PEOPLES GAS SYSTEM

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

Docket No. 080318-GU

**In Re: Petition for rate increase
by Peoples Gas System**

**Submitted for Filing:
January 30, 2009**

REBUTTAL TESTIMONY OF:

**J. Paul Higgins
On Behalf of Peoples Gas System**

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is J. Paul Higgins and my business address is 702 North Franklin Street, Tampa, Florida 33602.

Q. BY WHOM ARE YOU EMPLOYED AND IN WHAT CAPACITY?

A. I am employed by Peoples Gas System ("Peoples" or the "Company") as Assistant Controller.

Q. ARE YOU THE SAME J. PAUL HIGGINS WHO FILED DIRECT TESTIMONY IN THIS PROCEEDING?

A. Yes, I am.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. The purpose of my rebuttal testimony is to address serious errors, shortcomings and improper conclusions reached in the prepared direct testimonies of Mr. Helmuth W. Schultz, III and Dr. J. Randall Woolridge, hired by the Office of Public Counsel ("OPC") and testifying on behalf of the Citizens of the State of Florida.

Q. PLEASE SUMMARIZE THE AREAS OF KEY CONCERN AND DISAGREEMENT YOU HAVE REGARDING THE SUBSTANCE OF THE TESTIMONIES OF MR. SCHULTZ AND DR. WOOLRIDGE.

A. Most of my areas of concern and disagreement relate to Mr. Schultz's testimony. However, I do take exception to Dr. Woolridge's testimony regarding the Company's short-term debt rate. Overall, my key concerns and disagreements relate to the following areas:

- Uncollectible Accounts Recovery Mechanism
- Incentive Compensation

- Stock Compensation
- Directors and Officers Insurance
- TECO Energy Allocated Expenses
- Marketing Expense
- Rate Case Expense
- Payroll Expense
- Storm Damage Reserve
- Employee Benefits Expense
- Short-Term Debt Rate
- Interest Synchronization and Income Taxes

<u>Uncollectible Accounts Recovery Mechanism</u>

Q. MR. SCHULTZ CLAIMS THAT ALLOWING THE COMPANY'S REQUEST TO MOVE RECOVERY OF THE FUEL PORTION OF BAD DEBT EXPENSE TO THE PURCHASED GAS ADJUSTMENT ("PGA") WOULD RESULT IN A SOFTENING OF THE COMPANY'S EFFORTS TO COLLECT BAD DEBT. DOES THIS CLAIM HAVE ANY MERIT?

A. No. Mr. Schultz's conclusion is incorrect and inconsistent with sound regulatory principles. Regardless of whether Peoples recovers the fuel portion of bad debt through base rates or through the PGA, the Company will continue as it always has to use all appropriate resources to recover the full amount of outstanding accounts receivable. As noted in my direct testimony, the Company's proposed pro forma adjustment to remove the fuel portion of bad debt expense from the O&M expense reflected in base rates represents 46% of total bad debt expense. For the projected test year, the adjustment to reflect the fuel portion of bad debt expense is $723,580. This leaves a remaining balance of $849,420 of the Company's O&M expense in base rates, or 54% of the total calculated expense. In my opinion, 54% of the expense represents a material expense to the Company for which ample motivation still remains to maintain its excellent history of collections.

Q. **DO YOU AGREE WITH MR. SCHULTZ'S STATEMENT THAT THE PGA IS VIRTUALLY AN AUTOMATIC PASS THROUGH?**

A. No. Florida has no automatic pass through clauses. The PGA mechanism is thoroughly audited every year by Commission staff. As such, all charges to the PGA are reviewed each year by the Commission, which has the authority to disallow expenses.

Q. **HAS THE COMMISSION'S POLICY BEEN TO RECOVER ALL PRUDENTLY INCURRED GAS RELATED EXPENSES THROUGH THE PGA?**

A. Yes, but the Commission has never addressed the recovery of the fuel cost portion of bad debt expense through the clause. Peoples believes recovery of the fuel cost portion of bad debt expense through the PGA would be consistent with the Commission's policy with respect to all other gas related costs. Mr. Schultz appears to never consider this policy.

Incentive Compensation

Q. **MR. SCHULTZ COMPLAINS THAT THE COMPANY DID NOT PROVIDE SUFFICIENT INFORMATION IN THE DISCOVERY PROCESS IN ORDER TO EVALUATE THE INCENTIVE GOALS AND RELATED INCENTIVE COMPENSATION. HOW DO YOU**

RESPOND TO THIS COMPLAINT?

A. I don't believe this is true. To date, of the more than 100,000 pages of documents the Company has produced as part of the discovery process, more than 41,000 pages have been copied for OPC and Commission Staff. Included in this production were a significant number of documents related to incentive compensation, especially those produced in response to OPC's First and Second Sets of Requests for Production of Documents (Nos. 35, 59, and 60) and OPC's First and Second Sets of Interrogatories (Nos. 22, 28, 41, 42, 43, 61 and 79). If this data was not sufficient for Mr. Schultz's needs, he could have and should have asked for additional detail. Despite having as much as two and a half months between the date of the Company's responses to discovery and the date of Mr. Schultz's testimony, the first I learned of this alleged incompleteness was in reading his filed testimony.

Q. WHAT ADJUSTMENT IS MR. SCHULTZ PROPOSING REGARDING INCENTIVE COMPENSATION?

A. In the face of what he claims was incomplete information with respect to the Company's incentive goals, Mr. Schultz has proposed to eliminate 100% of the Company's targeted 2009 incentive compensation.

Q. DO YOU AGREE WITH MR. SCHULTZ'S PROPOSED ADJUSTMENT?

A. No. Mr. Schultz does not adequately support this conclusion and his proposed adjustment is not appropriate.

Q. PLEASE DESCRIBE PEOPLES' COMPENSATION PLAN.

A. The Company targets total compensation at the market average when comparing external market data to similar Company positions. For all employees of Peoples, there are two parts of compensation – base salary, which is the fixed portion of total compensation, and short-term incentive, which is the cash portion of compensation that is "at risk". For officers and key employees, there is a third component of compensation, long-term incentive, which is the equity portion of total compensation.

The Company considers these multiple components to be key elements of its total rewards plan, which also includes other benefits such as health care and life insurance benefits. Each of these components plays an important role in enabling Peoples to remain competitive with other companies seeking to attract similarly qualified employees.

Q. PLEASE DESCRIBE HOW THE COMPANY'S SHORT-TERM INCENTIVE PROGRAMS WORK.

A. As I said, Peoples has three types of short-term incentive plans – an officer short-term incentive plan, a key employee short-term incentive plan, and a general employee short-term incentive plan known as "RSVP", or "Rewarding Service, Valuing Performance".

The officers' short-term incentive plan provides a consistent framework for applying annual incentive pay to officers of Peoples. Each participant is assigned a target award amount, expressed as a percentage of annual base salary. The target award levels are established at a level that, when combined with each participant's base salary, provides a competitive total cash compensation opportunity. The incentive portion reflects compensation "at risk" which is directly related to performance and results achieved. Performance is measured, in part, against a combination of quantifiable financial and operational goals. Each participant has a "business plan" goal which reflects the participant's contribution to achieving initiatives in support of the business plan and overcoming any business changes by mitigating the impact of unexpected adverse business developments or enhancing profitability through effective management initiatives beyond the business plan.

The key employee short-term incentive plan works virtually identically to the incentive plan for officers. As with officers, key employees have both financial and operational goals.

The general employee short-term incentive RSVP plan is available to all other employees working at least 20 hours per week. For 2008, the plan is comprised of customer service, safety, financial and individual performance goals. The target payout percentage is applied to the higher of the employee's total earnings or job market value for the calendar year.

The incentive plans put a portion of employees' compensation "at risk". This means that if performance goals are not met, the payout is not made. If certain performance results are achieved, a predictable award will be earned based upon objective criteria. The actual amount of the award depends upon the achieved results.

All of the incentive plans are designed to emphasize key operational and financial goals, link pay with business performance and personal contributions to results, motivate participants to achieve high levels of performance, and reinforce desired business behaviors and results. Incentive plans such as these encourage cost control and resource optimization, both of which benefit customers. While there is no empirical evidence to support it, the Company attributes its incentive plans to helping it manage costs for an extended period of time with only one base rate increase request and to its favorable performance under the Commission's O&M expense benchmark test.

Q. IS INCENTIVE PAY A KEY COMPONENT OF TOTAL COMPENSATION?

A. Yes, it is. The Company uses market data and benchmarking results to measure the competitiveness of its compensation. In a time when utilities are facing workforce challenges requiring numerous industry-wide initiatives, it is critical for Peoples to attract and retain talented individuals. Its total compensation plan, including incentive compensation, is designed to cost-effectively do so.

Q. HOW DOES THE COMPANY DETERMINE REASONABLE AND APPROPRIATE COMPENSATION LEVELS?

A. The Company uses market data and benchmarking results to measure the competitiveness of its compensation. For each Company position, it matches essential job functions to those found in external market surveys. These same surveys show that incentive compensation programs like Peoples' are common. Based on the *World at Work 2008/2009 Annual Salary Budget Survey*, over 80% of the 2,375 companies surveyed use an incentive pay program.

Incentive compensation plans are not new. In fact, Peoples' RSVP program has been in place for many years, and its appropriateness was not challenged by the Commission in the Company's last rate case in 2002. In the most recent Gulf Power Company ("Gulf") base rate proceeding

(Docket No. 010949-EI), Mr. Schultz filed testimony that recommended the removal of portions of incentive pay from O&M expense. The Commission disagreed and made no adjustment, noting that Gulf offers a plan consisting of base salary and incentive compensation and that only receiving a base salary would mean Gulf employees would be compensated below employees at other companies. While I am not familiar with the details of Gulf's plan, its utilization of market data appears to be similar to Peoples'. One apparent difference is that Gulf's philosophy is to pay employees at the 75th percentile while Peoples' is to target the market average.

Q. WOULD PEOPLES NEED TO CONSIDER RESTRUCTURING ITS TOTAL COMPENSATION PACKAGE IF ANY INCENTIVE COMPENSATION EXPENSES WERE EXCLUDED?

A. Yes. Peoples would consider redesigning its total compensation package, focused on decreasing or eliminating the "at risk" incentive compensation component. It is inappropriate to single out the incentive component of employees' total compensation just because it is called "incentive" compensation. Peoples' total compensation packages, including the portion that is contingent on achieving incentive goals, is set near the average level, which is the relevant level of cost that should be considered for ratemaking purposes. Accepting Mr. Schultz's recommendation to disallow incentive compensation would adversely affect the Company's ability to compete in attracting and retaining a high quality and skilled workforce. Otherwise, total compensation would be below the average for comparable jobs putting it at a competitive disadvantage.

It's also worth noting that using incentive compensation programs is less costly than increasing base salaries because incentive compensation is "at risk" and, by definition, not guaranteed. The "at risk" component motivates employees to perform at high levels and results in more efficiency, which translates to direct benefits for the Company's customers.

Q. MR. SCHULTZ CLAIMS THAT THE COMPANY HAS FAILED TO SHOW THAT THE GOALS SET ARE REALISTIC GOALS. CAN YOU EXPLAIN THE GOAL SETTING PROCESS?

A. Yes. But I must begin by saying Mr. Schultz completely misunderstands the term "incentive compensation." Goals are established each year to focus the organization on customer service, safety, financial and individual performance priorities. The goals are designed to be measurable and attainable but still represent a challenge to achieve. The goal-setting process includes a review of historical results and achievements, the challenges of the goal, and the applicability to the upcoming year's operational and financial objectives. The goals are set to have a reasonable chance of achievement while requiring efforts that challenge the organization's employees and balance the cost to provide targeted levels of service. The goals have been appropriately set and have helped Peoples accomplish overall operational and financial successes over the years. The goal-setting process is not taken lightly by the Company and there are numerous factors that go into setting goals and targets each year, including consideration of past achievements, organizational changes, and system enhancements.

Q. WHAT DID YOU MEAN WHEN YOU SAID MR. SCHULTZ "COMPLETELY MISUNDERSTANDS" THE TERM "INCENTIVE COMPENSATION"?

A. My statement might best be explained by an example, since the <u>total</u> compensation of each Peoples employee is established at the market average for similar positions in order for Peoples to be competitive in acquiring capable employees.

Assume the <u>total</u> market-based annual compensation for a particular position is \$100. For non-key and non-officer employees, this \$100 might be broken down into a base salary of \$95 and an "incentive" component of \$5. In order to be paid the \$5, the employee must achieve certain goals. If the goals are not achieved to the extent required, the Company doesn't pay the full \$5 to the employee, and the employee is therefore compensated for the year at less than the market average for his or her position. If the goals (whatever they may be) are achieved, the employee is paid the \$5 "incentive" and is compensated at the market average for his or her position.

Peoples could just as easily change its compensation program and pay the employee in the example a base salary of \$100, establish no goals beneficial to the Company's business plans or customer satisfaction, and "go its merry way." There would therefore be no "incentive" compensation, and nothing for Mr. Schultz to question. It should "go without saying" that an employee who failed to perform – whether under an "incentive" plan or a market-based program in which his or her total compensation was all base salary – would be terminated.

Q. PLEASE PROVIDE ADDITIONAL DETAIL REGARDING GOALS FOR OFFICERS AND KEY EMPLOYEES.

A. While much of what I have just described is applicable to all employees, including officers and key employees, there are some differences with respect to these latter groups of employees. For 2008, Peoples' officers' short-term incentive plan consisted of 40% operational goals, 40% financial goals focused on Peoples Gas' net income and 20% focused on TECO Energy financial results. For key employees, 50% of their goals were operational, 35% tied to Peoples Gas' net income, and the remaining 15% focused on TECO Energy's financial results.

Q. IS INCENTIVE COMPENSATION APPROPRIATE TO INCLUDE IN THE COMPANY'S O&M EXPENSE FOR PURPOSES OF THIS PROCEEDING?

A. Yes. The overall focus of both the officer and key employee programs is on Peoples' operational and financial results. Participants in these plans help ensure the Company's goal of providing customers with safe and reliable service is achieved. The participants also focus on ensuring an adequate return to shareholders. Both of these objectives benefit ratepayers. The first directly benefits ratepayers who rely on natural gas service to meet their energy needs, and the second indirectly benefits ratepayers by having a Company that is able to attract needed capital at a reasonable cost to provide safe and reliable service.

Q. MR. SCHULTZ SUGGESTS DENYING THE ENTIRE AMOUNT OF INCENTIVE COMPENSATION FOR PURPOSES OF THIS PROCEEDING. IS THAT RECOMMENDATION APPROPRIATE?

A. Absolutely not. There is no basis for any adjustment to "incentive" compensation, and Mr. Schultz has provided no study, assertion, guess or any other evidence to even suggest that the Company's paying its employees total compensation at the market average for comparable positions is either imprudent or unreasonable. Certainly, he suggests no alternative method of determining how they should be paid for the work they perform for the Company, or how the prudency or reasonableness of their compensation should be judged.

"Incentive" compensation is simply a portion of Peoples' employees' total market-based compensation that may or may not be paid, depending on whether or not certain goals are, or are not, achieved. As described in detail above and as documented in the Company's answers to interrogatories and requests for production of documents throughout the discovery process, the Company's short-term incentive compensation program is part of an overall total compensation package and is heavily weighted toward providing benefits to customers. The goals promote safety, reliable service, cost containment and the financial soundness of Peoples. The entire expense should be allowed because it is designed to achieve favorable customer results. Whatever the goals to be achieved may be, Peoples believes – as do numerous other companies – that making a portion of its employees' total market-based compensation contingent on meeting such goals is beneficial not only to the Company, but to its customers.

<u>**Stock Compensation**</u>

Q. MR. SCHULTZ CHARACTERIZES RESTRICTED STOCK

GRANTS AND STOCK OPTIONS AS "EXCESSIVE COMPENSATION THAT SHOULD NOT BE PAID FOR WITH RATEPAYER FUNDS". DO YOU AGREE WITH THIS CHARACTERIZATION?

A. No, I do not, and his proposal to remove 100% of this expense from the Company's request is not appropriate. Mr. Schultz has provided no analysis, market benchmarks, or other data to support his recommended adjustment. Simply characterizing these elements of compensation as "excessive" and making a few inflammatory statements about them is not sufficient evidence to warrant excluding the entire amount from the Company's O&M expense, which is already below the Commission's benchmark.

Q. PLEASE DESCRIBE THE COMPANY'S LONG-TERM INCENTIVE COMPENSATION PLAN.

A. The Company's long-term incentive plan is another component of officers' and key employees' total compensation package. Through stock awards, the Company's plan is designed to reward long-term Company and individual successes and, as such, it is used as a retention tool. For eligible employees, the Company awards a mix of 70% performance and 30% time-vested restricted shares based on an annual market review conducted by outside consultants that compares the value of the grants to salary levels to determine the appropriate award amounts. The Company's performance must be strong and employees must remain employed by the Company for the duration of the vesting period to be eligible for any payout.

For performance restricted shares, the Company's performance is measured against a set of peer companies. The performance measurement period is three years and the award (ranging from zero to 150% of the grant amount) depends on the Company's total return as compared to other peer companies.

Unlike performance restricted shares, time-vested restricted shares are not measured against TECO Energy total shareholder return but are used solely as a retention tool. The eligible employee must be employed at the end of a three-year vesting period in order to receive payment of these shares.

Like the incentive plans discussed at length earlier in my testimony, the long-term incentive program is part of Peoples' total compensation package and it specifically allows the Company to retain some of its key talent. All aspects of these plans are market-based and benefit ratepayers and shareholders alike. Accordingly, the associated costs are appropriately included in the Company's cost of service. Mr. Schultz has offered no evidence to suggest that any portion of these costs is unreasonable, imprudently incurred, or not in the best interests of either the Company or its customers.

Q. MR. SCHULTZ ALSO INDICATES THAT EQUITY COMPENSATION INCREASES THE DISPARITY BETWEEN THE GENERAL EMPLOYEE POPULATION AND MANAGEMENT, AND THAT THIS BENEFIT IS ESPECIALLY EXCESSIVE GIVEN THE CURRENT ECONOMY. HE ALSO NOTES THAT VERY FEW OF THE COMPANY'S RATEPAYERS

HAVE THESE BENEFITS AVAILABLE TO THEM. HOW DO YOU RESPOND TO THESE STATEMENTS?

A. Mr. Schultz's comments, besides being unsupported, are not relevant in determining whether these expenses are appropriate for the particular level of employee and his or her role in the Company's management. What is relevant are the points I have previously made with respect to the benefits required to attract and retain high-quality individuals who are motivated to make good decisions for both the Company and its ratepayers. Finally, while the current economy might eventually impact comparable job market values, it would have no impact on the "at-risk" payment rationale for the Company's incentive compensation plan.

<u>**Directors and Officers Insurance**</u>

Q. WHAT ARE MR. SCHULTZ'S COMPLAINTS WITH RESPECT TO DIRECTORS AND OFFICERS ("D&O") INSURANCE EXPENSE?

A. Mr. Schultz argues, in a somewhat circular manner, that D&O insurance should be the responsibility of shareholders and that the expense should not be borne by the ratepayers. Without any market studies or information supporting his claim, he also states that compensation and benefit packages provided to officers and directors are sufficient to provide remuneration for their services, and that D&O insurance represents an incremental expense that is, therefore, not required to attract and retain qualified individuals to serve in these valuable roles. Finally, Mr. Schultz states that if the Commission finds justification for the ratepayers to share in this expense, it should arbitrarily base it on the 2003 expense level rather than the 2009 expected expense level.

Q. SHOULD D&O INSURANCE BE TREATED ANY DIFFERENTLY THAN OTHER INSURANCE?

A. No. D&O insurance is a cost of doing business that is every bit as essential as traditional property and casualty insurance. D&O insurance is clearly a necessary part of conducting business for any large corporation. In light of the growing risk exposures related to corporate governance, it would be impossible to attract and retain highly qualified directors and officers without the protections afforded by a D&O insurance program. Corporate surveys indicate that virtually all publicly traded entities maintain D&O insurance. It is a necessary and prudent cost of providing gas service to customers and is appropriately included in the Company's determination of revenue requirements in this case.

Q. DO YOU AGREE WITH MR. SCHULTZ'S ASSERTION THAT D&O INSURANCE PROVIDES NO BENEFIT TO RATEPAYERS?

A. No. To the contrary, it is highly unlikely that Peoples and its affiliated companies would be able to obtain capable directors and officers if it did not maintain D&O liability coverage. D&O insurance enables the Company to assemble a highly qualified team of directors and officers to manage and oversee the conduct of its business. Furthermore, it provides a significant source of balance sheet protection from losses from lawsuits, thereby safeguarding the utility from financial stress and preserving capital for uses that ensure the efficient and continuing delivery of gas service to customers. In my opinion, it would be imprudent for Peoples not to have D&O coverage, and I am not personally aware that this

Commission has ever disallowed D&O insurance premiums as an expense for ratemaking purposes.

Q. WHAT HAS HAPPENED IN THE D&O INSURANCE MARKET IN THE PAST FEW YEARS THAT HAS IMPACTED COSTS?

A. D&O insurance premiums fluctuate as a result of some of the same market forces that impact the premiums for property, liability, workers' compensation, and other insurance policies. The D&O insurance market rapidly shifted from a very "soft" pricing environment in the late 1990's into a difficult or "hard" market in the early 2000's. The primary drivers for the significant change in market conditions included the negative claims experience of D&O insurance underwriters resulting from the "dot com" stock market bubble, the negative influence of the September 11th terrorist attacks on the entire insurance market, increasing and significant claim activity related to companies such as Enron, and a general increase in attention and scrutiny surrounding corporate governance, including the passage of Sarbanes-Oxley legislation. A significant contraction in the availability of, and an increase in the pricing for, D&O insurance is directly attributable to these factors.

Since 2007, Peoples' premiums have stabilized to a point that represents the current "market" pricing level for D&O insurance but the Company anticipates that it will be challenging to sustain the pricing included in its 2009 budget forecast due to the negative insurance market influences that are expected given the current financial market distress.

Q. PLEASE COMMENT ON MR. SCHULTZ'S STATEMENT THAT IF THE COMMISSION DETERMINES THERE IS SOME

RATEPAYER BENEFIT TO D&O INSURANCE, IT SHOULD LIMIT THE EXPENSE LEVEL TO THE 2003 EXPENSE AMOUNT.

A. This position is arbitrary and totally inappropriate. Mr. Schultz has arbitrarily chosen a year simply because it reflects an expense level lower than the amount requested. Interestingly, he ignores the fact that the test year expense is actually less than the Company's 2007 and 2008 amounts. The 2009 projected expense is reasonable and prudent, not because of its relationship to historical levels that happen to be favorable, but because it is a well-supported projection of the cost of this type of insurance based on expected market conditions.

Q. WHAT OTHER DIFFICULTY EXISTS WITH RESPECT TO MR. SCHULTZ'S PROPOSED ELIMINATION OF $342,000 OF EXPENSE RELATED TO D&O INSURANCE?

A. In addition to the previously mentioned reasons Mr. Schultz's adjustment is not appropriate, he has mistakenly proposed to eliminate D&O insurance expense twice. That is, he has "double dipped" in his attempt to reduce the Company's projected expenses.

Q. PLEASE EXPLAIN MR. SCHULTZ'S "DOUBLE DIP" ERROR.

A. In the Company's books and records, the full amount of D&O insurance expense is included in the TECO Energy allocation of its general and administrative ("G&A") expenses; that is, the Company incurs no direct expense for D&O insurance. Mr. Schultz proposed elimination of this expense based on the Company's response to an interrogatory, not based on a review of its books and records, and apparently assumed the expense was one incurred directly by Peoples, rather than indirectly via the TECO Energy G&A expense allocation. Separately, as discussed below and as shown on Schedule C-8 of his Exhibit HWS-1, Mr. Schultz proposed an adjustment of $1.26 million to eliminate three specific items included in TECO Energy's G&A allocation, including approximately $337,000 for D&O insurance. As I have previously testified, the Company does not agree that any adjustment to remove D&O insurance expense is appropriate. Additionally, in proposing two separate adjustments, Mr. Schultz would have the Commission remove the Company's D&O insurance expense twice.

<u>TECO Energy Allocated Expenses</u>

Q. DO YOU AGREE WITH MR. SCHULTZ'S PROPOSED $1.26 MILLION ADJUSTMENT TO TECO ENERGY ALLOCATED EXPENSES?

A. No. Mr. Schultz has recommended exclusion of TECO Energy's allocated expenses for incentive compensation, restricted stock grants and stock options, and D&O insurance for the same reasons he is recommending a disallowance for Peoples. To his credit, Mr. Schultz recognizes that the expense levels allocated from TECO Energy included in the projected test year are lower than in the historic base year, and he reduces his proposed adjustment on a pro rata basis. As stated earlier, however, there is no basis for his recommended adjustments and they are not appropriate.

<u>Marketing Expense</u>

Q. WHAT DOES MR. SCHULTZ PROPOSE REGARDING THE COMPANY'S MARKETING EXPENSE?

A. Mr. Schultz proposes reducing the Company's expense level by $2 million. His adjustment, however, is based on a misunderstanding of the targets and related variable payment mechanism contained in the contract between Peoples and TECO Partners, Inc. ("TECO Partners"). He also displays a general lack of understanding of Peoples' natural gas business in proposing this adjustment. Mr. Schultz's recommended adjustment is arbitrary and without merit.

Q. PLEASE EXPLAIN MR. SCHULTZ'S MISUNDERSTANDING OF THE TECO PARTNERS CONTRACT.

A. Mr. Schultz bases his proposed adjustment on the difference between the contractual target of 12,000 new "signings" for 2009 and the net number of customer additions. He confuses gross customer additions with net customer additions. This accounts for most of the difference. Second, Mr. Schultz misunderstands the difference between "signings" and customer additions. Signings do not necessarily result in customer additions in the same year as the signing; a customer addition can lag the date of the signing for various reasons.

Q. CAN YOU GIVE EXAMPLES OF HOW ACTUAL CUSTOMER ADDITIONS CAN LAG THE DATE OF A SIGNING?

A. Yes. A development with 336 homes in Orlando was signed in March 2008 for gas service. Customers will begin receiving service over a period of years as the development builds out. However, no homes in the "signed" development began receiving service in 2008. Under the contract with TECO Partners, 336 customers would have been classified as "signings", but would not be deemed "new customers" until the year they begin taking natural gas service.

Another example is a restaurant signed in December 2007. The restaurant's construction was not scheduled to be completed for twelve to eighteen months and it was not deemed a customer until one or two years after the signing.

Q. MR. SCHULTZ SEEMS CONCERNED THAT TECO PARTNERS COULD BE COMPENSATED BY PEOPLES EVEN IF CUSTOMER LEVELS WERE DECLINING. IS THIS CONCERN WARRANTED?

A. No. Mr. Schultz's concern is apparently based on a misunderstanding of the depth and breadth of services provided by TECO Partners to Peoples under the contract. The contract is not simply one that reflects new sales efforts that add customers. While this is clearly one aspect of the services provided, there are many other areas of marketing and sales support services, including customer retention efforts, that are provided under the contract.

The marketing services provided by TECO Partners to Peoples have cost the Company less than when Peoples had its own marketing resources. As noted in my direct testimony, the Company's marketing costs compared to the Commission's benchmark amount for marketing expenses is a direct result of this contract. In fact, the projected expense for 2009 is significantly lower than the expense allowed by the Commission in the Company's last rate proceeding in 2002. Both the contract and the charges for which it provides are appropriate, and have provided Peoples' ratepayers with millions of dollars of savings over the years. No amount of adjustment is warranted with respect to the Company's marketing contract with TECO Partners.

Rate Case Expense

Q. **MR. SCHULTZ ASSERTS THAT PEOPLES' RATE CASE EXPENSE IS EXCESSIVE. HE ARGUES THAT THE COMPANY'S EXISTING ACCOUNTING STAFF SHOULD HAVE BEEN ABLE TO HANDLE MORE TASKS INTERNALLY, AND THAT RATE CASE COSTS SHOULD BE LIMITED TO STATED CONTRACT AMOUNTS. DO YOU AGREE?**

A. No. Mr. Schultz makes a number of inaccurate assertions related to rate case expense. At this stage in this proceeding, I doubt any interested party would disagree that assembling the filing made by the Company requires resources that are incremental to Peoples' day-to-day business operations. Just as the intervenors have hired outside resources to assist in preparing their cases, Peoples has hired consultants to assist in case preparation and to serve as expert witnesses. The Company is staffed to handle ongoing, day-to-day responsibilities, and the additional workload of this rate filing required supplementing the existing team. For Peoples to do otherwise would result in increased cost to customers.

Q. **WHAT ADJUSTMENTS DOES MR. SCHULTZ PROPOSE REGARDING THE COMPANY'S RATE CASE EXPENSE AMOUNTS AND ARE THERE ANY PROBLEMS WITH HIS PROPOSALS?**

A. Mr. Schultz proposes adjustments to reflect the "bid" amounts in the Company's contracts with the service providers. In some cases, the differences he mentions are simply differences due to the amounts included in the filing being estimates of expenses which, although based on the contracts, may have been rounded for estimation purposes. More importantly, Mr. Schultz's proposed $37,000 reduction for Huron Consulting Group is not reflective of that contract bid, which was for professional services only and did not reflect out-of-pocket expenses that are reimbursable by the Company.

Q. WHAT ADJUSTMENT DOES MR. SCHULTZ PROPOSE WITH RESPECT TO THE SERVICES OF C. HOLDEN?

A. Mr. Holden was retained as a contractor on an "as needed" basis to supplement the Company's accounting staff. While the related fees are paid on an hourly basis, the Company was required to estimate the total expenses expected for Mr. Holden's work. Mr. Schultz arbitrarily says that the amount related to Mr. Holden's contract should be reduced by 50% "because the Company should have been handling more of the rate case internally". Mr. Schultz's statement is totally unsubstantiated and is not based on any understanding of the Company's staff size, its workload, any studies of the same, or any information other than his arbitrary and conclusory statement. To provide the detailed information required by the Company for this proceeding requires quality professionals to supplement Peoples' existing staff. Mr. Holden is familiar with the Company and its accounting systems and he provided quality services. It would be significantly more expensive for the Company to maintain the level of resources required to process such a case on a permanent basis so that the resources were in place for periodic rate filings. Mr. Schultz's proposed adjustment for Mr. Holden's services, as well as his comments about the services of Huron Consulting Group and others, is inappropriate and unsubstantiated.

Q. MR. SCHULTZ RECOMMENDS THAT RATE CASE EXPENSE BE AMORTIZED OVER FIVE YEARS RATHER THAN THREE AS PROPOSED BY THE COMPANY. DO YOU AGREE?

A. No. While it is difficult to predict when Peoples will file its next base rate case, I am relatively certain it will be sooner than five years. Three years is an appropriate amortization period for rate case expense and no adjustment should be made.

Payroll Expense

Q. WHAT DIFFICULTY DOES MR. SCHULTZ HAVE WITH THE COMPANY'S PAYROLL INCLUDED IN THE FILING AND WHAT ADJUSTMENT DOES HE PROPOSE?

A. Mr. Schultz has basically two issues with the proposed payroll expense included in the filing. First, he goes to great lengths in discussing a purported discrepancy between the Company's MFR filing and an interrogatory response. Second, he takes issue with the Commission's prescribed method of projecting O&M expense in gas rate cases.

Q. CAN YOU SHED SOME LIGHT ON THE FIRST ISSUE?

A. Yes. As discussed more fully in my direct testimony, the Company employed its typical budget methodology in preparing its forecast of 2009 O&M expenses, including payroll. This methodology projects costs on a resource basis (payroll, material and supplies, outside services, etc.). For purposes of the MFRs (specifically MFR Schedule G-2, pages 10-19), the

Company prepared the "FERC account trending" analysis prescribed by the Commission for gas company rate cases. Although historical data for the base year segregates payroll in this approach, there is really no way to compare specific detailed cost information between Peoples' budget methodology and the Commission's FERC account trending methodology. The only valid comparison between these two methods is at the "total O&M expense" level. In that regard, the Company reconciled total O&M expense using these two distinct methods with immaterial differences. I discussed this minor difference in my direct testimony and in my Exhibit ___ (JPH-2). In noting the apparent discrepancy between the MFRs and an interrogatory response with respect to payroll expense, Mr. Schultz is basically attempting to reconcile expenses at a resource level, and that comparison cannot be accurately performed.

Q. WHAT CAN YOU CONCLUDE FROM THE RECONCILIATION OF TOTAL O&M EXPENSE SHOWN IN EXHIBIT ___ (JPH-2)?

A. Based on that reconciliation, it is apparent that the two methods produce almost the same result. This is a strong indication that the O&M expense requested in the filing is reasonable, including the payroll expense included in the filing.

Q. CAN YOU ADDRESS FURTHER MR. SCHULTZ'S PROPOSED ADJUSTMENT TO ELIMINATE $210,199 OF PAYROLL EXPENSE FROM THE FILING?

A. Yes. Mr. Schultz takes issue with the Commission's prescribed approach for calculating O&M expense in natural gas utility rate cases. The Company followed this approach in presenting its O&M expense, but as noted above and in my direct testimony, it also utilized its usual budget methodology to calculate O&M expense for the projected test year. In a few instances, isolated new positions were included in the 2009 payroll budget. These are clearly limited and do not reflect a significant increase in expense. Mr. Schultz's blanket approach lacks merit and justification, and it does not consider the Company's reconciliation of total O&M expense that I included on Exhibit ___ (JPH-2).

Storm Damage Reserve

Q. WHAT PROBLEMS DOES MR. SCHULTZ CITE WITH RESPECT TO THE COMPANY'S PROPOSAL TO ESTABLISH A MODEST STORM DAMAGE RESERVE?

A. Mr. Schultz takes issue with the Company's proposal for two reasons. First, he says there is no evidence that a significant level of storms will occur and result in damage. Second, he takes issue with the Company's proposal of an unfunded reserve, stating that it's not appropriate that the Company recover these funds "cost free" from the rate payers and use them for any purpose desired.

Q. PLEASE DISCUSS THE FIRST ISSUE RAISED BY MR. SCHULTZ.

A. His first point is not backed up by any evidence in the record, including his own testimony. He states that only two years of the 10 years examined by the Company experienced abnormal levels of damages from storms. In my view, this fact strongly supports the Company's position of having a steady accrual for a storm damage reserve rather than being faced with periodic and potentially significant expenditures following a storm. Mr.

Schultz has presented nothing to support the denial of the Company's proposal; simply stating his assumption does not prove it. To subject Peoples' customers to burdensome surcharges for storm costs based on Mr. Schultz's optimistic assumption would be inappropriate.

Q. PLEASE DISCUSS HIS ISSUE REGARDING THE UNFUNDED NATURE OF THE REQUESTED RESERVE.

A. Unfunded reserves are common in the electric industry, at least in Florida. An unfunded reserve is more cost-effective and reduces rate base. The unfunded reserve allows Peoples to secure its credit lines and otherwise reduces overall capital needs (for the benefit of customers). Mr. Schultz's concerns regarding this issue are unfounded.

Q. PLEASE SUMMARIZE WHY IT IS BENEFICIAL FOR RATEPAYERS TO EMPLOY A STORM DAMAGE RESERVE AS REQUESTED IN THIS PROCEEDING.

A. There are several customer advantages to Peoples' having a reasonable storm damage reserve: costs are spread over a longer period of time, overall costs are lower in the long term, and rate shock is mitigated or avoided when a storm does hit. Peoples' proposed reserve is prudent and appropriate, the amount is reasonable, and no adjustment is warranted.

Employee Benefits Expense

Q. WHAT ADJUSTMENTS ARE PROPOSED BY MR. SCHULTZ RELATED TO CERTAIN EMPLOYEE-RELATED EXPENSES?

A. Mr. Schultz takes exception to two employee benefit expenses. His first adjustment, totaling approximately $8,400, is because the Company failed to adjust its regulatory adjustment in excluding certain costs from regulatory Net Operating Income by an inflation factor. While this adjustment is clearly not material to this proceeding, Mr. Schultz is correct.

Q. WHAT IS THE SECOND ASPECT OF MR. SCHULTZ'S PROPOSED EXPENSE REDUCTION IN THIS AREA?

A. Mr. Schultz takes exception to an additional $164,500 of costs related to new employee-related programs. He characterizes these items as "additional unjustified costs" and simply proposes an adjustment to remove the entire $164,500.

Q. ARE THESE COSTS "UNJUSTIFIED" AS CHARACTERIZED BY MR. SCHULTZ?

A. No. Mr. Schultz's own testimony describes the nature of these items. Other than his own characterization, Mr. Schultz provides no explanation as to why he believes these costs are unjustified other than the fact that they are new. As noted in my direct testimony, the Company's budget process for purposes of this rate proceeding included making a request to field and corporate managers with respect to any new prudent expenses anticipated in 2009. In the case of the costs in question, the Company's Human Resources area provided detailed information noting these additional employee costs.

Q. WHY IS MR. SCHULTZ'S PROPOSED ADJUSTMENT TO REMOVE THE $164,500 INAPPROPRIATE?

A. Mr. Schultz inappropriately picks and chooses certain categories of expenses that happen to be higher than specifically selected previous years and calls for reductions in test year expenses. He completely ignores all of the other categories of expenses that are lower than previous years. Blindly cutting certain expenses in isolation, without considering all other expenses and revenues for the test year, is one-sided and totally inappropriate.

Q. DO YOU HAVE SPECIFIC EXAMPLES WHERE THE COMPANY HAS PROJECTED A LOWER EXPENSE LEVEL FOR 2009 THAN IT ACTUALLY EXPERIENCED IN RECENT YEARS?

A. Yes, there are several such instances. In 2007, health care expense exceeded $4.0 million. For the 2009 projected test year, the Company included health care costs at $3.6 million. Additionally, pension expense, which was $2.1 million in 2007, is projected to be $1.7 million in 2009. Ironically, both of these items are recorded in account number 926, the same account number used for the employee-related expenses Mr. Schultz proposes be disallowed.

Q. HOW IS THIS RELATED TO MR. SCHULTZ'S PROPOSED ADJUSTMENT FOR EMPLOYEE-RELATED EXPENSES?

A. Ultimately, Mr. Schultz proposes an adjustment that results in 2009 expenses reverting back to the 2007 amounts. If 2009 expenses should be adjusted to match historical amounts, then in order to be fair, Mr. Schultz must make similar adjustments for expenses like health care and pension expenses. This targeted isolated approach is obviously unfair and imbalanced and should not be the basis for an adjustment to revenue requirements. In the end, none of these expense items should be adjusted. The expenses in question are based on reasonable and prudent cost projections based on the facts and circumstances that are expected to exist in the 2009 projected test year.

Short-Term Debt Rate

Q. PLEASE ADDRESS THE DIFFERENCE BETWEEN DR. WOOLRIDGE'S PROPOSED COST OF SHORT-TERM DEBT COMPARED TO THE COMPANY'S.

A. Because of the volatility and uncertainty surrounding short-term interest rates, the Company utilized average historical LIBOR rates in developing its proposed short-term interest rate of 4.5%. Dr. Woolridge bases his recommendation on the December 17, 2008 LIBOR rate. Current LIBOR rates are at historical lows reflecting the current turmoil in the financial markets. Rates have been extremely volatile and presumably will continue to be volatile for the foreseeable future. It is therefore prudent to use a historical average LIBOR rate as the Company proposes rather than a rate at a particular point in time as Dr. Woolridge has done to determine future short-term funding costs.

Interest Synchronization and Income Taxes

Q. WHAT DOES MR. SCHULTZ RECOMMEND REGARDING THE ISSUES OF INTEREST SYNCHRONIZATION AND INCOME TAXES?

A. Both of these items are "fallout" issues and the adjustments proposed by Mr. Schultz are necessary only if his other adjustments are accepted. Since the Company does not agree with any of these other adjustments, these fallout adjustments are not necessary.

Summary of Rebuttal Testimony

Q. PLEASE SUMMARIZE YOUR REBUTTAL TESTIMONY.

A. I have delineated the concerns and disagreements regarding the substance of the testimonies of OPC witnesses Schultz and Woolridge. Their assertions contain a variety of points that are not accurate, not logical, not appropriate, and/or not in accordance with prior Commission practice. I have presented facts and information that support the Company's petition, the reasonableness and prudence of amounts and positions presented by Peoples, and the appropriateness of the revenue requirement contained in its filing.

Q. DOES THIS CONCLUDE YOUR REBUTTAL TESTIMONY?

A. Yes, it does.