost for investment tax credits is calculated in accordance with current IRS regulations using the three main sources of capital as shown in the Company's response to Staff's Interrogatory No. 132. [Labrato, R. 628; Exhibit 3, pages 27-28]

ISSUE 31: Have rate base and capital structure been reconciled appropriately?

**

SUMMARY:

> Yes. The reconciliation of rate base and capital structure for the current filing is presented in MFR Schedule D-12a, and the proposed adjustments to rate base discussed in other issues have been reconciled on a pro rata basis over all sources of capital to determine the appropriate jurisdictional capital structure for use in the calculation of the overall cost of capital [see Issue 36].

**

DISCUSSION:

The reconciliation of rate base and capital structure for the current filing is shown on Mr. Labrato's Exhibit RRL-1, Schedule 18, page 2 of 4, as revised January 31, 2002, and filed as Exhibit 2 of Mr. Labrato's deposition. [Exhibit 11] Five adjustments were identified and removed from specific classes of capital, including an adjustment to remove non-utility

investment from equity and adjustments to remove the unit power sales capital structure amounts. The remaining rate base adjustments required to reconcile the rate base and capital structure were made on a pro rata basis consistent with the capital structure methodology approved in Gulf's last rate case. [Labrato, R. 628-629] The Company's response to Staff's Interrogatory No. 130 provides a justification for removing the remaining rate base adjustments at the Company's overall cost of capital and references two Commission orders from Gulf's prior rate proceedings that support this treatment. [Exhibit 3, pages 29-31] Also, a reconciliation of total company rate base, as shown on Mr. Labrato's Exhibit RRL-1, Schedule 6, page 1, to total company capital structure, as shown on Exhibit RRL-1, Schedule 18, page 2, was provided in response to Staff's Interrogatory No. 124. [Exhibit 3, page 19]

The reconciliation of rate base and capital structure as presented in Mr. Labrato's Exhibit RRL-1, Schedule 18, page 2 of 4, as revised January 31, 2002, and filed as Exhibit 2 of Mr. Labrato's deposition has been updated in the table below to reconcile the proposed adjustments to rate base as discussed in other issues on a pro rata basis over all sources of capital.

	($000's)				($000's)
	Note (1) Total Adjusted Capital Structure Net of UPS	Note (2) Additional Post Filing Adjustments To Rate Base	Revised Adjusted Capital Structure Net of UPS	Jurisdictional Factor	Note (3) Jurisdictional Capital Structure
Long-term Debt	433,355	375	433,730	0.9760999	423,364
Short-term Debt	34,525	30	34,555	0.9760999	33,729
Preferred Stock	101,052	88	101,140	0.9760999	98,723
Common Equity	504,014	438	504,452	0.9760999	492,396
Customer Deposits	13,249	12	13,261	1.0000000	13,261
Deferred Taxes	114,946	100	115,046	0.9760999	112,296
Regulatory Tax Asset/Liability	9,511	8	9,519	0.9760999	9,291
Investment Credit-Weighted Cost	16,992	15	17,007	0.9760999	16,601
Total	1,227,644	1,066	1,228,710		1,199,661

Note (1) – Amounts per Mr. Labrato's Exhibit RRL-1, Schedule 18, page 2 of 4, column 10, as revised January 31, 2002, and filed as Exhibit 2 of Mr. Labrato's deposition. [Exhibit 11]

Note (2) – See system amounts of adjustments to rate base as discussed in Issues 9A, 12, 18, and 64. These rate base adjustments were spread on a pro rata basis.

Note (3) – Ties to total adjusted jurisdictional rate base as shown in Issue 27.

ISSUE 32: Stipulated

ISSUE 33: Stipulated

ISSUE 34: In setting Gulf's return on equity ("ROE") for use in establishing Gulf's revenue requirements and Gulf's authorized range, should the Commission make an adjustment to reflect Gulf's performance?

**

SUMMARY:

Yes. In recognition of Gulf's past and continuing high level of performance in customer satisfaction, customer complaints, transmission and distribution reliability, and generating plant availability, the Commission should increase the return on equity for purposes of setting rates by a minimum of 50 to 100 basis points over the Company's cost of equity.

**

DISCUSSION:

In recognition of Gulf's past and continuing high level of performance in customer satisfaction, customer complaints, transmission and distribution reliability, and generating plant availability, the Commission should increase the Company's return on equity for purposes of setting rates by a minimum of 50 to 100 basis points over the Company's cost of equity and expand the authorized return on equity range to 150 basis points or more above and below the return on equity used for setting rates. [Labrato, R. 1102-1103] By doing so, the Commission would be sending a message to both the Company and to customers that these areas are important. This is a proper incentive to the Company to promote superior performance in the future and would recognize the Company's past superior efforts. [Bowden, R. 84] Mr. Breman supports rewarding the Company if it provides superior service. [Breman, R. 867; Labrato, R. 1099]

It is well-settled law that the Commission has the legal authority to make adjustments to the rate of return for a utility to account for management efficiency. In Commission Order No. 23573, the Commission stated that the more efficient utility should be rewarded. The

Commission's actions with regard to management efficiency in that case were upheld in Gulf Power Co. v. Wilson, 597 So.2d 270 (Fla. 1992). In Commission Orders 10557-EI and 9628-EI, the superior efforts regarding conservation were recognized by the Commission and the utility was rewarded with a 10 basis point increase to its rate of return. Recently, in Order No. PSC-99-1047-PAA-EI, the Commission proposed to set Gulf's midpoint return on equity 50 basis points higher than the level recently approved for another investor owned electric utility based in part on Gulf's record of superior performance. Although Order No. PSC-99-1047-PAA-EI was later withdrawn as part of the stipulation approved in Order No. PSC-99-2131-S-EI, the resulting ROE was approved by the Commission in Order No. PSC-99-1970-PAA-EI, consummated by Order No. PSC-99-2147-CO-EI. Other jurisdictions have also rewarded utilities for superior performance. For example, in Docket No. 01-UN-0548 on December 3, 2001, the Mississippi Public Service Commission ("MPSC") approved the continued application of a performance-based rate plan for Mississippi Power Company. As a result of that decision, the plan currently operates to reward Mississippi Power for continued superior performance by setting rates at a level greater than 100 basis points above the cost of common equity for Mississippi Power as determined by the MPSC. By operation of the performance-based rate plan, the 11.75% cost of equity established by the MPSC translates into a rate setting point of 12.88%. [Bowden, R. 88]

Gulf Power Company has demonstrated through the testimony of several witnesses in this case, including customer testimony at Gulf's service hearings, that it has provided high quality service to its customers at low rates with excellent customer satisfaction ratings. [Labrato, R. 612; Fisher, R. 442, 1005] In fact, Mr. Burgess, on behalf of the citizens of the state of Florida,

began this proceeding stating that "Gulf is an efficient, well-run company" and that Gulf should be congratulated for providing high quality service without a rate increase since 1990. [R. 43] It is undisputed that Gulf's residential rate for 1000 kWh is among the lowest in Florida and in the nation. This remains true considering Gulf's proposed residential rate in this case. [Labrato, R. 612] Mr. Fisher testified that Gulf's goal is to be an industry leader in service and customer satisfaction. As a part of that goal, Gulf undertook initiatives to understand and be responsive to customers' needs and expectations. [Fisher, R. 442, 460] The record of this proceeding reveals that Gulf has been very successful in achieving this goal. In addition to Mr. Burgess' statement about Gulf's high quality service, several of Gulf's customers testified at the customer service hearings held in Pensacola and Panama City that they felt that Gulf provided "excellent" or "outstanding" service.[2] Not one customer at either of the customer service hearings had a negative comment about Gulf's electric service or customer care. [Fisher, R. 459] Gulf has a low level of customer complaints and has had no FPSC rules infractions in three and a half years. [Fisher, R. 482-83, 1005] In addition, Gulf has performed very well in independent surveys which are conducted annually and include comparisons among peer utilities. Gulf ranked first in overall customer satisfaction last year among major utilities in a national customer value and

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[2]For example, at the January 16, 2002 Customer Service Hearing in Pensacola, Paul Goudy stated ". . . I would also like to comment on the service. I believe it is excellent. I have absolutely no complaints except for squirrels who knock us out but that is taken care of very rapidly." [Pensacola Customer Service Hearing, Transcript at page 26] John Marts stated "And I would like to say though, I'll save it to last, that Gulf Power service is excellent. I have absolutely no complaint at all. I'm very pleased with it. I have been other places. It's good." [Pensacola Customer Service Hearing, Transcript page 30] Jeff Schembera, of Okaloosa-Walton Junior College, stated ". . . we think that their involvement in the community and their work with their customers has been outstanding and that the quality of service is outstanding and we would just like to attest to that." [Pensacola Customer Service Hearing, Transcript at page 34]

satisfaction survey. [Exhibit 12, Schedule 2; R. 1020] The Company was ranked among the best for residential, general business and large business customers. [Exhibit 12, Schedule 3; R. 442-443] The System Average Interruption Duration Index ("SAIDI"), an industry recognized measure of distribution system reliability, improved 19 percent between 2000 and 2001. [Fisher, R. 1020] In the Public Confidence Survey regarding "Providing Reliable Service" the Company has earned high marks with 93 percent of the respondents giving a favorable response regarding Gulf's reliability. [Fisher, R. 1019-1020] Likewise, Gulf has maintained high system reliability with regard to its generation fleet while maximizing the performance of its generation units. The transmission system reliability has also been superior. [Moore, 423-424]

The Commission should recognize the Company's past and continuing high level of performance in customer satisfaction, customer complaints, transmission and distribution reliability, and generating plant availability, by increasing the return on equity for purposes of setting rates by a minimum of 50 to 100 basis points over the Company's cost of equity. Nothing in the record disputes that Gulf has performed in a superior manner in keeping its rates low while maintaining high levels of reliability, service and customer satisfaction.

<u>ISSUE 35</u>: What is the appropriate ROE to use in establishing Gulf's revenue requirement?

**

SUMMARY:

> The appropriate ROE to use in establishing Gulf's revenue requirements is 13.0%, plus an adjustment of 50 to 100 basis points to reflect Gulf's superior performance in terms of reliability, low prices, and customer satisfaction. This adjusted ROE should be used as the rate setting point, and as the center of the authorized range of ROE established in Issue 37.

**

DISCUSSION:

The determination of the cost of a utility's equity capital is probably the most important and complex ratemaking function of a regulatory agency. Since most of the other elements included within the cost of capital calculation are fixed, it is the cost of equity capital that effectively determines the overall cost of capital and, in turn, the fair rate of return which the utility will be given the opportunity to earn.

Legal Standard

The determination of a fair rate of return must be made within the legal standards fixed primarily by three decisions of the Supreme Court of the United States. The Court's first decision, Bluefield Waterworks & Improvement Co. v. Public Service Commission of West Virginia, 262 U.S. 679 (1923), established the principle that a public utility is entitled to earn a return on the value of its property equal to that generally being made at the same time and in the same general part of the country on investments in other business undertakings. In the second case, Federal Power Commission v. Hope Natural Gas Company, 320 U.S. 591 (1944), the Court elaborated on the comparable earnings test by saying that the utility's return on equity should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital. In the third case, Permian Basin Area Rate Case, 390 U.S. 747 (1968), the Supreme Court held that there is no single yardstick or sole criteria which must be considered in the determination of the fair and reasonable rate of return, but that regulatory decisions should reasonably be expected to maintain financial integrity, attract necessary capital, and fairly compensate investors for the risk they have assumed. The U.S. Supreme Court more recently

confirmed the criteria set forth in these cases in Duquesne Light Co. v. Barasch, 488 U.S. 299 (1989).

Gulf's Cost of Common Stock Equity

Mr. Benore applied the principles articulated in this line of Supreme Court cases in making his recommendation that the appropriate return on common stock equity for Gulf is at least 13.0%. [Benore, R. 119-120] In developing his recommendation, Mr. Benore began with the cost of common stock definition provided by Petty, Keown, Scott and Martin in Basic Financial Management, 6th edition. Under that definition, the cost of common stock is the rate of return the firm must earn in order for the common stockholders to receive their required return. [Benore, R. 138] The first step in applying that definition is to determine the market return required by investors. The next step is to convert the investor-required market return into the book return, or regulatory allowed return, that is necessary to enable investors to have an opportunity to achieve their required market return, which is a process Mr. Benore refers to as transformation. [Benore, R. 138-139]

To estimate the market return required by investors, Mr. Benore employed three different market-based models, the discounted cash flow ("DCF") model, the equity risk premium ("ERP") model, and the capital asset pricing model ("CAPM"). [Benore, R. 138] A detailed description of the methodology and data inputs initially used for each model were presented in Exhibit 26, Schedules 7, 8 and 9. Mr. Benore then converted the results of these models through the process he refers to as transformation in order to determine the regulatory book return that is necessary in order for investors to have the opportunity to earn the required market return

indicated by the models. As discussed in more detail below, such transformation is a necessary prerequisite to capital attraction and reliable utility service to customers. [Benore, R. 130-131, 138-139] In addition, Mr. Benore performed a comparable earnings analysis to determine the investor-expected return on common stock equity. Because the comparable earnings method provides a book-to-book comparison, there is no need for transformation. [Benore, R. 139, 141-142] A description of the methodology and data inputs for the comparable earnings analysis is presented in Exhibit 26, Schedule 10.

For each model, Mr. Benore used a group of seven companies determined to be comparable to Gulf on a variety of risk indicators.[3] [Exhibit 29, Schedule 23] The results of all four models were summarized on Exhibit 26, Schedule 1a. This analysis led Mr. Benore to conclude that at least a 13.0% return on common stock equity is necessary for Gulf to (i) fulfill investor expectations, (ii) enable Gulf to reliably access the capital markets in good and bad market conditions, and (iii) continue to provide reliable service at reasonable cost to its customers. [Benore, R. 143] As noted by Mr. Bowden, a financially sound utility is better able to take advantage of opportunities, can negotiate better deals for goods and services and is ultimately able to provide service at much lower rates than a company with a weak financial position. [Bowden, R. 85-86]

Mr. Benore subsequently updated his analyses at the time of his rebuttal testimony in order to use the most recent information available on stock prices, bond yields, Value Line

[3] Mr. Benore's initial analysis used a group of eight companies. He subsequently determined that C.A. Turner's published bond rating information for Progress Energy was incorrect, leading to its elimination from the group at the time of his updated analysis. [Benore, R. 325]

earnings and dividend projections, and other data. The results of this update are summarized on Exhibit 29, Schedule 21. While this update indicated a moderately higher cost of capital, Mr. Benore made no change in his final recommendation of a 13.0% cost of equity. [Benore, R. 326]

The results of Mr. Benore's updated analysis are as follows. Except for the final recommended return, all estimates exclude flotation costs of 0.2%. [Exhibit 29, Schedule 21]

Gulf's Cost of Common Stock Results
Without and With Transformation

Test	Standard Test Results	Transformed (reflects actual price/book ratio)
Standard DCF (Note 1)	12.1%	14.2%
Equity Risk Premium (Note 1)	11.2%	13.3%
Standard CAPM Empirical CAPM Average of Standard and Empirical CAPM (Note 1)	10.6% 11.6% 11.1%	13.2%
Comparable Earnings Test	13.5%	13.5%
Average of Four Tests Range of Four Tests Midpoint of Four Test Range		13.6% 13.2% to 14.2% 13.7%
Recommended Return for Gulf		at least 13.0%

Note 1: Standard results assume a price-to-book ratio of 1.0 times.

CAPM Understates Investor Required Market Return

Empirical research shows that the standard CAPM understates the investor required market return for small stocks and for stocks with a low beta, both of which apply to Gulf. [Benore, R. 303; Exhibit 26, Schedule 9, pages 3-4]

Mr. Benore also noted that electric utility stocks have detached themselves from the market since regulatory restructuring concerns surfaced about a decade ago. Electric utility stocks have moved sideways as selling pressures overwhelmed buying and caused the stocks to dramatically under-perform the market on a risk adjusted basis. [Benore, R. 303-304; see Exhibit 29, Schedule 22] This disconnect from the market has reduced the beta for electric stocks from what it otherwise would have been. Beta therefore understates investor risk and the investor required market return as the industry moves from a monopoly to a more competitive structure. Rising risk is confirmed by the increasing yield on single A utility bonds versus long-term treasury bonds shown on Schedule 3 of Exhibit 26. [Benore, R. 304; Exhibit 26, Schedule 3]

For all of these reasons, the CAPM model is likely to understate the investor required market return for Gulf under the market conditions which prevail at this time. [Benore, R. 303-304]

Necessity for Transformation

Transformation is necessary in order to provide investors with the opportunity to earn the returns that are estimated by market-based models such as the DCF, ERP, and CAPM. When properly used, these models do indicate the investor-required market return. However, the book return set by regulators does not produce the market return required by investors except when price-to-book value ratios are not significantly different from 1.0. Under current market conditions, where prices are closer to 1.5 to 2.0 times book value, setting the regulatory return at the rate indicated by market-based models will not yield the growth rate and market return required by investors. [Benore, R. 126-127]

Mr. Benore illustrated this principle by a simple mathematical example which assumes that the current price-to-book value ratio is 1.6. This example shows that if the required market return calculated by the DCF model is 10.0%, the regulatory allowed book return must be set at 13.0% to give investors the opportunity to achieve their required market return. If instead the regulatory return is set at the 10.0% indicated by the DCF model, investors will have the opportunity to earn only 7.0%, significantly less than their required return. [Benore, R. 127-130, 147-148; Exhibit 26, Schedule 1b]

Transformation is necessary because both common sense and investment theory indicate that investors must receive fair compensation for the use of their capital. That compensation must be comparable, on a risk adjusted basis, to their other investment opportunities. Unless the allowed regulatory or book return for a regulated utility is set at a level that will give investors the opportunity to earn their required market return, they will turn elsewhere. [Benore, R. 130-131] From a customer perspective, transformation is therefore necessary to:

(1) avoid dictating rather than reflecting investor expectations, driving stocks to book value, causing investors to lose money, and repelling rather than attracting investors;

(2) insure that Gulf can maintain its financial integrity;

(3) provide Gulf's investors with an opportunity to earn competitive returns so that Gulf can attract capital in both good and bad markets; and

(4) protect Gulf's customers from higher risk and related capital costs, less reliable access to capital markets, and over time deteriorating service.

[Benore, R. 131; Exhibit 27, page 6]

From a more practical focus, electric utility stocks have substantially underperformed the S&P 500 over the last decade. This is due to a number of factors, including rising risk in the industry, declining profitability and investor desirability compared to other investment opportunities, and the inability of utility investors to earn their required returns unless transformation is used. If utilities are to maintain financial integrity, it is increasingly important that regulatory returns be set at (transformed) levels that will give investors an opportunity to earn returns comparable, on a risk-adjusted basis, to other investments available to them in the marketplace. [Benore, R. 124-126, 149-150; Exhibit 27, pages 7-8]

Performance Based Adjustment

As discussed in detail in Issue 34, the 13.0% cost of capital recommended by Mr. Benore should be adjusted upward for ratemaking purposes by 50 to 100 basis points to reflect Gulf's outstanding performance in terms of low prices, reliability and customer satisfaction.

Flaws in OPC's Cost of Capital Recommendation

OPC witness Rothschild recommended a cost of equity of only 10.0% based on his calculations using a single-stage DCF model, a two-stage DCF model, and two versions of a risk premium/CAPM method. [Rothschild, R. 170-175] His recommendation is flawed for a number of reasons, including errors in input data and calculations; use of arbitrary assumptions that ignore investor expectations; failure to account for the higher business risk associated with Gulf's

relatively small size; failure to account for flotation costs; and failure to recognize that his recommendation will yield only a 7.3% return to investors rather than the 10.0% he testifies they require. [Benore, R. 276, 331-334]

Mr. Benore identified numerous errors and mismatches in Mr. Rothschild's input data and calculations. These include, among others, incorrect market to book value ratios; incorrect number of shares outstanding; incorrect growth rate for common shares; use of artificially calculated prices, rather than actual prices, in his two-stage DCF calculation; incorrect book values; and inconsistent use of nominal interest rates to adjust real market returns. [Benore, R. 284, 290, 296-297, 298] After learning of these errors, Mr. Rothschild filed revised exhibits to correct only two isolated data errors. [Exhibit 14, pages 6-7] The other errors remain uncorrected.

Mr. Rothschild's testimony contains other errors and inconsistencies. For example, his footnote 6 makes reference to water companies and PSE&G in reference to quarterly dividend rate calculations [R. 198]; his testimony makes numerous references to gas distribution companies or gas utility stocks which he does not appear to have used in his analyses [R. 209, 212]; and several of the footnotes to his exhibits do not appear to tie to the calculations he actually made. [E.g., Exhibit 28, footnote [B] on revised JAR-5; Exhibit 28, footnote [A] on JAR-8]

One of the more significant problems with Mr. Rothschild's analyses is his use of personal judgment rather than investor expectations for important inputs such as expected returns on common stock equity, dividend policy, and reinvestment rates. For example, in both his

single-stage and two-stage DCF analyses, Mr. Rothschild ignored investor expectations for return on common stock as reported in Value Line and Zacks, and instead substituted his own lower numbers. [Benore, R. 285, 287-288, 291-292, 331-332] In the second stage of his two-stage DCF analysis, Mr. Rothschild did not carry-forward to 2006 the terminal retention rate from the last year of the first stage (47.39%) but instead reverted to a lower retention rate (41.33%) applicable in 2001. In effect, he substituted his personal view of the dividend policy of comparable companies for the investor expected dividend policy reported by Value Line. This change alone reduces his cost of equity calculation by 75 to 100 basis points. [Benore, R. 291, 332-333]

Finally, in his risk premium/CAPM analysis, Mr. Rothschild effectively uses a 4.0% equity risk premium to reflect the required market return on common stocks over the return on long-term U.S. Government bonds. This number, which was based on a 30-year moving average for the period 1926 to 2000, is one of the lowest that could be derived from the 75 years of historical data and is not representative of reasonable investor expectations. [Benore, R. 202-203, 335-336; see Exhibit 29, Schedule 17]

In his CAPM analysis, Mr. Rothschild ignored the empirical studies which show that the standard CAPM understates expected market returns for small companies like Gulf Power, which has a market capitalization of only about $630 to $640 million compared to the $5.3 billion average for companies in the comparable group used by both Mr. Rothschild and Mr. Benore. [Benore, R. 303, 333; Exhibit 26, Schedule 9, pages 3-4; Exhibit 29, Schedule 23] While this size differential would typically make approximately a 75 basis point difference in the

indicated cost of equity, Mr. Benore recognized that the favorable regulatory climate in Florida offsets some of this risk, and accordingly would reduce the small size allowance to approximately 25 basis points. [Benore, R. 333]

Mr. Rothschild's analyses also ignored flotation costs even though such costs are real and need to be recognized. The appropriate flotation cost adjustment is approximately 20 basis points. [Benore, R. 276, 282-283, 333-334; Exhibit 26, Schedule 11]

The most significant problem with Mr. Rothschild's analysis is that he recommended a 10.0% regulatory (book) return that will yield only a 7.3% market return to investors. This is lower than the market return of 7.7% available on Moody's Single A utility bonds, which is the same rating as Gulf enjoys. This result is shown on Exhibit 29, Schedule 11. A prospective market return (growth plus yield) that is less than the return on the company's bonds is an untenable investment prospect for investors. [Benore, R. 277-278, 334] If Mr. Rothschild's 10.0% recommendation were adopted by the Commission, stock prices would likely be driven toward book value. This would require a 39% drop, based on data for the list of companies comparable to Gulf. This reduction would repel investors, who simply do not invest in companies which they expect to experience a 39% decline in market value. [Benore, R. 278] As shown on Exhibit 29, Schedule 12, a regulatory return of 12.7%, before flotation costs, is necessary to provide investors with the opportunity to achieve the 10.0% market return that Mr. Rothschild testifies they require. [Benore, R. 278-279, 334]

Mr. Rothschild's criticisms of transformation are not valid. His "best illustration" of the claim that transformation produces inappropriate results is his statement that, using

transformation, the higher the stock price, the higher the return that Mr. Benore would recommend. [Rothschild, R. 224] That statement is simply incorrect. As demonstrated by Exhibit 26, Schedule 20, all other things being equal, an increase in stock price reduces the investor-required market return, but does not result in a higher book return on common equity. Further, if the investor-required market return drops as a result of the increase in stock price concurrent with an investor expected decline in the return on common stock equity, the necessary book return on common equity also declines. [Benore, R. 317-318, 336-337] Transformation is also consistent with the principles articulated in the Hope decision, not inconsistent as Mr. Rothschild claims. [Benore, R. 312,338-339]

Corrections to Rothschild's Analyses

Even without correcting the flaws in Mr. Rothschild's analyses, a regulatory return of 12.7% (before flotation costs) is needed to provide investors with the opportunity to achieve the 10.0% market return which Mr. Rothschild testifies they require. [Benore, R. 278-279, 334; Exhibit 29, Schedule 12]

When Mr. Rothschild's analysis is corrected to use investor expected returns on common stock equity as reflected by Value Line and Zacks, to use to the investor expected retention rate of 47.49% in the second stage of his two-stage DCF model, and to correct other noted errors, his analyses would support an allowed regulatory return of 13.5% to 14.2%, an amount which is higher than Mr. Benore's 13.0% recommendation. [Benore, R. 308-309]

Summary

In order to provide investors with an opportunity to earn returns comparable to those that they can achieve on a risk-adjusted basis in other investments, thereby maintaining Gulf's financial integrity and its ability to attract capital, the Commission should determine that Gulf's cost of equity capital is at least 13.0%, before any upward adjustment for superior performance.

ISSUE 36: What is the appropriate weighted average cost of capital including the proper components, amounts and cost rates associated with the capital structure?

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SUMMARY:

Based on a 13.0% cost of equity (before any performance-based adjustment), the appropriate weighted average cost of capital is 8.35% for the test year. This weighted average cost of capital utilizes the stipulated cost of short-term and long-term debt approved by the Commission and revised rates for preferred stock and investment tax credits. This weighted average cost is based on the reconciliation of rate base and capital structure described in Gulf's position on Issue 31.
**

DISCUSSION:

Based on a 13.0% cost of equity (before any performance-based adjustment), the appropriate weighted cost of capital is 8.35% for the projected test year. This amount, which is calculated as follows, utilizes updated costs for short-term and long-term debt as established by Commission-approved Stipulation Nos. 3 and 4 and updated cost rates for preferred stock and investment tax credits, which reflect the actual amounts and rates of all permanent financing impacting the May 2003 projected test year. [See Exhibit 11 (Deposition of Ronnie Labrato), at page 27 (deposition exhibit 2)] The jurisdictional amount has been reconciled to the 13-month

average rate base identified in Issue 27 using the pro rata reconciliation method discussed in Issue 31.

Item	Jurisdictional Amount ($000's)	Ratio (%)	Cost Rate (%)	Weighted Component (%)
Long-Term Debt	423,364	35.29	6.44	2.27
Short-Term Debt	33,729	2.82	4.61	0.13
Preferred Stock	98,723	8.23	4.93	0.41
Common Equity	492,396	41.04	13.00	5.34
Customer Deposits	13,261	1.11	5.98	0.07
Deferred Taxes	121,587	10.13		0.00
Investment Credit - Weighted Cost	16,601	1.38	9.48	0.13
Total	$1,199,661	100.00		8.35

As discussed in Issue 34, based on Gulf's outstanding performance, the Commission should set rates that are designed to produce a return on equity of 50 to 100 basis points above the 13.0% cost of equity used in the above calculation.

ISSUE 37: What is the appropriate authorized range on ROE to be used by Gulf for regulatory purposes on a prospective basis?

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SUMMARY:

The appropriate authorized range on ROE should have a spread of 150 basis points or more above and below the return on equity used for the purpose of setting rates (authorized range of 300 basis points). This range is appropriate in recognition of the fact that Gulf has provided high quality service to its customers at low rates with excellent customer satisfaction ratings. The expanded range would help the Company remain in sound financial condition.

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DISCUSSION:

The appropriate authorized range on ROE to be used by Gulf should have a spread of 150 basis points or more above and below the return on equity used for the purpose of setting rates (authorized range of 300 basis points). [Bowden, R. 71] Gulf Power Company has demonstrated that it has provided high quality service to its customers at low rates with excellent customer satisfaction ratings through the testimony of several Company witnesses. [Labrato, R. 612; Fisher, R. 442, 1005] Therefore, the Commission should allow a broader range than the traditional 100 basis points above and below the revenue set point (authorized range of 200 basis points) for regulatory purposes on a prospective basis. This will give the Company an incentive for maintaining its high level of performance on such matters as customer satisfaction, customer complaints, transmission and distribution reliability, and generating unit availability. [Bowden, R. 84] An expanded range provides the Company flexibility needed in managing its business operations to maintain its favorable credit rating and attract investors for future growth. [Bowden, R. 77] In addition, the expanded range could facilitate the implementation of sharing plans. [Bowden, R. 71] The proposed expanded range would, if approved by the Commission, help the Company remain in sound financial condition. This benefits the customers because it positions the Company such that it can better balance decisions affecting both long and short-term needs. A strong financial position also allows the Company to negotiate from a stronger position when it is buying goods and services. [Bowden, R. 85-86] A financially sound company can provide better service at much lower rates when compared to a financially weak company. For these reasons, the Commission should set Gulf's range on ROE to have a spread

of 150 basis points or more above and below the return on equity used for the purpose of setting rates (authorized range of 300 basis points).

Gulf has proposed a broad based incentive mechanism as a substitute for traditional ratemaking. Under Gulf's proposal [see Exhibit 25], the Company would agree to share earnings above the top of its normal authorized range between its customers and its shareholders. The relative amounts to be shared between the two groups would vary depending on the Company's performance on key indicators of importance to the Commission as identified in the proposal. This mechanism provides benefits to customers by providing for refunds to customers without the need for the Commission to initiate proceedings to hold prospective revenues subject to refund. The Company's willingness to accept such a mechanism is tied to the opportunity to continue to earn higher returns.

ISSUE 38: Stipulated

ISSUE 39: Stipulated

ISSUE 40: Should the Commission accept Gulf Power's modified zero based budget as support for the requested increase?

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SUMMARY:

Yes. The modified zero based budget methodology used by Gulf is a proven and accurate method of budgeting to meet its resource management needs. This methodology gives the planning units the ability to build their budget program by program each year. This methodology was used to develop the budget for the May 2003 projected test year, which reasonably reflects expected future operations during the period that new rates will be in effect.

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DISCUSSION:

Gulf utilizes a very straightforward, logical, and comprehensive process in developing its budget. [Saxon, R. 966] Mr. Bass, a Staff witness in this docket, conducted an audit of Gulf's O & M budget process and did not find any exceptions or take issue with any part of Gulf's budget process. [Exhibit 47, page 11] The budget process is ongoing and is intended to develop a financial forecast for use by management in making decisions about the future direction of the Company. [Saxon, R. 352] Eight component budgets, including the Construction, O & M, Interchange, Fuel, Revenue, Customer, Energy and Peak Demand budgets, are reviewed and approved by the Company's Leadership Team and are incorporated into Gulf's financial forecast. [Saxon, R. 352; Exhibit 30, Schedule 1]

A high-level view of the budget process begins with the fact that there are five major functional areas that breakdown into 29 individual planning units. These 29 planning units each develop a detailed budget that is used as an input into one or more of the eight budgets referenced above. [Exhibit 1, pages 25-26] In developing their budgets, the individual planning units use a modified zero based budget methodology. [Exhibit 1, pages 25-26] This methodology is a proven and accurate method of budgeting to meet the Company's resource management needs. This methodology gives the planning units the ability to build their budget program by program each year. [Saxon, R. 354-55; Exhibit 1, pages 25-26] A budget message is used to communicate to the individual planning units various assumptions and parameters such as customer growth and inflation rates. [Exhibit 47, page 11] The information in the budget message is a reference tool for the planning units. The planning units do not automatically start

with a base amount and simply escalate the base by the inflation factors to arrive at a new budget year, though they do use escalation factors for the forecast years in their budget. [Exhibit 1, pages 25-26] Corporate Planning reviews the budgets, both at the planning unit level and at the level of the eight component budgets, for compliance with the company guidelines and compiles the data for use by the Company's management team to develop a financial forecast. [Saxon, R. 353-54; Exhibit 30, Schedule 1] The individual planning units monitor their O & M budget to actual on a quarterly basis and prepare variance explanations when the difference exceeds a defined threshold of plus or minus ten percent and greater than or equal to plus or minus $25,000. [Saxon, R. 355; Exhibit 47, page 11] The planning units maintain the supporting documentation for their budgets. [Exhibit 47, page 11] From beginning to end, Gulf utilizes a very straightforward, logical, and comprehensive process in developing its budget. [Saxon, R. 966]

Mr. Schultz makes several remarks in his testimony about a lack of information supporting Gulf's budget process. The Commission's record of all of the filings in this docket is clear that Gulf responded in a timely manner to all requests for discovery from the parties in this docket and even gave the Office of Public Counsel additional information beyond that required in the discovery process. [Saxon, R. 966-967] Mr. Schultz claims that he was waiting for more details at the time of the filing of his testimony; however, the Commission's record of filings indicates that at the time that his testimony was filed there were no discovery requests that were past due or any pending motions to compel discovery. The additional detail was available, just

not requested through discovery. Gulf was responsive to all formal discovery and Mr. Schultz's implication otherwise is completely without basis and is misleading.

The budget methodology used by Gulf to develop the budget for the May 2003 projected test year was reasonable and appropriate and, reasonably reflects expected future operations during the period that new rates will be in effect. [Saxon, R. 966] Claims that Gulf inflated the test year for setting rates are simply unfounded. The individual programs and activities for which this claim has been made are discussed in connection with other specific issues herein. The budget process was scrutinized by the Commission's audit staff and no such concerns were expressed. [Exhibit 47, page 11]

ISSUE 41: Is Gulf's requested level of O & M Expense in the amount of $182,419,000 ($186,354,000 system) for the May 2003 projected test year appropriate?

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SUMMARY:

No. The O & M Expense for the May 2003 projected test year should be increased by $149,000 to $182,568,000 on a jurisdictional basis to reflect the net effect of changes to inflation factors, amortization of rate case expense, security expense, lobbying expense, hiring lag, and cable injection costs, and to correct the Company's operating expense adjustment related to industry association dues.

**

DISCUSSION:

This issue is primarily a fall-out of Issues 39, 40, and 43 through 72. As discussed in those issues, adjustments are required as a result of changes to inflation factors, amortization of rate case expense, security expense and lobbying expense.

In addition, a correction is required to the Company's operating expense adjustment related to industry association dues. As shown on Exhibit 37, Schedule 13, Gulf disallowed 5% of the dues for all organizations in the MFRs. Consistent with past Commission policy, Gulf should have disallowed 5% of the dues only for area and economic development organizations. There should have been no disallowance for the dues for professional and industry organizations. As can be seen from Exhibit 37, Schedule 13, the correction of this error would result in a disallowance of 5% of $48,639 (or $2,432) rather than the disallowance of $15,426 in the MFRs. This results in a $13,000 increase in O & M expense for the test year.

As discussed in Issue 64 relating to cable inspection expense, Gulf is willing to accept the Staff's position that the cost of the cable injection program should be capitalized rather than expensed. If this proposal is approved by the Commission, the entire amount of cable injection costs ($166,000 jurisdictional) will be removed from test year O & M expense. [See Issue 64]

Finally, Gulf has agreed that a hiring lag adjustment would be appropriate to reduce test year salaries and employee benefits by $324,000 jurisdictional ($331,000 system). [See Issue 51]

These changes are summarized in the following table:

Summary of O & M Expense Adjustments to MFRs
($000's)

O & M Expense Components	**Jurisdictional Amount**	**Basis for Adjustment**
O & M Per MFRs	182,419	--
Inflation Factor Adjustment	(98)	Stipulation 16
Amortization of Rate Case Expense	(13)	See Issue 58
Additional Security O & M Expense	744	See Issue 47
Lobbying Expense Adjustment	(7)	Stipulation 21
Industry Association Dues Correction	13	See discussion above
Cable Injection Cost Capitalization	(166)	See Issue 64
Hiring Lag Adjustment	(324)	See Issue 51
Total Adjusted O & M	182,568	--

ISSUE 42: Stipulated

ISSUE 43: Stipulated

ISSUE 44: Stipulated

ISSUE 45: Stipulated

ISSUE 46: Stipulated

ISSUE 47: What are the appropriate adjustments, if any, to Gulf's test year operating expenses to account for the additional security measures implemented in response to the increased threat of terrorist attacks since September 11, 2001?

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SUMMARY:

An adjustment of $845,000 ($901,000 system) should be made to test year operating expenses to reflect the cost of additional security measures implemented in response to the increased threat of terrorist attacks since September 11, 2001. This amount includes $578,000 ($623,000 system) due to an increase in Gulf's property insurance costs as a result of the terrorist events of September 11, 2001 and $101,000 ($105,000 system) of depreciation on the additional investment in security measures.

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DISCUSSION:

Jurisdictional operating expenses should be increased by $845,000 to reflect the additional expenses that Gulf is projected to incur in the test year as a result of the increased threat of terrorist attacks since September 11, 2001. As shown on Confidential Exhibit 7 at Staff Interrogatory No. 238, page 2, this amount consists of $744,000 of production O & M expense and A & G expense, which includes $578,000 jurisdictional increase in all-risk property insurance premiums as a result of the terrorist event. [McMillan, R. 952-953] The $845,000 increase also includes depreciation of $101,000 on the additional investment required in production plant and general plant, which is included in Issue 75. No intervenor took a position on this issue, and there is no evidence in the record that questions the amount of Gulf's request.

<u>ISSUE 48:</u> Should an adjustment be made to advertising expenses for the May 2003 projected test year?

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SUMMARY:

No. Gulf depends on advertising as one of the primary methods of communicating with our customers. The ability to communicate effectively with our customers is essential and helps to build awareness regarding the various products and services Gulf provides. It establishes Gulf's credibility as an information source and encourages loyalty. Adjustments to the May 2003 projected test year advertising expenses would reduce the level of success of Gulf's demand side management and conservation programs.

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DISCUSSION:

Gulf is asking the Commission to revisit the position taken in its previous decisions and approve the Company's request to recover all of the advertising expenses budgeted for the May 2003 test year. [Neyman, R. 1074] Advertising is critical to Gulf's operations as one of the primary methods by which the Company can communicate with its customers. [Neyman, R. 548] Through this essential interaction, Gulf works to educate its customers about the Company's performance in areas such as rates, reliability, commitment to the environment and customer service. [Neyman, R. 548] Advertising provides the Company with an avenue to inform its customers about the various products and services provided by Gulf. [Neyman, R. 548] Furthermore, these communications help to establish the Company's credibility and encourage trust and loyalty among its customers. [Neyman, R. 548] All of these are crucial elements to Gulf's goal of encouraging customers to participate in products, programs and initiatives involving energy conservation, energy efficiency, power quality, and reliability.

[Neyman, R. 548, 1073] Customers will not participate in such offerings if they do not believe in the program or the provider. [Neyman, R. 548, 1073]

Staff witness Mr. Bass has testified that, based on prior Commission orders, the Commission should disallow a portion of Gulf's requested advertising expenses. [Bass, R. 903-904] However, as Mr. Bass himself admitted, if the Commission should choose to change its policy in this rate proceeding, he would no longer have a concern with the Company's requested advertising expense being included in base rates. [Bass, R. 919] The simple fact is that the times have changed since Order No. 6465 denying "image-enhancing" advertising was entered in 1975 as part of Docket 9046-EU. Unlike the ads mentioned in the previous order, today's ads are not focused on the utility's stockholders or vendors. Instead, Gulf's proposed advertising is focused on educating the consumer regarding products and services available to ensure the efficient use of energy. Gulf has recognized that there are many new communication channels affecting the consumer and is constantly seeking to find new ways to communicate with its customers. For example, GoodCents energy audits offered to customers have progressed from on-site audits to reaching out to its customers and providing these services through direct mail, by telephone, and over the Internet. [Neyman, R. 549-552] All of Gulf's advertising efforts are targeted specifically towards communicating with its customers and building the relationship that is critical to the mutual success and satisfaction of both the Company and the consumer. [Neyman, R. 1073]

OPC's witness Ms. Dismukes argues against allowing Gulf's requested advertising expenses because the ads "merely enhance Gulf's image with its customers." [Dismukes, R.

769] Ms. Dismukes goes on to support her position by quoting from Order PSC-96-1320-FOF-WS. [Dismukes, R. 769] What Ms. Dismukes fails to point out, however, is that the Commission recognized in that order that often customer communications may serve multiple purposes, and that the costs associated with building public support for conservation programs may be indistinguishable from costs associated with image enhancement. [Neyman, R. 1075-76, Order PSC-96-1320-FOF-WS] On this basis, in Order PSC-96-1320-FOF-WS the Commission ultimately allowed recovery for advertising such as that at issue for Gulf in this case. [Neyman, R. 1076, Order PSC-96-1320-FOF-WS]

ISSUE 49: Stipulated

ISSUE 50: Should an accrual for incentive compensation be allowed?

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SUMMARY:

> Yes. The full accrual for the projected test year should be allowed. Gulf's compensation philosophy links base pay and incentive compensation to provide base salaries at or near the median of an appropriate external comparator group and to provide incentive pay up to the top quartile for exceptional performance. Recent reviews of Gulf's total cash compensation (base plus incentive) indicate that Gulf Power is currently paying its employees "at market".

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DISCUSSION:

Gulf's full test year accrual for incentive compensation should be allowed. Gulf's incentive compensation program, which was modified in 2000, is part of Gulf's total package of cash compensation for its employees. As demonstrated below, the total cash compensation is

reasonable, and both the base salary and incentive compensation portions of that compensation package should be included in test year expenses.

Gulf's compensation philosophy is centered on the need to attract, retain and motivate talented employees. Gulf therefore offers a compensation package that consists of base salaries and incentive compensation. Base salaries are targeted at or near the median of the appropriate external comparator. Through the Company's incentive pay plan, employees can earn incentive pay up to an amount targeted at the top quartile of the industry. [Bell, R. 942] The combination of base salary plus incentive compensation provides overall cash compensation for all job groups that is, on average, within plus or minus 5% of competitive market rates. [Silva/Twery, R. 947]

OPC witness Schultz considered the year 2000 accrual for incentive compensation to represent a significant amount in relation to gross payroll and proposed a tentative disallowance of $4.9 million, representing the difference between the incentive compensation accrual in 2000 and the accrual in 1999. [Schultz, R. 804; Exhibit 43 at HWS-1, Schedule C-3] Given the fact that a new incentive plan was established in 2000, this results in an apples-to-oranges comparison and does not provide a valid basis for adjustment. Mr. Schultz's prefiled testimony acknowledged that his adjustment was "preliminary," and that he could not make a final assessment of either the new plan or a reasonable amount of incentive compensation until he completed his review of additional discovery. Mr. Schultz apparently did not find any basis in that discovery to make a specific adjustment, since he never finalized a recommendation to the Commission, and his counsel conducted no cross-examination on incentive compensation issues.

In any event, Mr. Schultz's concern regarding the level of incentive compensation as a percentage of gross payroll is the result of an inappropriate comparison, since different companies can have different philosophies on the appropriate mix of base and incentive compensation. The pertinent question is whether Gulf's total cash compensation package (base plus incentive) is competitive in the marketplace. To ensure that Gulf's pay policy is competitive with the external market, an annual market position report is prepared to determine an estimated market value for each specific benchmark job. This report is based on the use of survey data from approximately 40 different third-party salary surveys. Organizations are considered to be "at market" if the combined base plus incentive pay for the applicable job categories falls within plus or minus 10% of the market benchmarks. An August 2001 market position report confirmed that Gulf's total compensation pay policy was within 5%, on average, for all job groups. This demonstrates that the overall level of compensation, including the entire incentive compensation accrual, is both reasonable and consistent with Gulf's compensation philosophy. [Bell, R. 943; Silva/Twery, R. 947-948]

<u>ISSUE 50A</u>: Should an adjustment be made to employee relocation expense for the May 2003 projected test year?

**

SUMMARY:

No. The amount of employee relocation expense of $461,754 jurisdictional ($486,580 system) included in the May 2003 test year is conservative. The amount is derived using a four year (1997-2000) average escalated for inflation. The test year budget is less than the 5-year historical (1997-2001) average for this expense and the actual relocation expenses incurred in 2000 and 2001.

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DISCUSSION:

Competitive employee relocation packages are necessary to attract qualified employees. Relocation expenses for moving and the costs associated with buying and selling houses are continually increasing. The Company based its test year budget on an average of actual relocation costs incurred by Gulf during the years 1997-2000, the same four year period used by the Commission's Staff in its preliminary position, adjusted for inflation. However, the preliminary position taken by the Commission's Staff fails to include an allowance for inflation. The four-year average should be adjusted for inflation because the test year is for the period June 2002 through May 2003 and the historical average was based on actual expenses for the years 1997 through 2000.

ISSUE 51: Should an adjustment be made to Gulf's requested level of Salaries and Employee Benefits for the May 2003 projected test year?

**

SUMMARY:

Yes. An O & M adjustment of $324,000 ($331,000 system) should be made to reflect a hiring lag during the test year. No other adjustments are justified because the levels requested are necessary to maintain a competitive compensation and benefits package for Gulf employees. A competitive package is required to attract, retain, and motivate employees. The positions reflected during the test year represent the employees Gulf needs in the test year and beyond to accomplish its objectives.

**

DISCUSSION:

The number of employee positions reflected during the test year represents the employees that Gulf needs in the test year and beyond to accomplish its objectives, including the new activities and programs that are to be implemented within the Power Generation and Power

Delivery areas of Gulf Power Company. [Saxon, R. 368-369] These new activities and programs are more fully discussed in Issues 60-69. Gulf Power's compensation package for the number of employee positions reflected during the test year, including the level of salaries and employee benefits, is both reasonable and appropriate when compared to the current market. [Bell, R. 942-943] The levels requested are necessary to maintain a competitive compensation and benefits package for Gulf's employees. A competitive package is required to attract, retain, and motivate employees. Gulf's surveys and analysis indicate that these levels are both reasonable and appropriate to maintain the competitiveness of the Company's salaries and benefits. [See Issue 50]

Mr. Schultz's proposed adjustment to payroll expense for the removal of 19 "unexplained" positions from the projected test year is inappropriate. The details regarding the nineteen positions inappropriately referred to as "unexplained" by Mr. Schultz could have been determined by Mr. Schultz through discovery. Gulf's test year expenses include six cooperative educational students. The cooperative education program provides Gulf with a pool of potential employees who have some level of working knowledge of the Company and a proven track record of ability. [Saxon, R. 969] Another eleven positions are found in Power Delivery's earned progression program. [Saxon, R. 969] A class of eleven employees will be hired and trained together. This class consists of line and substation technician apprentices. It addresses a workforce issue and enables Gulf to have a diverse competitive workforce for the future. [Fisher, R. 1019] The remaining two positions are in the Leadership Development program. The Leadership Development program provides selected employees experience in many areas of

the Company in an effort to have a group of leaders ready to assume increasingly responsible positions in the future. [Saxon, R. 969] Each of these nineteen positions is justified in the test year and beyond.

The Company has agreed that a hiring lag adjustment would be appropriate for the test year. [Exhibit 21, page 8] The Company's proposed adjustment is $324,000 ($331,000 system), which includes an O & M labor adjustment in the amount of $265,000 ($271,000 system) and an adjustment to fringe benefits in the amount of $59,000 ($60,000 system). With the exception of the amount stated for hiring lag, no credible record evidence supports any other adjustment to Gulfs requested level of salaries and employee benefits for the May 2003 projected test year.

ISSUE 52: Stipulated

ISSUE 53: Stipulated

ISSUE 54: Should adjustments be made for the net operating income effects of transactions with affiliated companies for Gulf?

**

SUMMARY:

No. Gulf's test year O & M expenses related to affiliate transactions are conservative, and are less than the 1999 actual O & M charges. Based upon the 2002 Southern Company Services ("SCS") Budget, Gulf's test year O & M expenses are understated by $1.5 million.

**

DISCUSSION:

Gulf's projected O & M expenses related to affiliate transactions are conservative. The amounts were based upon the best information available at the time Gulf prepared the test year data for the original filing in this case. [McMillan, R. 955] The SCS O & M expenses included

in the test year are reasonable and are representative of future costs. In fact, applying 2002 budget allocation ratios (which include Southern Power Company, a new Southern Company subsidiary) to the SCS budget data used in preparing this case, Gulf's allocated costs would actually increase $218,000 over that which was requested by Gulf in this filing. [McMillan, R. 954] A comparison of the SCS O & M expense included as part of Gulf's request in this case to the O & M amounts for the period included in the test year from the recently completed SCS 2002 Budget shows that Gulf's test year request is understated by $1.5 million. [McMillan, R. 954] Gulf's test year SCS O & M expense is lower than the current forecast for the test year and is also less than the 1999 actual SCS expense incurred by Gulf. This clearly demonstrates that Gulf's test year amount is conservative.

The only adjustment for the effects of transactions with affiliated companies proposed in any of the testimony in this docket is related to the SCS allocated costs. [McMillan, R. 953] The proposed adjustment is based upon Ms. Dismukes' reallocation of SCS allocated costs to include Southern Power Company ("SPC"). Ms. Dismukes based her reallocation of costs to Gulf on her allocation of costs to SPC using projected or estimated 2003 data for SPC. The proposed adjustment calculated by Ms. Dismukes is inaccurate and flawed due to numerous errors and inappropriate assumptions. She arbitrarily changed components of allocation factors that were approved by the Securities & Exchange Commission ("SEC") and made numerous errors in her reallocation of costs to SPC. Ms. Dismukes ignored changes in SCS total allocated cost as well as changes in other affiliate statistics. In fact, while increasing capacity related allocations to include SPC, she ignored the increase in capacity related to Gulf's Smith Unit 3 and other

Southern generating capacity additions. In addition, Ms. Dismukes assumed that all allocated costs were charged to O & M expense. Therefore, her proposed adjustment to O & M expense included capital and below the line charges.

Ms. Dismukes also allocated SPC a larger portion of SCS's costs by using a factor of seven to estimate some of SPC's statistics. There is no basis for using such a factor. [McMillan, R. 954-955] More importantly, Ms. Dismukes' reallocation is flawed because she made no attempt to account for overall increases in total SCS costs and changes to the other affiliates' statistics and allocations which may offset most, if not all, of the impact of injecting SPC into the allocation. Compounding this omission, the period of time selected by Ms. Dismukes goes beyond the test year and she erroneously assumes that SPC should receive allocations for all SCS activities except those based on customers. [McMillan, R. 555] In fact, in Schedule No. 3 to her testimony, Ms. Dismukes failed to exclude activities, such as transmission and distribution related activities, which clearly are not related to generation, and therefore are not applicable to SPC.

The erroneous assumption that SPC should receive allocations for all SCS activities except those allocated based on customers resulted in Ms. Dismukes' proposed adjustment being overstated by approximately $600,000. [McMillan, R. 955] Another error by Ms. Dismukes occurred when she modified numerous SEC approved allocation methods, resulting in an additional overstatement of approximately $450,000 within her proposed adjustment. The SCS allocation methods are reviewed and approved by the SEC and cannot be arbitrarily changed. [McMillan, R. 555] The adjustment proposed by Ms. Dismukes is not supported by any credible

evidence in the record and is flawed due to the errors and inaccurate assumptions and representations contained in her analysis.

ISSUE 55: Should an adjustment be made to the accrual for property damage for the May 2003 projected test year?

**
SUMMARY:

No. The appropriate amount for the property damage reserve accrual of $3,245,000 jurisdictional ($3,500,000 system) is included in the May 2003 projected test year. This is consistent with the Commission's decision in Order No. PSC-96-1334-FOF-EI approving a reserve target level of $25.1 million to $36 million based on a storm damage study filed as required by the Commission.
**

DISCUSSION:

The amount requested by Gulf for the property insurance expense is conservative. [McMillan, R. 952-953] The property insurance reserve balance is projected to be only $16.5 million at May 31, 2003 assuming very conservative charges to the reserve. This projected amount assumes that no charges will be incurred as a result of a hurricane or other major property damage through May 31, 2003. [McMillan, R. 951-952] The projected reserve amount is significantly below the target level of between $25.1 and $36 million approved by the Commission in Order No. PSC-96-1334-FOF-EI. [McMillan, R. 952] The amount requested by Gulf in this filing is consistent with the Commission's findings in Order No. PSC-96-1334-FOF-EI, where the Commission approved an annual reserve accrual of $3.5 million. [McMillan, R. 952]

The only proposed adjustment to the accrual for property insurance reserve was by Mr. Schultz. The adjustment proposed by Mr. Schultz is without basis. Mr. Schultz admitted that he did not conduct a storm damage study, but merely proposed an adjustment based on using the five-year average historical charges to the reserve (adjusted for inflation), during a period when no significant storm damages were incurred by the Company. As noted above, the projected property insurance reserve balance is significantly below the target level approved by the Commission, and would never reach the target level if Mr. Schultz's proposed property insurance reserve accrual was implemented. [McMillan, R. 953; Schultz, R. 848] Mr. Schultz's method is not a valid substitute for the results obtained from the storm damage study conducted pursuant to Order No. PSC-96-0023-FOF-EI. The adjustment proposed by Mr. Schultz is unjustified and should not be approved.

ISSUE 56: Stipulated

ISSUE 57: Stipulated

ISSUE 58: Should an adjustment be made to Rate Case Expense for the May 2003 projected test year?

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SUMMARY:

Yes. Based on the updated rate case expense estimate in Late-Filed Exhibit 55, total rate case expense should be reduced by $50,000 (to $1,333,000). This amount should be amortized over four years at the rate of $333,000 per year, which is consistent with the amortization period approved by the Commission in Gulf's last rate case. The change in the annual amortization of rate case expense results in a reduction to jurisdictional O & M expense of $13,000.

**

DISCUSSION:

The Commission should approve total rate case expense of $1,333,000 and allow that amount to be amortized over four years at the rate of $333,000 per year. This amount reflects a reduction of $50,000 in total expense (or a reduction of $13,000 in annual amortization) from the amount requested in the MFRs. [See MFR Schedule C-24; Exhibit 54, Schedule 2; Late-Filed Exhibit 55]

The reduction is the net result of (i) an increase in outside consultant services, including services of consultants who were not anticipated at the time the MFRs were filed (i.e. witness Roff on depreciation and witnesses Silva and Twery on employee compensation), (ii) an increase in paid overtime, and (iii) reductions in legal services and meals and travel due primarily to the fact that the scheduled 5-day hearing concluded in less than two days. [Labrato, R. 1110-1112; Late-Filed Exhibit 55]

The total amount of rate case expense requested is reasonable and is only a 28.6% increase over the amount allowed in the prior rate case. [Compare Late-Filed Exhibit 55 with Exhibit 54, Schedule 2] Thus, the total amount requested is less than the prior rate case amount adjusted by the compound CPI multiplier of 38.6% and is less than the prior rate case as a percentage of jurisdictional rate base and as a percentage of jurisdictional revenues. [MFR Schedules C-24 and C-56] The annual amortization is also less on a per customer basis than the amount allowed in the last rate case. [MFR Schedule C-24]

The appropriate amortization period for rate case expense is four years. This is consistent with the amortization period approved by the Commission in Gulfs last rate case. [Labrato, R. 1098; Order 23573 at page 35]

ISSUE 59: Should an adjustment be made to marketing expenses for Gulf's marketing of high efficiency electric technologies for heating and water heating?

**
SUMMARY:

No. Gulfs marketing of high efficiency electric technologies for heating, water heating and other end uses is beneficial to the participating customer, the Company, and to the general body of customers. Gulf provides information on end-use technologies and efficiencies in all market segments so as to influence choices toward the most efficient and cost-effective technology. The Company's programs are designed and intended to reduce or control the growth in energy consumption and weather-sensitive peak demand.
**

DISCUSSION:

Gulfs marketing of high efficiency electric technologies for heating, water heating and other end uses is beneficial to the participating customer, the Company, and to the general body of customers. [Neyman, R. 566; Exhibit 4, pages 18-26] In terms of high efficiency energy technologies, the Company provides information on competing equipment efficiencies (electric technologies versus electric technologies and electric technologies versus natural gas technologies when applicable). Gulf Power Company provides information on end-use technologies and efficiencies in all market segments in an effort to influence choices toward the most efficient and cost-effective technology. The Company's efforts are directed at reducing the customer's peak demand and annual energy consumption consistent with the customer's lifestyle and budget. Chapter 366.81, Florida Statutes, authorizes the FPSC ". . . to require each utility to develop

plans and implement programs for increasing energy efficiency and conservation within its service area, subject to approval of the commission." [Exhibit 4, pages 18-26] The Company's programs related to marketing high efficiency electric technologies are directly aligned with the Legislative intent and findings in Chapter 366.81. Each of the Company's programs is designed and intended to reduce or control the growth in energy consumption and weather-sensitive peak demand.

Gulf Power also engages in activities that improve the overall efficiency of its generation and distribution system. Gulf's water heating conversion program is an example of such an activity. The water heating conversion program improves the efficiency of the Company's generation and distribution system by increasing sales and utilizing investments that would otherwise be used to serve summer air conditioning load. [Neyman, R. 535, 577] In addition, the water heating conversion program benefits the general body of ratepayers by putting downward pressure on rates since the program is cost effective as demonstrated by both the rate impact measure and the participant's test. [Neyman, R. 568, 576-577]

ISSUE 60: Dropped

ISSUE 61: Dropped

ISSUE 62: Should an adjustment be made to Production Expenses for the May 2003 projected test year?

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SUMMARY:

No. Gulf's request of $74,522,000 jurisdictional ($77,202,000 system) is the reasonable and prudent amount necessary to effectively maintain and operate Gulf's generating fleet, and is less than the 5-year average projected for 2002-2006. This amount exceeds the benchmark due to a combination of factors including: the addition of Smith Unit 3; the increased generation demands being placed on an aging fleet; and a more proactive maintenance philosophy which has resulted in all-time high generation reliability.

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DISCUSSION:

No adjustment should be made to Gulf's Production Expenses for the projected test year. Gulf's request is the reasonable and prudent amount necessary to effectively maintain and operate Gulf's generating fleet and is representative of the level of expenses Gulf expects to incur in the future. [Moore, R. 401, 410, 416, 418] In fact, the test year request is $9.5 million below the forecasted five-year average for the years 2002-2006. [Moore, R. 999; Exhibit 50, Schedule 4] Gulf has adequately explained the factors that cause the test year production O & M expenses to exceed the benchmark. [Moore, R. 405-409; Exhibit 32, Schedule 7; Exhibit 50, Schedules 2 and 3]

Gulf has requested $74,522,000 jurisdictional ($77,202,000 system) in production O & M expense for the test year. When combined with production related administrative and general ("A & G") expenses, total production expenses are $83,695,000 on a system basis. This total amount exceeds the benchmark by $9,367,000. [Moore, R. 409-410; Exhibit 32, Schedule 7 at page 1] It is important to note that although production O & M expenses in isolation exceed the

benchmark, Gulf's overall O & M expense request is $3.7 million below the Commission benchmark. [Bowden, R. 658-659; Moore, R. 409]

Mr. Moore, Gulf's Vice President of Power Generation and Transmission, provided a detailed justification for the projected production expenses, along with a detailed explanation of the benchmark variances. This information was provided both in terms of the FERC accounts in which the expenses are classified (Production Steam, Production Other, Production Other Power Supply, Production A & G) and in terms of the categories that Gulf uses for internal management purposes (Baseline, Special Projects, Planned Outages).

With regard to the FERC account classifications, Production Steam expenses of $70.9 million exceed the benchmark by $5.8 million. The variance from the benchmark is due to a number of factors, including the increased age of the units and the increased amounts of generation those units are called on to provide. Gulf's generating fleet is 12 years older than it was as the time of the last rate case, and generation has increased by 37%. Even with these increased demands, Gulf's peak season reliability for its units is at an all-time high. Gulf cannot expect its generating fleet to continue to operate at this high level without additional maintenance expenditures. [Moore, R. 401-402, 406-407, 417-418, Exhibit 32, Schedule 7 at page 2] The pattern of maintenance spending shows that while Gulf was able to operate within the benchmark through 1998, expenses exceed the benchmark beginning in 1999. This increase over the past three years is a direct result of the increase in generation and the increased age of Gulf's fleet. [Moore, R. 418, 999; Exhibit 32, Schedule 3] In addition, Gulf has diagnostic tools available to it today that were not available in 1990. These tools allow Gulf to identify problems before they

actually occur and to address them before they result in a unit outage. Although this increases maintenance costs, these increased expenditures help to reduce the equivalent forced outage rate ("EFOR") and thereby provide more reliable, low cost generation to Gulf's customers. [Moore, R. 406-407, 417-418]

Production Other expenses exceed the benchmark by $3.8 million. This variance is due entirely to O & M expenses associated with the addition of Smith Unit 3 ($3.4 million) and the Pea Ridge cogeneration facility ($450,000). Production Other Power Supply expenses exceed the benchmark by $1.1 million. This variance is directly related to Gulf's share of costs associated with operating the Southern electric system's wholesale energy trading floor ($896,000) and increased costs for the Power Coordination Center ($208,000) which are related to the implementation of FERC regulations under Orders 888, 889 and 2000. These increased costs are offset by the benefits that Gulf's customers receive through an enhanced wholesale energy market. [Moore, R. 408-409; Exhibit 32, Schedule 7 at pages 3-4] It should be noted that during the hearing a stipulation was reached and approved on Issue 42, adopting Gulf's position that no adjustment should be made with respect to wholesale energy costs. [R. 20-23] Finally, Production A & G is under the benchmark by $1.3 million. [Moore, R. 409; Exhibit 32, Schedule 7 at page 5]

In order to better manage its O & M expenses, track costs, and monitor performance results, Gulf has adopted a management philosophy of capturing production expenses in three categories: Baseline, Planned Outage, and Special Projects. Baseline expenses are costs required to conduct the day-to-day operation and maintenance of the plant. Special Projects are expenses

for projects that are significant in cost. These projects are tracked individually to enhance cost control and ensure acceptable performance. Planned Outage expenses are those that occur to support periodically scheduled maintenance of plant major components. [Moore, R. 402-403] Gulf gauges the effectiveness of its overall planned outage and maintenance program by tracking its EFOR. By proactively implementing several major preventative maintenance programs, taking advantage of new diagnostic tools, and targeting its expenditures to those projects that have the greatest impact, Gulf has succeeded since 1997 in reducing its EFOR, even though the demand on its units has increased by 25 percent over that time period. [Moore, R. 404-405, 406; Exhibit 32, Schedule 6] Without O & M dollars sufficient to continue its current maintenance practices, the EFOR of Gulf's units would be negatively impacted and Gulf's customers would ultimately bear the burden of higher costs. For example, a one percent higher summer EFOR in 1999 caused by a single outage (64 hours) on Crist Unit 7 could have cost customers as much as $10 million in market-priced replacement power costs. [Moore, R. 405, 418]

OPC witness Schultz recommended that one component of total production O & M, Production Steam expense of $70.8 million, should be reduced by $10.2 million to $60.6 million. Mr. Schultz calculated his adjustment by taking an amount he believed to represent actual 2000 production steam expense ($53.4 million), inflating the amount to year 2002 ($56.1 million), then averaging this amount with the test year benchmark of $65 million to produce an allowance of $60.6 million. (Schultz, R. 809; Exhibit 43, HWS-1 at Schedule C-4) In addition to being flawed in concept, Mr. Schultz's calculation was based on faulty input for 2000 production steam expense and therefore must be rejected. The correct amount for 2000 production steam expense

is $63.6 million, not the $53.4 million used by Mr. Schultz. The amount used by Mr. Schultz was derived from Gulf's Response to OPC's Interrogatory No. 18. That interrogatory, however, included only items budgeted or incurred within the power plants, and did not include charges to production expenses that occur outside the plant (i.e. corporate functions) but are still included in the benchmark for Production Steam. This misunderstanding of the scope of dollars included in the interrogatory response resulted in Mr. Schultz making an apples-to-oranges comparison. [Moore, R. 988-990; Exhibit 50, Schedule 2]

In summary, the production O & M expenses included in the test year are reasonable in light of the programs that Gulf has instituted to maintain its units at a high level of reliability (low EFOR) despite their increasing age and the increased generation demands being placed on them. The amount requested is $9.5 million below the projected five-year average for 2002-2006. The record does not support a reduction to the amount requested and any reduction could adversely affect the reliability of Gulf's generating fleet, resulting in much higher costs to customers in terms of replacement power costs.

ISSUE 63: Stipulated

ISSUE 64: Should an adjustment be made to cable inspection expense?

**

SUMMARY:

There should be no adjustment to the level of costs projected for this program. Injecting a selected group of cables will reduce the likelihood of outages caused by premature failures. The recent changes in the manufacturer's warranty improve the economics of this process and have resulted in Gulf reinstating cable injection. Gulf is willing to follow Staff's recommendation and capitalize the costs of this program rather than charge them to expense.

**

DISCUSSION:

The cable injection expense budgeted for the May 2003 projected test year is appropriate and accurately represents the Company's expected need for future operations. Cable injection is a proven process whereby a silicone fluid is injected into underground primary cables to remove water and fill voids. [Fisher, R. 436] The fluid acts to slow the deterioration of the insulation and will extend the life of a select group of Gulf's older underground primary cables, specifically certain underground cable installed prior to 1985. [Fisher R. 436-437, 464] Gulf anticipates that through implementation of the cable injection process the Company can reduce the likelihood of future outages caused by the premature failure of these older cables. [Fisher, R. 437, 464]

OPC witness Schultz has taken the position that the cable injection expense should be reduced because the amount requested for the May 2003 projected test year is higher than the five-year historical average. [Schultz, R. 810-811] This historical average is so low because it includes several years in which Gulf did not incur costs for cable injection, and therefore is not representative of the Company's needs looking forward. [Fisher, R. 1014] What Mr. Schultz's analysis fails to take into account is that a recent change to the warranty offered by the

manufacturer of the cable injection process prompted Gulf to reevaluate the cost effectiveness of the cancelled program. [Fisher, R. 1032-1033] Specifically, the warranty was changed so that treated cables now carry an unconditional 20-year guaranty, up dramatically from the previous warranty of just three years. [Fisher, R. 1014] Whereas under a three-year warranty the program was not cost effective, the change to a 20-year warranty has placed cable injection on a better footing with competing alternatives the Company was exploring with regard to this aging underground cable plant. [Fisher, R. 1032-1033] This new improvement in the cost effectiveness of the program prompted Gulf to reinstate cable injection for the May 2003 test year and beyond. [Fisher, R. 1014, 1032-1033]

Mr. Schultz also questions Gulf's decision to expense the cost of the cable injection process rather than treat it as a capital improvement simply because the program will help to extend the life of the treated cables. [Schultz, R. 810] The cable injection process has been treated by Gulf as a maintenance expense because it did not involve the installation or removal of a plant unit. [Fisher, R. 1013-1014] Furthermore, the cable injection process did not qualify for a retirement unit code under the Company's capitalization guidelines, and Gulf believed its actions to be consistent with those of other electric utilities. [Fisher, R. 1112] It is apparent, however, from a review of Exhibit 56, which is Order Number PSC 95-1199-FOF-EI, that the Commission has directed in at least one previous matter that such cable injection expenses be capitalized. [Exhibit 56]

Although the Company believes that it has properly classified the cost of the cable injection program as an expense since the expenditure does not qualify as a retirement unit code

under the Company's capitalization guidelines, Gulf has no objection to capitalizing the cable injection costs if the Commission so directs. [Labrato, R. 1115] This would result in changes to both expense and rate base.

The original amount requested in the test year for cable injection expense totaled $166,000. If the cable injection program is capitalized rather than expensed, Gulf's O & M expense for the May 2003 projected test year should be reduced by $166,000 jurisdictional ($166,000 system) to remove the cost of the cable injection program. An adjustment should be made to increase depreciation expense by $4,000 jurisdictional ($4,000 system). Also, adjustments should be made to the rate base for the May 2003 projected test year as follows: increase plant-in-service by $152,000 jurisdictional ($152,000 system) to reflect the cost of the investment and increase the balance of accumulated depreciation by $2,000 jurisdictional ($2,000 system). The net impact of these adjustments on rate base is an increase of $150,000 jurisdictional ($150,000 system).

ISSUE 65: Should an adjustment be made to substation maintenance expense?

**
SUMMARY:

No. To adhere to Gulf's substation maintenance program and to prevent failures of this aging equipment, the budgeted funds are needed to return six existing substation technicians that have been assigned to construction projects back to their normal maintenance activities.

**

DISCUSSION:

The substation maintenance expense budgeted for the May 2003 projected test year is appropriate and accurately represents the Company's expected need for future operations. A number of factors have contributed to the increase in O & M expenses attributable to substation maintenance. Diagnostics have indicated that Gulf's aging substation equipment will require a significant increase in the levels of maintenance required during future years in order to continue to adhere to Gulf's Substation Maintenance Program. [Fisher, R. 434] Also, maintenance requirements will continue to grow as new equipment is installed to meet Gulf's increasing system-wide demand. [Fisher, R. 434] In addition, Gulf has experienced insulator arching and outages at a distribution substation due to salt contamination, requiring annual cleanings to prevent the problem from reoccurring. [Fisher, R. 434-435, 1015-1016]

In addition to the expenses noted above, Gulf is transferring six substation electricians back to substation maintenance. [Fisher, R. 1015] These technicians had been temporarily assigned to substation plant construction during calendar years 1999, 2000, and 2001 due to a need for additional resources in that function. [Fisher, R. 1015] These employees account for nearly $755,000 of the increase in substation maintenance O & M expenses, and their assignment back to maintenance is necessary for Gulf to continue to stay current on its Substation Maintenance Program and prevent the possibility of increasing maintenance-related failures in its substation equipment. [Fisher, R. 1015]

OPC witness Schultz has based his recommended reduction on the fact that Gulf's proposed substation maintenance O & M expenses for the May 2003 projected test year is higher

than the adjusted five-year historical average. [Schultz, R. 811-812, 825-828] As explained above, however, the five-year historical average is unusually low because of the temporary reassignment of the six substation maintenance electricians during 1999-2001. [Fisher, R. 1015] Mr. Schultz's recommendation apparently fails to take into account the return of these electricians to substation maintenance, and ignores new costs such as insulator cleaning related to salt contamination. [Fisher, R. 1015]

ISSUE 66: Should adjustments be made to tree trimming expense?

**

SUMMARY:

No. The requested level of tree trimming expense is necessary to allow Gulf to transition from the present spot trimming program to a more effective tree trim cycle and reduce tree related outages, which have escalated in recent years.

**

DISCUSSION:

The tree trimming expense budgeted for the May 2003 projected test year is appropriate and accurately represents the Company's expected need for future operations. Based on an analysis of tree growth in Gulf Power Company's service territory, the optimum tree trim cycle is three years. [Fisher, R. 435] Attempts to manage costs in this area during recent years have prompted a move to a less efficient spot-trimming program. [Fisher, R. 435, 1016, 1033] Though spot trimming was effective in lowering overall costs and allowed Gulf to fund programs such as the Y2K effort, it has reduced the overall miles of line being trimmed on an annual basis. [Fisher, R. 435, 1016, 1033-1034] This has led to a dramatic increase in annual minutes of interruption caused by tree-related outages. [Fisher, R. 1016]

OPC witness Schultz has based his recommended reduction on the fact that Gulf's proposed tree trimming expenses for the May 2003 projected test year are higher than the adjusted five-year historical average. [Schultz, R. 813, 825-828] Mr. Schultz's analysis fails to take into account that the five-year historical average represents a period in which Gulf was attempting to manage costs using a less expensive, but also less efficient, spot trimming program. [Fisher, R. 1016] Gulf recognizes the need to move to a three-year tree trim cycle in order to reduce tree-related outages and maintain the high service standards our customers expect. [Fisher, R. 1016] Such a move, however, cannot be made at historical expense levels, and the amount requested for the May 2003 test year reflects the Company's necessary tree-trim expenses going forward. [Fisher, R. 1016-1017]

ISSUE 67: Should an adjustment be made to pole line inspection expense?

**

SUMMARY:

No. The level of expense budgeted for this program is necessary to maintain Gulf's aging pole plant to avoid more expensive repairs in the future.

**

DISCUSSION:

The distribution pole inspection expense budgeted for the May 2003 projected test year is appropriate and accurately represents the Company's expected need for future operations. Gulf's distribution poles are located in the worst of five wood decay zones (Zone 5 "Severe") as defined by the American Wood Preservers Association. [Fisher, R. 433, 1017] Prior to 1980, Gulf installed Southern Pine Creosote or Penta treated wood poles for distribution, switching over to

Chromated Copper Arsenate ("CCA") treated wood poles in the early 1980's. [Fisher, R. 433] In 1991, Gulf began a ground line inspection program to inspect the Creosote and Penta treated poles and, as necessary, treat, repair, or replace the poles. [Fisher, R. 433]

Approximately 48,000 poles have been inspected as a part of this program, with approximately 82% of the poles being retreated, 4% being reinforced, and 14% needing replacement. [Fisher, R. 433-434] One of the results of this program is that Gulf has determined a need to speed up its inspection process in order to review the remaining 60,000 aging Creosote and Penta poles within the next five years. [Fisher, R. 434, 1017] Furthermore, the increase in funding for the pole inspection program is expected to reoccur indefinitely into the future as Gulf revisits the treated Creosote and Penta poles and begins inspections of the CCA pole plant. [Fisher, R. 471-472]

OPC witness Schultz has based his recommended reduction on the fact that Gulf's proposed pole inspection expenditures for the May 2003 projected test year are higher than the adjusted five-year historical average. [Schultz, R. 813, 825-828] Mr. Schultz's recommendation fails to take into account the findings of the initial pole inspection program regarding the condition of Gulf's aging pole plant and the need to inspect the remaining Creosote and Penta poles over the next five years. [Fisher, R. 1017] Furthermore, Gulf expects that as the remaining Creosote and Penta poles are inspected, overall program costs will be higher that those incurred during previous inspection cycles due to the fact that all the remaining Creosote and Penta poles now are more than 20 years old. [Fisher, R. 1017] Proceeding with the pole inspection program in a prompt, organized manner will help to prevent pole replacement under

emergency conditions, reduce customer outages and maintain a higher level of customer satisfaction and safety. [Fisher, R. 433]

ISSUE 68: Should an adjustment be made to street and outdoor light maintenance expense?

**

SUMMARY:

No. The amount requested is appropriate due to the increase in the number of lighting facilities and the group relamping program.

**

DISCUSSION:

The street and outdoor light maintenance expense budgeted for the May 2003 projected test year is appropriate and accurately represents the Company's expected need for future operations. Between 1990 and the year 2000 the number of high-pressure sodium street and outdoor lights grew from 47,413 lamps to 124,891 lamps, an overall growth rate of 263%. [Fisher, R. 438] Furthermore, the Company expects to undertake significant group relamping programs throughout its territory during the May 2003 test year and continuing into the future. [Fisher, R. 438, 1018, 1036]

OPC witness Schultz has based his recommended reduction on the fact that Gulf's proposed street and outdoor light maintenance expenditures for the May 2003 projected test year are higher than the adjusted five-year historical average. [Schultz, R. 815, 825-828] Once again, however, Mr. Schultz has failed to take into account the future needs of the company and factors that significantly affect the historical average costs. [Fisher, R. 1018, 1043] For example, the five-year historical average includes only one year in which a group relamping program was

implemented. [Fisher, R. 1018, 1047] This was primarily a result of hurricanes Opal and Erin, both of which came ashore in Gulf's service area in 1995. [Fisher, R. 1047] Damage from the hurricanes forced Gulf to do significant relamping at that time, reducing the subsequent need during the five-year period ending with 2001. [Fisher, R. 1047] Those areas are now in need of relamping, and the May 2003 projected test year budget includes those costs and accurately reflects Gulf's need in this area going forward. [Fisher, R. 1018]

ISSUE 69: Dropped

ISSUE 70: Stipulated

ISSUE 71A: Should an adjustment be made to Customer Accounts-Postage Expense for the May 2003 projected test year?

**
SUMMARY:

No. An error was found in the breakdown of Customer Accounts Expense that did not affect the total Customer Accounts Expense in the test year. $489,000 that was budgeted in Postage should have been budgeted in Operations. The corrected May 2003 projected test year Postage amount of $1,157,000 compares favorably to the 2000 actual amount of $1,114,000.
**

DISCUSSION:

No adjustment should be made to Customer Accounts-Postage Expense for the May 2003 projected test year. The amount of Customer Accounts Expense of $16,659,000 jurisdictional ($16,662,000 system) included in Gulf's May, 2003 projected test year is reasonable, prudent, and necessary. [Saxon, R. 362] In preparing the 2001 budget and forecasted years, an error was found in the breakdown of Customer Accounts Expense that did not affect the total Customer

Accounts Expense in the test year. As a result, $489,000 that was budgeted in Postage should have been budgeted in Operations. The corrected May 2003 projected test year Postage amount of $1,157,000 compares favorably to the 2000 actual amount of $1,114,000. With this correction of an additional $489,000 included in Operations, the May 2003 projected test year amount for Operations is still under the 2000 actual amount. [Saxon, R. 969]

ISSUE 71B: Should an adjustment be made to Customer Records Expense for the May 2003 projected test year?

**

SUMMARY:

No. A change in the allocation of corporate and district facility operation and maintenance expenses was made in 2001 to more accurately assign the expenses to the various business functions. This increased the Customer Accounts Expense by $658,000 over 2000 actual. Prior to 2001, these facility operation and maintenance expenses were budgeted and charged to Administrative and General expense.

**

DISCUSSION:

Gulf centralized the operations and maintenance associated with the corporate and district facilities, and in 2001 began charging the associated expenses directly to the functional accounts. [Saxon, R. 970, 976] This allowed Gulf to be able to more accurately track facility expenses to the functions. Prior to this change, these expenses were budgeted and charged to an Administrative and General Account. This change in allocation accounts for an increase of approximately $658,000 during the test year, and is the reason that the test year amount for customer records expense is higher than the actual 2000 expenses. [Saxon, R. 970] Customer Accounts Expense for the test year is projected to be $89,000 less that the actual expenses for

those accounts in 2001. [Saxon, R. 977] Mr. Schultz's proposed adjustment to customer records expense fails to account for the change in allocation discussed by Mr. Saxon. [Saxon, R. 970]

ISSUE 72: If the deferral of the return on the third floor of the corporate offices is allowed in rate base, what amortization period should be used?

**
SUMMARY:

The accumulated balance of deferred return on the third floor should be amortized over three years. This treatment is consistent with the provision included in Gulf's revenue sharing plan, resulting from the Commission-approved stipulation in Order No. PSC-99-2131-S-EI, which allowed Gulf the discretion to amortize up to $1 million per year. The annual amortization as filed in the MFRs should be reduced by $336,000 (jurisdictional) to reflect the effect of additional amortization booked during 2001.
**

DISCUSSION:

The balance of the deferred return on the third floor of the corporate offices should be amortized over three years at the rate of $801,000 jurisdictional ($815,000 system) per year. This annual amortization is less than the $1,137,000 jurisdictional ($1,157,000 system) per year requested in the MFRs. This change results from the reduction in the balance of the deferred return due to additional amortization booked for 2001 after the MFRs were filed. [Labrato, R. 1096; Exhibit 54, Schedule 1] The requested level of amortization is consistent with the revenue sharing plan approved by the Commission in Order No. PSC-99-2131-S-EI, which permitted amortization of up to $1,000,000 per year. [Labrato, R. 620] It is also consistent with the three-year amortization period initially approved by the Commission in Order No. PSC-99-1047-PAA-EI that was later withdrawn as part of the stipulation approved by Order No. PSC-99-2131-S-EI. [See discussion in Issue 9A]

OPC witness Schultz opposes recovery of the deferred return and, in the alternative, suggests that the deferred return should be recovered over the remaining life of the building. In justifying his recommendations, Mr. Schultz incorrectly claims that the request to amortize the balance over three years is "not consistent with the stipulation" which allowed a write-off of up to $1 million per year. His prefiled testimony also incorrectly states that Gulf did not make an election to write-off any of the deferred balance pursuant to the revenue sharing agreement. [Schultz, R. 795] Mr. Schultz made no attempt to correct this misstatement [R. 785] even though he admitted on cross-examination that he was aware, as a result of reviewing discovery responses, that amortization had been booked for the year 2000. [Schultz, R. 839] Even at the hearing, Mr. Schultz was still unaware that $1.0 million of additional amortization had been booked for 2001, despite the fact that Mr. Labrato testified about this additional amortization in his rebuttal testimony. [See Schultz, R. 839]

In summary, three years is a reasonable period over which to amortize the remaining deferred balance and results in an annual level of amortization that is fully consistent with the level in the revenue sharing stipulation. If the Commission for any reason were to extend the recovery period, a corresponding adjustment would have to be made to increase working capital, since the test year working capital request is calculated based on the assumption of a three-year amortization period beginning June 1, 2002. [See Exhibit 54, Schedule 1]

ISSUE 73: Stipulated

ISSUE 74: Stipulated

ISSUE 75: Should an adjustment be made to Depreciation Expense for the May 2003 projected test year?

**

SUMMARY:

Yes. Depreciation expense should be reduced by $2,272,000 ($2,350,000 system). This adjustment should be made to reflect the effect of the depreciation stipulation related to Smith Unit 3, the impact on depreciation expense of investment in additional security measures, a change in the balance of the deferred return on the third floor of the corporate office, and the effect of capitalizing cable injection costs.

**

DISCUSSION:

The test year jurisdictional depreciation expense should be reduced by $2,272,000 to $75,292,000. The major portion of this change is the result of a stipulation which increased the depreciable life of Smith Unit 3 to 25 years and reduced the annual depreciation expense for the test year by $2,041,000 ($2,117,000 system) for purposes of this rate case. [Stipulation for Settlement of Depreciation Issues, page 6] Except for that change, and any fall-out change resulting from other issues, the stipulation accepted the depreciation rates and dismantlement accrual as filed by the Company in this docket and Docket No. 010789-EI. [Stipulation, pages 6-7] That stipulation was approved by the Commission at the start of the hearing. [R. 12-15] In addition, depreciation expense should be reduced by $336,000 (jurisdictional) as a result of the reduction in the balance of the deferred return on the third floor of the corporate office. [See Issues 9A and 72]

These reductions are offset in part by additional depreciation expense of $101,000 (jurisdictional) associated with investment in additional security measures (see Issue 12) and

additional depreciation expense of $4,000 (jurisdictional) associated with Gulf's proposal to capitalize, rather than expense, cable injection costs (see Issue 64). [Confidential Exhibit 7 at Staff Interrogatory 238, page 2]

ISSUE 76: Dropped

ISSUE 77: Dropped

ISSUE 78: Stipulated

ISSUE 79: Should an adjustment be made to Taxes Other Than Income Taxes for the May 2003 projected test year?

**
SUMMARY:

Taxes Other Than Income Taxes should be reduced by $11,110,000 ($11,110,000 system) to remove gross receipts tax from operating expenses in the calculation of Net Operating Income, rather than removing gross receipts tax from total revenue requirements in the calculation of proposed base rates. Taxes Other Than Income Taxes should also be reduced by $20,000 ($20,000 system) to reflect the adjustment to payroll taxes associated with the hiring lag discussed in Issue 51.
**

DISCUSSION:

As part of the Company's initial filing in this case, adjustments were made to Taxes Other Than Income Taxes to remove the gross receipts taxes that are associated with clause revenues and franchise fee revenues. [Labrato, R. 626] Also, the Company's response to Staff's Interrogatory No. 168 provides a detailed calculation of the adjustments made to Taxes Other Than Income Taxes. [Exhibit 3, pages 90-92] Gross receipts taxes associated with base rate revenues were removed by the Company from total revenue requirements in the calculation of proposed base rates as shown on MFR Schedules E-11, E-15, E-16a, E-16c, and E-16d. This is

consistent with the stipulation of Issue 78 to remove gross receipts tax from base rates and show it as a separate line item on the bill. However, the Company has agreed to remove gross receipts tax from operating revenues and expenses in the calculation of Net Operating Income, rather than removing gross receipts tax from total revenue requirements in the calculation of proposed base rates; therefore, an additional adjustment needs to be made to reduce Taxes Other Than Income Taxes by $11,110,000. The corresponding adjustment to operating revenues is $11,084,000.

The Company has agreed that a hiring lag adjustment would be appropriate for the test year. [Exhibit 21, page 8] A proposed calculation of a hiring lag adjustment was filed as Exhibit 1 to Mr. Saxon's deposition. [Exhibit 21] This calculation was later revised; and, as discussed in Issue 51, Salaries and Benefits, the Company's proposed adjustment is $331,000, which includes an O & M labor adjustment in the amount of $271,000. The payroll taxes associated with this labor amount is $20,000 (7.26% * $271,000). Therefore, Taxes Other Than Income Taxes should be reduced by $20,000 ($20,000 system) to reflect the adjustment to payroll taxes associated with the hiring lag.

<u>ISSUE 80</u>: Stipulated

ISSUE 81: Should an adjustment be made to Income Tax expense for the May 2003 projected test year?

**

SUMMARY:

Yes. The requested amount for income tax expense for the May 2003 projected test year should be increased by $1,475,000 ($1,530,000 system) to $17,321,000 ($16,892,000 system) to reflect the impact of the net increase to taxable income as a result of the revenue and expense adjustments proposed by the Company in other issues and to reflect the tax effect of the change in synchronized interest expense.

**

DISCUSSION:

The appropriate amount of income tax expense is $17,321,000 ($16,892,000 system), which is an increase of $1,475,000 ($1,530,000 system) from the amount originally requested as shown in MFR C-2, page 3 of 3, and on Mr. Labrato's Exhibit RRL-1, Schedule 8, page 1 of 3. [Exibit 37] Based on the adjustments to revenues and expenses as set forth in other issues, there is a net increase in taxable income, therefore, income tax expense should be increased by $199,000 ($213,000 system). Also, income tax expense should be increased by $1,276,000 ($1,317,000 system) to reflect the tax effect of the change in synchronized interest expense. In the calculation of synchronized interest expense, the long-term debt, short-term debt, customer deposits, and unamortized investment tax credit amounts and cost rates have been updated to reflect the amounts and rates included in the revised cost of capital calculation as shown in the discussion of Issue 36.

The calculation of these income tax adjustments is as follows:

Income Tax Adjustments
($000's)

Tax Effect of Revenue and Expense Adjustments	**Jurisdictional**	
Revenue Adjustments	(12,736)	See Issue 82
Expense Adjustments	(13,253)	See Issue 82
Net Increase to Taxable Income	**517**	.
Federal Income Tax @ 33.075%	171	
State Income Tax @ 5.5%	28	
Total Tax Effect of Adjustments	**199**	**(213 system)**

Tax Effect of Interest Synchronization Adjustment		**Jurisdictional**		
	Amount	**Cost Rate**	**Expense**	
Long-term Debt	423,364	6.44%	27,265	
Short-term Debt	33,729	4.61%	1,555	
Customer Deposits	13,261	5.98%	793	
ITC-Debt Component	6,928	6.44%	446	
Total Synchronized Interest Revised			**30,059**	
Total Synchronized Interest as Filed			**33,367**	
Change in Interest			**(3,308)**	
Federal Income Tax @ 33.075%			1,094	
State Income Tax @ 5.5%			182	
Total Tax Effect of Change in Interest			**1,276**	**(1,317 system)**

	Jurisdictional	
Total Income Tax Adjustment	1,475	(1,530 system)

ISSUE 82: Is Gulf's projected Net Operating Income in the amount of $61,378,000 ($61,658,000 system) for the May 2003 projected test year appropriate?

**

SUMMARY:

No. The projected jurisdictional Net Operating Income should be adjusted by $958,000 to $60,420,000 to reflect the impact of removing capacity revenues and expenses recoverable through the Purchased Power Capacity Cost Recovery Clause; to account for changes in O & M expense, depreciation and amortization expense, payroll taxes, and income tax expense; and to remove gross receipts tax revenues and expenses in the calculation of NOI.

**

DISCUSSION:

This is a fall-out issue. As discussed in other issues, adjustments to the test year operating expenses are needed for changes in various O & M expenses summarized in Issue 41, changes in depreciation and amortization expense summarized in Issue 75, the change in payroll taxes as a result of the hiring lag adjustment in Issue 51, and resulting changes in income tax expense which are summarized in Issue 81. In accordance with the Commission-approved stipulations on Issues 38 and 45, NOI must also reflect an adjustment to Total Operating Revenues to remove capacity revenues recoverable through the Purchased Power Capacity Cost Recovery Clause. In addition, the Company has agreed to remove gross receipts tax revenues of $11,084,000 and expenses of $11,110,000 in the calculation of NOI as discussed in Issue 79.

These changes are summarized in the following table:

Summary of NOI Adjustments to MFRs
($000's)

NOI Components	(1) Jurisdictional NOI Per MFRs	(2) Adjustments	(3) Adjusted NOI (1) + (2)	(4) Basis for Adjustment
Operating Revenues	372,714	(12,736)	359,978	See Issues 38, 45, and 78 (Stipulated) (Note 1)
Operating Expenses				
O & M	182,419	149	182,568	See Issue 41 (Note 2)
Depreciation & Amortization	77,564	(2,272)	75,292	See Issue 75 (Note 3)
Amortization of ITC	(1,462)	0	(1,462)	--
Taxes – Other	36,969	(11,130)	25,839	See Issues 51 and 79
Current Income Taxes	22,259	1,475	23,734	See Issue 81
Deferred Income Taxes (net)	(6,413)	0	(6,413)	--
Total Operating Expenses	311,336	(11,778)	299,558	--
Net Operating Income (NOI)	61,378	(958)	60,420	--

Note 1: Includes $11,084,000 to remove gross receipts taxes in revenues as discussed in Issue 79.

Note 2: Includes effect of changes to inflation factors, amortization of rate case expense, security expense, lobbying expense, hiring lag, and a correction to the Company's operating expense adjustment related to industry association dues. Also includes the effect of proposed capitalization of cable injection costs.

Note 3: Includes effect of depreciation of investment in additional security measures, stipulated change to the depreciable life of Smith Unit 3, an adjustment to the amortization of the deferred return on the third floor of the corporate office, and the additional depreciation expense associated with the proposal to capitalize cable injection costs (see Issue 64).

<u>**ISSUE 83**</u>: Stipulated

ISSUE 84: Is Gulf's requested annual operating revenue increase of $69,867,000 for the May 2003 projected test year appropriate?

**
SUMMARY:

No. The requested increase should be reduced by $4,947,000 to a new total of $64,920,000 to reflect the impact of the adjustments proposed by the Company as discussed in the other issues. This amount is before the effect of any additional return on equity that the Commission allows as a result of Gulf's superior performance.
**

DISCUSSION:

This is the final fall-out issue. Based on the adjustments discussed in all prior issues, Gulf should be granted an annual operating revenue increase of $64,920,000, which is a reduction of $4,947,000 from the amount requested in the MFRs. The calculation of this revised amount is shown in the following table:

Summary of Adjusted Revenue Increase Request
($000's)

Line	Description	Adjusted Amount	Basis for Adjusted Amount
1	Jurisdictional Adjusted Rate Base	1,199,661	See Issue 27
2	Rate of Return (before performance adjustment)	8.35%	See Issue 36
3	Jurisdictional Income Requested	100,172	Line 1 x Line 2
4	Jurisdictional Adjusted NOI	60,420	See Issue 82
5	Income Deficiency (Excess)	39,752	Line 3 - Line 4
6	Earned Rate of Return	5.04%	Line 4 / Line 1
7	Net Operating Income Multiplier	1.633125	Stipulation 28
8	Revenue Deficiency (Excess)	64,920	Line 5 x Line 7

ISSUE 85: Stipulated

ISSUE 86: Stipulated

ISSUE 87: Stipulated

ISSUE 88: What is the appropriate cost of service methodology to be used in designing Gulf's rates?

**

SUMMARY:

The appropriate methodology for designing rates is reflected in Attachment A to MFR Schedule E-1 and in Exhibit 38. This cost of service methodology is the same as that approved by the Commission in Gulf's previous rate case except that the Minimum Distribution System ("MDS") was used in the cost of service study to determine customer and demand related cost. The MDS was used in order to adhere more closely to sound cost causative principles.

**

DISCUSSION:

The cost of service methodology proposed by Gulf in this docket is the same as that approved by the Commission in Gulf's previous rate case except that the Minimum Distribution System ("MDS") was used in the cost of service study to determine customer and demand related cost. [O'Sheasy, R. 675, 679] Attachment A to MFR Schedule E-1 and Exhibit 38 reflect the appropriate methodology for designing rates for Gulf in this case. MDS is the appropriate cost of service methodology for designing Gulf's rates because the use of MDS adheres more closely to sound cost causative principles than other methods used in Gulf's previous rate cases. [O'Sheasy, R. 675-676, 682] No other cost of service methodology is supported through testimony in this docket by the Commission staff or any party. In fact, no party to this docket other than the Commission staff objects to the use of the MDS cost of service methodology. Gulf utilized MDS because MDS best classifies Gulf's distribution accounts into customer and demand components so as to enable a better allocation of these costs. [O'Sheasy,

R. 684-685, 688-689, 694-695] This is especially important in Gulf's case given its preponderance of residential customers and significant growth in distribution related accounts. [O'Sheasy, R. 689]

Any concern that using MDS could negatively impact Gulf's residential customers is misplaced. MDS is not an issue of cost shifting but rather of revealing the true cost to serve. MDS enables the cost to serve to be determined much more accurately. The Commission has within its authority the ability to vary from strict cost-based rate design and develop a rate design based on its sound judgment. MDS merely allows the Commission to allocate costs on the most sound cost-causative basis and obtain a clear picture of exactly where cross-subsidies may exist. [O'Sheasy, R. 689] The Commission should take comfort from the fact that MDS is an accepted method of cost allocation and other public service commissions have adopted MDS. For example, the public service commissions in Mississippi and in Georgia recently approved cost of service studies which included the MDS. [O'Sheasy, R. 677-678, 681, 688] Likewise, the NARUC Electric Utility Cost Allocation Manual supports the use of MDS. [O'Sheasy, R. 677-678, 688] Each of these entities have recognized that MDS provides the best basis for determining cost to serve and in turn determining what cross-subsidies exist. [O'Sheasy, R. 677-678, 686-687, 689] The cost of service methodology proposed by Gulf is appropriate and is the best method in the record of this case for determining the cost to serve customers on Gulf's system.

ISSUE 89: What is the appropriate treatment of distribution costs within the cost of service study?

**

SUMMARY:

Where possible, direct assignments are appropriate. For demand related distribution cost, allocation based on NCP is appropriate. For customer related cost, the customer allocator is appropriate. Where cost must be divided into demand and customer components, the Minimum Distribution System ("MDS") is appropriate in order to adhere more closely to sound cost causative principles.

**

DISCUSSION:

Distribution costs are classified as demand related, customer related or a combination of the two. [R. O'Sheasy, R. 669] Where possible, direct assignments are appropriate. An example is the direct assignment of customer substations. For demand related distribution cost, allocation based on NCP is appropriate. An example is the demand related portion of Account 368 – line transformers allocated upon NCP. [R. O'Sheasy, R. 669, 675, 681] For customer related cost, the customer allocator is appropriate. An example of this is the customer-related portion of Account 364 – Poles and Fixtures allocated upon the average number of customers at levels 4 and 5. [R. O'Sheasy, R. 669, 681] Where cost must be divided into demand and customer components, the Minimum Distribution System ("MDS") is appropriate in order to adhere more closely to sound cost-causative principles. [O'Sheasy, R. 682, 684-685]

ISSUE 90: If a revenue increase is granted, how should it be allocated among the customer classes?

**
SUMMARY:

Based on Gulf's position on Issues 88 and 89, the increase should be allocated as shown in Gulf's MFR E-11. This allocates the requested increase to the rate classes in a manner that moves class rate of return indices as close to parity as reasonable, with the following constraints: (1) No class should receive an increase greater than 1.5 times the system average percentage increase in total; and, (2) No class should receive a decrease.
**

DISCUSSION:

The increase should be allocated as shown in Gulf's MFR E-11. The total amount of annual revenue increase sought by Gulf in its initial filing for rate relief was $69,867,000. This amount has been allocated to the rate classes such that no class receives an increase greater than 1.5 times the overall retail increase in percentage terms (no class receives a base rate increase greater than 30.3 percent which is 1.5 times the 20.2 percent overall retail base rate increase) and that no class receives a rate level decrease. [Thompson, 746-747] The proposed allocation of the rate increase is appropriate and reasonable when consideration is given to the rate of return that each of the various rate classes generates, fairness, and the value of service. [Thompson, 746-747]

ISSUE 91: What are the appropriate demand charges?

**
SUMMARY:

The appropriate demand charges based on Gulf's original filing are listed in the table included as part of the discussion below. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.
**

DISCUSSION:

Determining the appropriate demand charges entails consideration of the economic relationships between rate classes, the cost of service data from the Commission-approved cost of service study, the transition of rate components from current rates, and relationships between standard (non-Time-of-Use) and Time-of-Use rates within rate classes. The overall levels of demand charges set forth in the table below have been increased in order to achieve the proposed revenue level for each rate class. [Thompson, R. 750-751]

Rate Schedule	Monthly Demand Charge
GSD	$5.23
LP	$8.66
PX	$8.20
GSDT	$2.81 (On-Peak) $2.49 (Maximum)
LPT	$6.95 (On-Peak) $1.75 (Maximum)
PXT	$7.61 (On-Peak) $0.68 (Maximum)

If rates are re-designed at the conclusion of this case, this same process should be used to design demand charges for those rate classes that receive an overall rate level increase.

ISSUE 92: What are the appropriate energy charges?

**

SUMMARY:

The appropriate energy charges based on Gulf's original filing are listed in the table included as part of the discussion below. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.

**

DISCUSSION:

Determining the appropriate energy charges entails consideration of the economic relationships between rate classes, the cost of service data from the Commission-approved cost of service study, the transition of rate components from current rates, and relationships between standard (non-Time-of-Use) and Time-of-Use rates within rate classes. The overall levels of

energy charges set forth in the table below have been increased in order to achieve the proposed revenue level for each rate class. [Thompson, R. 750-751]

Rate Schedule	Energy Charge
RS	4.124¢/kWh
GS	5.257¢/kWh
GSD	1.271¢/kWh
LP	0.543¢/kWh
PX	0.303¢/kWh
RSVP	1.800¢/kWh-P_1 3.021¢/kWh-P_2 7.798¢/kWh-P_3 29.000¢/kWh-P_4
GSTOU	15.963¢/kWh (Summer On-Peak) 5.660¢/kWh (Summer Intermediate) 2.076¢/kWh (Summer Off-Peak) 3.086¢/kWh (Winter All-Hours)
GSDT	1.271¢/kWh
LPT	0.543¢/kWh
PXT	0.300¢/kWh

If rates are re-designed at the conclusion of this case, this same process should be used to design energy charges for those rate classes that receive an overall rate level increase.

ISSUE 93: What are the appropriate customer charges?

**
SUMMARY:

The appropriate customer charges based on Gulfs original filing are shown in the table included as part of the discussion below. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.
**

DISCUSSION:

Customer charges should be set at appropriate levels to recognize customer-related costs, while limiting any increase in the customer charge to 50% above current levels. Gulf's proposed customer charge levels set forth in the table below provide an appropriate transition from current customer charges with due consideration of the fact that these charges are for those costs that are not related to the amount of electricity consumed. [Thompson, R. 750]

Rate Schedule	Monthly Customer Charge
RS, RSVP	$12.00
GS, OSIV	$15.00
GSD, GSDT, GSTOU	$40.00
LP, LPT	$226.00
PX, PXT	$566.38
RTP	$1,000.00

Gulf has proposed increases to the customer charge rate component for two rate classes. [Thompson, R. 749] The MDS cost of service methodology indicates residential customer-related costs, at the proposed revenue level of $20.90, while the non-MDS methodology yields

customer-related costs of $11.66 at the proposed revenue level. [MFR E-17, page 112 of 115] Gulf's current residential customer charge is $8.07. [MFR E-17, page 112 of 115] The Company's proposed residential Customer Charge is $12 per month, an increase from the current charge of about 50%. [MFR E-17, page 112 of 115; Thompson, R. 749] Gulf has limited the proposed charge to $12 in consideration of the impact that a larger change would have on the small-usage residential customers. [Thompson, R. 750]

Similarly, for the GS customer class, the MDS methodology shows customer-related costs of $27.75, [MFR E-17, page 112 of 115], while the non-MDS methodology shows $18.31 for customer-related costs. Gulf's current customer charge for the GS rate class is $10.09. Gulf's proposed customer charge for this class is $15, again about a 50% increase over the current charge, and is limited to that amount for the same reason as stated above for residential. [Thompson, R. 749] The customer charges proposed by Gulf are reasonable and appropriate with considerations for the cost to provide service and the impact to the customer classes.

ISSUE 94: Stipulated

ISSUE 95: Stipulated

ISSUE 96: Stipulated

ISSUE 97: What are the appropriate charges under the Interruptible Standby Service (ISS) rate schedule?

**

SUMMARY:

Gulf proposes no change to this rate since no revenue increase is allocated to the rate. Using either the MDS or the non-MDS cost of service methodology there is not a revenue increase to this rate.

**

DISCUSSION:

The charges currently in effect for the Interruptible Standby Service (ISS) rate schedule are still appropriate and should not be changed. Gulf has not proposed a change to this rate since no revenue increase is allocated to the rate. The Commission's decision on the use of the MDS methodology in the cost of service study will not affect whether this rate should be changed because using the MDS or the non-MDS cost of service study produces the same result for this rate.

ISSUE 98: What are the appropriate charges under the Standby and Supplementary Service (SBS) rate schedule?

**

SUMMARY:

Gulf has proposed changes to the Standby and Supplementary rate schedule which simplify the rate by removing the Supplemental Energy (SE) option. The appropriate charges are listed in the table included as part of the discussion below. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.

**

DISCUSSION:

Gulf has proposed changes to the Standby and Supplementary rate schedule which simplify the rate by removing the Supplemental Energy (SE) option. [Thompson, R. 734] These changes have not been opposed by any party and no testimony in the record takes a position contrary to the position taken by Gulf. The charges set forth in the table below are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.

Contract Demand	100 to 499kw	500 to 7,499 kw	7,500kw and above
Customer Charge	$248.20	$248.20	$591.01
Demand Charge			
Local Facilities Charge	$1.66	$1.23	$0.51
On-Peak	$2.41	$7.16	$7.61
Reservation Charge	$0.99	$0.99	$0.98
Daily Demand Charge	$0.46	$0.46	$0.46
Energy Charge (per kWh)	1.177¢	0.311¢	0.300¢

ISSUE 99: What is the appropriate rate design for Gulf's Real Time Pricing (RTP) rate schedule?

**

SUMMARY:

The rate design utilized by Gulf in establishing the current RTP rate should be followed. Gulf proposes no change to this rate since no revenue increase is allocated to the rate. Using either the MDS or the non-MDS methodology in the cost of service study, there is no revenue increase to this rate.

**

DISCUSSION:

The rate design utilized by Gulf in establishing the current Real Time Pricing (RTP) rate should be followed. The charges currently in effect for Gulf's RTP rate schedule are still appropriate and should not be changed. Gulf has not proposed a change to this rate since no revenue increase is allocated to the rate. The Commission's decision on the use of the MDS in the cost of service study will not affect whether this rate should be changed because using the MDS or the non-MDS cost of service study produces the same result for this rate.

ISSUE 100: Stipulated

ISSUE 101: Stipulated

ISSUE 102: Stipulated

ISSUE 103: Stipulated

ISSUE 104: Stipulated

ISSUE 105: Stipulated

ISSUE 106: Stipulated

ISSUE 107: Stipulated

ISSUE 108: Stipulated

ISSUE 109: Stipulated

ISSUE 110: Stipulated

ISSUE 111: Stipulated

ISSUE 112: Stipulated

ISSUE 113: Stipulated

ISSUE 114: Stipulated

ISSUE 115: Stipulated

ISSUE 116: Stipulated

ISSUE 117: Stipulated

ISSUE 118: Stipulated

ISSUE 119: Stipulated

ISSUE 120: Stipulated

ISSUE 121: Stipulated

ISSUE 122: Stipulated

ISSUE 123: Stipulated

ISSUE 124: Stipulated

CONCLUSION

It has been more than 12 years since Gulf last filed a request to increase its base rates. In that time, the Company has worked diligently to achieve and maintain the confidence of its retail customers by providing highly reliable electric service at rates that are among the lowest in Florida and across the nation. The Company has responded to changing conditions by seeking out and implementing new operating efficiencies; developing plans and programs to meet the wants and needs of its customers; recruiting, training and retaining a dedicated and talented workforce that is focused on customer satisfaction; and efficiently managing its resources in order to maintain low rates and fulfill shareholder expectations. Customer expectations are higher now than ever before, and Gulf remains committed to fulfilling those expectations for the long-term.

Gulf does not relish the prospect of having to raise prices for electric service. However, the demands of Gulf's expanding customer base for more capacity and energy, along with the higher reliability expectations that are part and parcel of the electronic age in which we live, require a response from Gulf if the Company is to maintain the high degree of customer satisfaction that we have worked so hard to achieve. That response comes in the form of new or expanded programs to ensure that Gulf's efficient, low-cost generation continues to be available to provide energy to meet the demands of Gulf's customers. The response also comes in the form of new or expanded programs to ensure that Gulf's electric transmission and distribution systems continue to operate in a highly reliable fashion. It comes in the form of new or expanded communication programs to ensure that customers receive information necessary for

them to use energy efficiently. It comes in the form of diligent efforts to maintain the financial integrity of the Company in order to be able to fulfill customer and shareholder expectations in both the near-term and in the long run. These new or expanded programs require significant financial resources.

Gulf simply cannot continue to meet the expectations of our customers or shareholders based on rates established nearly 12 years ago. The important activities that Gulf is required to undertake to be responsive to its customers must be supported by the rates and charges this Commission authorizes for Gulf Power. Gulf has demonstrated that its requested increase is reasonable and necessary for the Company to be able to maintain its financial integrity and provide the resources necessary to continue fulfilling customer expectations for reliable electric service at rates that will remain among the lowest in the state and the nation. The Company's rates should be set at a level that will allow Gulf to support the capital investment and operating and maintenance activities detailed in its testimony and exhibits and fulfill shareholder expectations. The Company's rates should be set to achieve at least a 13.0 percent return on common equity. In addition, the Commission should recognize and reward the Company for its record of providing highly reliable electric service at low rates and achieving a superior degree of customer satisfaction in the process. That reward should come in the form of an additional 50 to 100 basis points to the return on common equity.

As the Company and the Commission continue to look towards the future, the Commission should provide Gulf with the opportunity to maintain its commitment to customers and shareholders without having to return for additional rate relief in the short-term. The

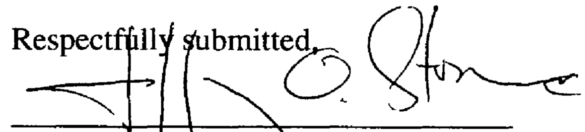
Commission should allow Gulf an expanded range on its authorized return on equity. The Commission should also accept Gulf's proposal regarding a performance-based incentive ratemaking plan that will allow the Company and its customers to share in any achieved earnings above the top of the authorized range. Gulf's proposal provides an appropriate balance of incentives to ensure that the needs and expectations of Gulf's customers continue to be fulfilled as the Company seeks out and implements further efficiencies in its operations and continues to adapt to changes in the future.

For the reasons expressed in the discussion of the individual issues set forth above, Gulf Power Company respectfully requests the Florida Public Service Commission to find and determine that the Company's present rates are insufficient to yield a fair rate of return once Smith Unit 3 is placed in commercial service for Gulf's retail customers and that the continued compulsory application of the Company's present rates and charges after the commercial in-service date of Smith Unit 3 will result in the unlawful taking of the Company's property without just compensation, resulting in confiscation of the Company's property in violation of the guarantees of the state and federal constitutions. The Company further requests that the Commission authorize the Company to revise and increase its retail base rates and charges to generate additional gross revenues of at least $64,920,000 on an annual basis before the addition of revenues associated with an appropriate performance-based addition to the cost of equity. The new rates resulting from this case should allow Gulf an opportunity to earn a fair overall rate of return of 8.35 percent, including a rate of return of 13.00 percent on common equity capital

(before consideration of the performance-based addition to the cost of equity), and thereby maintain the Company's financial integrity and its ability to serve the public adequately and efficiently.

Dated this 20th day of March, 2002.

Respectfully submitted,



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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In re: Request for rate increase by)
Gulf Power Company)
____________________________________)

Docket No. 010949-EI

Certificate of Service

I HEREBY CERTIFY that a copy of the foregoing has been furnished this 20th day of March 2002 by U.S. Mail to the following:

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