BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of:

DOCKET NO. 110138-EI

PETITION FOR INCREASE IN
RATES BY GULF POWER COMPANY.
_______________________________/

VOLUME 11

Pages 1966 through 2197

PROCEEDINGS: HEARING

COMMISSIONERS
PARTICIPATING: CHAIRMAN ART GRAHAM
COMMISSIONER LISA POLAK EDGAR
COMMISSIONER RONALD A. BRISE
COMMISSIONER EDUARDO E. BALBIS
COMMISSIONER JULIE I. BROWN

DATE: Wednesday, December 14, 2011

TIME: Commenced at 1:45 p.m.
Concluded at 4:20 p.m.

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

REPORTED BY: LAURA MOUNTAIN, RPR
Wilkinson & Associates
(850) 224-0127

APPEARANCES: (As heretofore noted.)

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P R O C E E D I N G S

(Transcript follows in sequence from Volume 10.)

CHAIRMAN GRAHAM: Okay, Mr. McGlothlin.

CROSS EXAMINATION (CONTINUED)

BY MR. McGLOTHLIN:

Q Dr. Vander Weide, shortly before we took up again, I provided you with copies of nine articles. Have you had an opportunity to compare those articles with the ones in your Table 3 of your rebuttal testimony?

A I didn't -- they appear to be the same ones there. I didn't specifically check that every one in that table was there, but I believe these are the correct articles.

Q We're going to talk about each one in turn so you'll have a further opportunity, if there's any doubt in your mind. But I would like to ask that an exhibit number be provided for our composite exhibit.

CHAIRMAN GRAHAM: Well, I believe we're at Number 210, and composite exhibit of -- what are we calling this?

MR. McGLOTHLIN: Articles referred to in Vander Weide rebuttal Schedule 3.

CHAIRMAN GRAHAM: Okay.

(Exhibit No. 210 was marked for identification.)

BY MR. McGLOTHLIN:

Q And my questions are limited in nature, sir. I'm going to ask you to review with me the duration of the projection period that was examined by the authors of each article. The first in your schedule and the first that should be in your stack is the Crichfield, Dyckman and Lakonishok. Do you have it in front of you?

A Yes, I do.

Q Would you turn to page 653 of the study?

A Yes.

Q Would you agree that this article looks at forecasts of annual earnings per share?

A Are you referring me to a particular sentence in here?

Q It should be underlined on your page.

A Oh, yes, I see it. Yes, I do.

Q The next article is the Elton Gruber and Gultekin study.

A Yes.

Q Would you turn to page 352 of that study.

A Yes.

Q And reviewing that page, would you agree with me that this study also looks at forecasts of annual earnings per share?

A Yes, for each of the next two years.

Q Would you look at the next in the series, which is Givoly and Lakonishok?

A Yes.
Q It appears to us that this particular article is a survey of other studies and does not itself examine a projection period. Are you familiar enough with the article to say whether we are right or wrong?
A I believe you're correct.
Q And the next is a study by a Lawrence Brown. Do you have that?
A Yes.
Q And if you'll look at page 82, there's a definition of an acronym, SURPE. Can you tell me what that stands for?
A Apparently it is equal to actual earnings minus predicted quarterly earnings. Actual quarterly earnings minus predicted quarterly earnings divided by actual quarterly earnings.
Q So would you agree with me that the projection periods here are quarterly projections?
A Yes.
Q The next article is by Keane and Runkle. Do you have that?
A Yes.
Q Please turn to page 778 of that study.
A I'm there.
Q Would you agree that this study looks at forecasts

of quarterly earnings per share estimates?
A Yes.
Q The next in the series is Abarbanell -- I'm sure I'm butchering that, but you get the gist.
A Yes.
Q If you'll turn to page 108 of the study.
A Yes.
Q Would you agree that there the authors indicate that the betas -- that the database includes 180,000 consensus quarterly forecasts over the '85-'98 time frame?
A Yes.
Q The next is an article by Ciccone -- am I pronouncing that correctly? Do you have that one, sir?
A Yes, I do.
Q Referring to the very first sentence of the abstract, do you see this sentence: Forecast dispersion, error, and optimism are computed using 120,022 quarterly observations from 1990 to 2001?
A Yes.
Q So would you agree that this study also uses quarterly projections?
A Yes.
Q The next is the article by Clarke, Ferris, and others. If you'll turn to page 176 of that study.
A Yes.

Q Would you agree with me that this study looks at forecasts of quarterly EPS estimates?
A Quarterly estimates starting eight quarters preceding the quarter of a bankruptcy filing.
Q The last in the series is Yang and Mensah. Do you have that?
A Yes.
Q Look at page 197, please, where the authors discuss their data.
A Yes.
Q Do they refer to 12,806 firm-quarter observations in the pre-Reg. FD period, and 13,104 firm-quarter observations in the post-Reg. period?
A Yes, they do.
Q So would those be forecasts of quarterly earnings?
A Yes.
MR. McGLOTHLIN: No further questions.
CHAIRMAN GRAHAM: Okay. Redirect.
MR. WRIGHT: A quick question for this witness.
CHAIRMAN GRAHAM: Okay. I thought you didn't have any questions of this witness.
MR. WRIGHT: I don't recall saying that. If I did, I was mistaken. I'm sorry.
CHAIRMAN GRAHAM: Okay.
MR. WRIGHT: Mr. Chairman, while these are being

distributed, I'd like to enter an appearance for my law partner, John T. LaVia, III. He will be covering the hearing for the Retail Federation this afternoon.

CHAIRMAN GRAHAM: Okay.

MR. WRIGHT: Thank you. Mr. Chairman, the exhibit that we are proffering here is the third-quarter 2011 rate case summary published by the Edison Electric Institute, and I'd like this marked for identification, please.

CHAIRMAN GRAHAM: The number is 211.

(Exhibit 211 marked for identification.)

CROSS EXAMINATION

BY MR. WRIGHT:

Q Good afternoon again, Dr. Vander Weide.

A Good afternoon.

Q I'm sure you're familiar with the EEI rate case summaries?

A Yes.

Q Okay, if I could ask you to turn to numbered page four within the document, itself.

A Yes.

Q I'd just like to ask you to agree that for the third quarter of 2011 there were 17 rate cases filed and the average ROE awarded in those cases was 10.13 percent.

A Yes, and I suppose that that applies to all -- I'm quite confident that applies to all electric utilities and doesn't distinguish between integrated electric utilities and distribution only electric utilities. And the number is similar to the numbers that I reported earlier for all utilities, but not -- it doesn't tell us about integrated electric utilities.

MR. WRIGHT: Thank you. That's all the questions I have, Mr. Chairman.

CHAIRMAN GRAHAM: Okay. Gulf, redirect for this witness?

REDIRECT EXAMINATION

BY MR. MELSON:

Q Dr. Vander Weide, could you turn to the Ciccone article? It's "Trends in analyst earnings forecast properties." My recollection is it's about halfway through the stack.

A Yes.

Q Mr. McGlothlin asked you if that used quarterly forecasts. Could you turn to page four of that. You see the bold number three?

A Yes.

Q Would you read the second and third sentences there.

A Quarterly forecasts are used to present all results. The results using annual forecasts are similar to the quarterly results and do not require separate analysis.

Q And you were asked on each of these articles to identify the forecast period. Does the fact that these articles have used quarterly or annual periods detract from your conclusion about the use of analyst growth forecasts?

A No, none -- not whatsoever. They all support evidence that the analysts are unbiased. They do not support the contrary conclusion that analysts are optimistic. Not a single one of them does.

And more importantly, they support the conclusion, along with the other articles that I cite, for instance, in Table 2, that analyst growth forecasts are impounded in stock prices and that investors use analyst earnings forecasts when they -- when they determine how much they're willing to pay for a stock.

MR. MELSON: That's all I had, and Gulf would move Exhibit 158.

CHAIRMAN GRAHAM: Page 26 -- page 26, Number 158 into the record.

(Exhibit 158 admitted in evidence.)

MR. WRIGHT: Move 210.

CHAIRMAN GRAHAM: Move 210 into the record.

(Exhibit 210 admitted in evidence.)

MR. WRIGHT: And 211, please, Mr. Chairman.

CHAIRMAN GRAHAM: And 211 into the record.

(Exhibit 211 admitted in evidence.)

MR. YOUNG: Mr. Chairman, Staff moves 185 and 186.

MR. McGLOTHLIN: I thank the Commissioners for their patience while we managed that production situation.

CHAIRMAN GRAHAM: 186 and 187, is that what you said?

MR. YOUNG: 185 and 186.

CHAIRMAN GRAHAM: 185 and 186. Okay.

(Exhibit 185 and 186 admitted in evidence.)

CHAIRMAN GRAHAM: Mr. McGlothlin, I'm sorry?

MR. McGLOTHLIN: I just expressed my thanks for being patient while we dealt with the copying situation.

CHAIRMAN GRAHAM: We were able to continue moving forward; that's all that matters.

MR. MELSON: May Dr. Vander Weide now be permanently excused?

CHAIRMAN GRAHAM: If there's no other questions, or no objections, Mr. Vander Weide, thank you very much for coming and your testimony.

THE WITNESS: Thank you. It was a pleasure being here.

MR. GUYTON: Gulf's next witness is Stacy Kilcoyne.

Thereupon,

STACY R. KILCOYNE

was called as a witness on behalf of Gulf Power Company, and having been previously duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. GUYTON:

Q Would you please state your name for the record.

A Stacy R. Kilcoyne.

Q And have you previously been sworn?

A I have.

Q Ms. Kilcoyne, did you have occasion to prefile rebuttal testimony consisting of 30 pages?

A I did.

Q And is that testimony true and correct?

A Yes, it is.

MR. GUYTON: We'd ask that Ms. Kilcoyne's rebuttal testimony be inserted into the record as though read.

CHAIRMAN GRAHAM: We will insert Mr. Kilcoyne -- Ms. Kilcoyne's rebuttal testimony into the record as though read.

GULF POWER COMPANY

Before the Florida Public Service Commission
Rebuttal Testimony and Exhibit of
Stacy R. Kilcoyne
Docket No. 110138-EI
In Support of Rate Relief
Date of Filing: November 4, 2011

Q. Please state your name, business address and occupation.

A. My name is Stacy R. Kilcoyne. My business address is 30 Ivan Allen Boulevard NW, Atlanta, GA 30308. I am the Vice President of Human Resources for Southern Company and Vice President of Gulf Power Company (Gulf or the Company).

Q. Please summarize your background and professional experience.

A. I have over 30 years of experience in Human Resources with Southern Company. I have served in various roles in Human Resources at Southern Company Services. My most recent position before assuming my current duties was the Director of Human Resources for Southern Company Generation. My responsibilities are to oversee all human resources activities for the Southern Company and its subsidiaries, including compensation and benefits, talent acquisition, HR operations, employee and leadership development, and diversity and inclusion.

Q. What is the purpose of your rebuttal testimony?

A. I, along with Gulf witnesses Wathen and Deason, rebut the portions of the testimony of Office of Public Counsel (OPC) witness Donna Ramas and Federal Executive Agency (FEA) witness Greg Meyer in which they propose adjustments of $16,937,512 to Gulf's projected test year Operations and Maintenance (O&M) and capital budgets for variable compensation, other employee benefits and the supplemental pension plan. Ms. Ramas proposes adjustments of $15,157,512 for variable compensation and other employee benefits. Mr. Meyer proposes adjustments of $1,780,000 for supplemental pension.

Ms. Ramas' and Mr. Meyer's adjustments reveal a fundamental misunderstanding of Gulf's approach to employee total compensation and the Company's need to retain its existing skilled workforce and attract qualified new employees. Their adjustments suggest a lack of knowledge regarding compensation design and how goals are established to benefit customers while balancing the needs of employees and shareholders. In addition, their adjustments seem indifferent to Gulf's dedicated and highly competent employees who work hard every day to provide reliable service, exceed the expectations of our customers and ensure the financial integrity of the company. The adjustments proposed by Ms. Ramas and Mr. Meyer, if adopted, would harm rather than benefit Gulf's customers and could increase compensation expenses over the long term.

Q. What exhibits are you sponsoring?

A. I am sponsoring:

Exhibit SRK-1	Schedule 1	Gulf Power – External Market Analysis
Exhibit SRK-1	Schedule 2	Analysis of Employee Impact with no Variable Compensation

Exhibit SRK-1 Schedule 3 Gulf Power Turnover Rates
Exhibit SRK-1 Schedule 4 2011 PPP Goals

I. SUMMARY OF MS. RAMAS' COMPENSATION ADJUSTMENTS

Q. Please summarize Ms. Ramas' compensation adjustments to Gulf's O&M and Capital in the test year.

A. Ms. Ramas has stated that all of Gulf's "at-risk" or variable pay programs and some Other Employee Benefits should be disallowed for rate making purposes. On Schedule C-4, page 1 of 2, Ms. Ramas identifies $13,883,805 in O&M expenses and capital expenditures in the 2012 test year that she believes should be disallowed. The total disallowance consists of every dollar of what she calls incentive compensation: the Company's Performance Pay Program, Stock Option Program, Performance Share Program and Performance Dividend Program. On page 39, lines 8 through 10, Ms. Ramas recommends a disallowance of $799,606 for estimated test year payroll taxes due to the disallowance of variable pay programs. Also on page 39, lines 21 through 24, Ms. Ramas recommends disallowing $474,101 for the following Other Employee Benefits: Interest on Deferred Compensation, SCS Early Retirement and Executive Financial Planning. Gulf witness McMillan addresses the adjustment for Executive Financial Planning in his testimony. Additionally, Ms. Ramas proposes disallowing any SCS charges that include "costs associated with the PPP, the various stock option plans and other incentive plans."

Q. Please place the magnitude of Ms. Ramas' variable compensation adjustment in perspective.

A. I will address the magnitude of Ms. Ramas' proposed compensation adjustments from three perspectives, each of which shows how unreasonable and extreme Ms. Ramas' adjustments are.

Total Compensation in 2012. Ms. Ramas advocates essentially a 13.7 percent reduction in total compensation paid to Gulf's work force in 2012. As shown on MFR C-35, page 1 of 2, Gulf projects total compensation in the 2012 test year to be $119,797,482. With Ms. Ramas' proposed compensation adjustments, total compensation in 2012 would decline to $103,333,012. This is a total drop in projected 2012 compensation of 13.7 percent.

Total Compensation in 2010 compared to Ms. Ramas' 2012 compensation. As shown in MFR C-35, Page 2 of 2, Gulf paid $107,897,170 of compensation to its employees in 2010. With Ms. Ramas' proposed compensation adjustments, total compensation in 2012 would decline to $103,333,012. Ms. Ramas proposes total compensation for Gulf in 2012 at a level of total compensation lower than 2010, when Gulf had an intentionally reduced work force!

Gross Average Salary, 2010 versus Ms Ramas' 2012. As shown on MFR-C35, Gulf paid a gross average salary (base compensation plus variable compensation) per employee of $80,042 in 2010. As shown on my Exhibit SRK-1, Schedule 2, under Ms. Ramas proposal, Gulf's gross average salary in 2012 would decline by over $11,000 per year! The impact would be even more significant for employees that have more pay at risk, since their total compensation is more dependent upon overall company performance.

Q. Do you agree with Ms. Ramas' recommendation to disallow all of Gulf's at-risk or variable pay programs?

A. No, I do not, for a number of reasons.

First, in making her recommendation, it appears Ms. Ramas did not consider whether Gulf's existing compensation plan is competitive and successful in retaining existing employees and attracting new employees. Gulf's compensation plan is competitive in the market as currently structured and has been successful in retaining employees.

Second, her recommendation to disallow every dollar of "at-risk" or variable compensation is based on her mistaken belief that Gulf's at-risk compensation is designed to benefit only shareholders. Gulf's compensation plan benefits customers as well as shareholders.

Third, Ms. Ramas does not appear to realize the adverse impact her compensation adjustments would have on Gulf's ability to succeed in retaining and attracting qualified employees. The adjustments made by Ms. Ramas, if accepted, would impede Gulf's ability to attract and retain the employees we need to meet our customers' needs.

Fourth, Ms. Ramas' adjustments imply that she may not understand the desirability of having performance based compensation and how such compensation motivates employees and aligns the interests of customers, employees and investors. It is in the customer's best interest to have some element of performance based compensation.

Fifth, Ms. Ramas did not address in her testimony the serious consequences of her recommended adjustments and the likely outcome they will have on Gulf's customers or Gulf's employees. Those consequences, which I will discuss in more detail below, will have long term negative impacts on Gulf's customers and employees.

Sixth, as Gulf witness Deason addresses, Ms. Ramas' disallowance of variable compensation is at odds with prior Commission policy, including the decision in Gulf's last rate case where the Company's compensation plan, which included a variable compensation element, was approved as discussed by Mr. Deason.

In contrast to Ms. Ramas' testimony, Gulf offers in rebuttal, my testimony, the testimony of an independent compensation expert who did not design Gulf's compensation plan and the testimony of a Commission policy expert that address the problems with Ms. Ramas' testimony.

Finally, I would be remiss in my role if I did not speak on behalf of the hard working employees that strive every day to put the customer first. The compensation Ms. Ramas' proposes to eliminate would reduce the pay of every Gulf employee in amounts that range from 6 percent up to as much as 64 percent.

II. MS. RAMAS' ERRONEOUS RATIONALES

Q. Does Ms. Ramas present any analysis showing the competitive position of Gulf's existing compensation plan?

A. No.

Q. Does Ms. Ramas present any analysis showing the competitive position of Gulf's compensation plan if her removal of at-risk compensation plan were adopted?

A. No.

Q. Is consideration of such information relevant in making an informed decision on whether at-risk compensation should be abandoned?

A. Absolutely. The Commission should have such analyses to be able to consider the impact of Ms. Ramas' adjustments. So, on rebuttal I have provided an analysis of the competitiveness of Gulf's compensation plan both with and without the variable compensation Ms. Ramas proposes to disallow. That analysis is shown on my Exhibit SRK-1, Schedule 1. My analysis compares Gulf's compensation, both base and variable, to the median of the market. It shows that all groups of Gulf employees are within a range of 7.5 percent below to 2.8 percent above the median of the market. Gulf's overall compensation is 3.2 percent below the median of the market.

In addition, Gulf has retained a well-regarded compensation firm to perform an independent compensation analysis of Gulf's plan, both before and after Ms. Ramas' adjustments. Gulf witness Wathen presents that analysis.

Q. If Ms. Ramas offers no analysis of the type appropriate for making decisions on compensation, what is the basis of her making her adjustment to abandon variable compensation?

A. It seems Ms. Ramas believes the goals of the variable compensation programs are too focused on Southern Company shareholders, as opposed to Gulf's customers. This opinion is outlined on pages 34 and 35 of her testimony. As she has not presented any analysis, it appears her recommendations were based on a subjective opinion rather than an objective market analysis.

Q. Please address the specific problems with Ms. Ramas' "justification."

A. She begins this passage with the following statement:

> The primary drivers and key focus of the program are financial goals that benefit Southern Company's shareholders but not Gulf's ratepayers in the state of Florida.

This statement is not accurate. The three goals used to measure performance all benefit Gulf's ratepayers.

Let me start with the financial goals. Achievement of these goals is in the interests of Gulf's customers. As Gulf witness Teel testifies, Gulf's earning a fair rate of return on equity helps maintain the Company's financial integrity, which, in turn, helps Gulf access capital markets to raise, at lower cost, the funds needed to serve customers. So, meeting the requirements of our investors is also in the interests of our customers.

Ms. Ramas' next statement is accurate, but her conclusion is incomplete and inaccurate. She states:

> As previously mentioned, in order for a payout to even occur under the plan, Southern Company's earnings per share must exceed the prior year's dividends. [accurate] This places the participants' primary emphasis on increasing

> Southern Company's earnings [inaccurate]. The large amount of emphasis and weighting on Gulf's return on equity as well as Southern Company's earnings per share shifts the focus of the plan to areas that benefit shareholders [incomplete, in that it fails to acknowledge that this also benefits customers by assuring financial integrity] and could [speculative] be detrimental to the level of service provided to customers.

Ms. Ramas is correct in identifying the trigger for the variable compensation program, that Southern Company earnings must exceed the prior year's dividends, but she draws the wrong conclusion. This trigger is used not to benefit shareholders, but to assure there are funds available to maintain customer operations. Variable compensation would not be paid in an extraordinary situation that would severely impact the company's cash flows. Being able to fund the operations of the business to serve customers, meet the expectations of investors and pay variable compensation would compete for the limited resources in this situation. This trigger gives management the discretion to meet the immediate needs of customers and investors before providing variable compensation to employees. That is one of the advantages of performance-based compensation – employees bear the risk of performing for the customer and the shareholders in order to earn variable compensation. Finally, Ms. Ramas suggests these payments "could be detrimental to the level of service provided to customers." This is unexplained, but as I have pointed out, customers benefit when the variable pay goals are met and the Company maintains its financial integrity.

Q. Ms. Ramas finishes this passage with the statement that, "the large emphasis on equity and earnings could shift away from operations in order to help the Company achieve its earnings targets. While one-third of the plan targets Gulf Power's operational goals, which could benefit customers, the operational goals are far outweighed by Southern Company's financial goals." Please address this conclusion.

A. The conclusion is not accurate. Ms. Ramas seems to be guessing when she suggests the current goals "could" shift focus away from operations. As I mentioned previously, there is no data to support that assertion. Also, she does acknowledge that "operational goals benefit customers." As I have noted, variable compensation aligns the interests of employees with our customers and investors. It does not pit shareholders against customers, as Ms. Ramas seems to suggest and would like the Commission to believe. However, what this conclusion really lacks is any observation about Gulf's employees and whether variable, at-risk compensation motivates them to serve the interests of customers.

Q. Ms. Ramas characterizes variable compensation as extra pay. Please comment on this.

A. Variable compensation is not "extra" pay. It is one component of an overall total compensation program, and at Gulf Power Company all employees have compensation at-risk. Ms. Ramas proposes to disallow all variable or "at-risk" compensation without replacing that compensation with any other form of compensation. Simply stated, that is a pay reduction for every hard working Gulf employee.

Q. Is there another passage in Ms. Ramas' testimony that you would like to address?

A. In her disallowance recommendation, Ms. Ramas makes an emotional appeal and then draws an incorrect conclusion. She says:

> Many of the ratepayers in the state of Florida, particularly along the Gulf Coast which was impacted by both the significant economic downturn and the oil spill, remain in precarious financial positions. It is not reasonable to expect ratepayers to fund incentive plans that almost entirely benefit the shareholders of Southern Company.

Absent any objective market analysis, Ms. Ramas is left with only an emotional argument that fails to recognize that Gulf needs to be financially healthy to serve customers.

Ironically, Ms. Ramas discredits the portion of the plan that is most aligned with customers' interests, at-risk compensation, and offers the misleading idea that variable compensation serves shareholders more than customers. In the end, Gulf's variable compensation program is good for the customers, employees and shareholders of the Company.

Q. What does Ms. Ramas recommend regarding charges from SCS or other affiliates associated with variable compensation plans?

A. Ms. Ramas recommends disallowing "costs associated with the PPP, the various stock option plans and other incentive compensation plans."

Q. Do you agree with Ms. Ramas' recommendation?

A. I do not. SCS employees participate in the same Southern Company compensation programs as Gulf employees, and for the same reasons, being paid variable pay based on performance is just as appropriate for SCS employees as it is for Gulf employees.

III. EFFECTS OF MS. RAMAS' COMPENSATION ADJUSTMENTS

Q. What would be the effects of Ms. Ramas' compensation adjustments if they were adopted?

A. The impacts would be very negative from several different perspectives. If adopted by the Commission and implemented by Gulf, those adjustments would adversely affect (a) Gulf's employees, who were hired with the understanding that variable compensation would be part of their total compensation if earned and who have earned by it delivering the results, (b) Gulf's ability to retain and replace highly skilled employees, and (c) most importantly, Gulf's customers whose quality of service is highly dependent upon Gulf employees. To address those effects fully, it would be helpful to first explain the composition of Gulf's workforce, the critical importance of Gulf's workforce in serving customers and Gulf's approach to employee total compensation, and the competitiveness of Gulf's compensation plan.

Q. Please explain the composition of Gulf's workforce.

A. Gulf Power has a very seasoned, experienced and capable workforce that has delivered high performance for customers as pointed out in the direct testimony of Gulf witnesses Jacob, Caldwell, Moore and Burroughs. These are the employees who have allowed Gulf to achieve unit EFOR rates that Mr. Burroughs reports are in the top decile in the country and which save customers fuel costs. These are the employees who, as Mr. Moore and Mr. Caldwell report, deliver excellent customer service in the transmission and distribution areas. These are the employees who, as Mr. Jacob reports, left their own storm-damaged homes to go out on storm duty and did a remarkable job of restoring the Gulf system in the wake of Hurricanes Ivan and Dennis. It is this work force that has achieved the consistently high levels of customer satisfaction, as covered by Gulf witnesses Jacob and Neyman, in their direct testimony.

Approximately 40 percent of Gulf's employees are governed by a Memorandum of Agreement with the International Brotherhood of Electrical Workers. That Memorandum Agreement addresses compensation, and under it Gulf has a contractual obligation to provide variable compensation, if earned. Another 45 percent of Gulf's work force is employed in positions that are not covered by a union agreement and which are not management positions.

Gulf has an aging workforce. The average age of the workforce is 45, with an average of 17 years of service. Over 38 percent of current employees are retirement-eligible, and Gulf faces the challenge of retaining these highly skilled employees or replacing them if they choose to retire. Gulf's workforce is highly skilled in successfully providing high quality service to customers at all times in all weather conditions. This skill comes, in part, from experience. They know Gulf's system, Gulf's generating units and Gulf's customers' expectations.

These highly skilled employees are primarily developed through experience and in-house training and apprenticeship programs. On average it takes five to seven years for a new hire to reach the skill and experience levels to be eligible to progress to journeyman classifications, such as Line Technician, Substation Electrician, Instrument & Control Technician or Plant Equipment Operator. To grow and maintain the skills of our employees, Gulf invests on average over 55,000 hours in training and developing our employees each year. That reflects an investment of approximately $1.7 million per year. This commitment illustrates the value we place on ensuring our employees have the skills required to safely perform the complex and dangerous work necessary to provide the reliability and service our customers expect and deserve. It also reflects a significant investment that Gulf has made in employees and illustrates another reason why Gulf should undertake to retain its employees in which it has invested.

Q. You said earlier that Gulf's workforce is critical to serving the customer. What do you mean by that, and why is it important?

A. As I mentioned earlier, the average years of service for a Gulf employee is 17 years, and the skills those employees have are absolutely critical to providing safe and reliable service to customers. For example, following Hurricane Ivan, Gulf restored electric service in 13 days to those customers that could take service. Mr. Jacob introduced a compilation of those heroic efforts in Exhibit PBJ-1 to his direct testimony. Also, as Mr. Moore testified, the Edison Electric Institute awarded Gulf the prestigious Emergency Recovery Award in 2004 and 2005 and the Emergency Assistance Award in 2004 and 2005 for its efforts during Hurricanes Ivan, Dennis, Frances, Katrina and Wilma. The day to day operations of an electric utility are dangerous and complex, and there are not many situations our employees have not encountered over the years. Because of the important role they play in serving our customers, we work hard to train our employees and retain their skills.

Q. Are Gulf's employees marketable to other utilities?

A. Yes. Gulf's work force is well-trained, highly skilled, experienced, dedicated and very capable. Perhaps their best attribute is that they are customer oriented. Employees with these attributes would be readily marketable. Moreover, there is an aging work force throughout the utility industry, so there are always other utilities looking for talent. Of course, Gulf's employees also know the requirements and expectations of the Southern System, and Gulf's operating company affiliates also have the need to attract and replace skilled employees. So, not only are Gulf's employees readily marketable, but also there is a market that would be interested in them.

Q. Given the importance of Gulf's employees to providing high quality service to Gulf's customers and their ready marketability to other utilities, what have been Gulf's employee retention rates under the existing compensation plan?

A. Gulf's retention rates under the existing compensation plan, which are shown in Exhibit SRK -1, Schedule 3, Turnover Analysis, show that Gulf's existing compensation plan, which includes the variable compensation elements that Ms. Ramas proposes to disallow, has been successful in retaining Gulf's highly skilled, capable and experienced employees. Ms. Ramas' proposed total compensation reduction will have a significant adverse impact on our ability to retain the experienced and skilled employees we currently have, and that proposed pay reduction would make it far more difficult to replace employees in the future.

Q. Given the importance of retaining and attracting highly skilled and experienced employees, please explain Gulf's approach to employee total compensation.

A. Gulf believes it is very important to ensure employees are focused on the things that are important to our customers and the people that invest in our company. We feel very strongly that it is important to focus on both, because Gulf cannot meet customer needs if Gulf does not operate a financially healthy company. Even OPC witness Woolridge articulates the need for Gulf to remain financially healthy to be able to serve its customers.

From a human resources perspective, the best way to achieve the alignment of customer, employee and shareholder interests is a total compensation program that has a base pay and variable pay component. A plan that only had a base pay component would increase fixed labor cost and would provide no opportunity to pay employees based on performance. This is the type of plan Ms. Ramas' adjustment would leave Gulf with if her adjustments were made and followed.

The better approach is a total compensation program that provides base pay and variable, or "at-risk", pay based on how well the Company performs in serving the customer. By serving the customer, I mean not only meeting operational goals, but also financial goals that maintain the economic integrity of Gulf, allow it access to financial markets to raise the capital necessary to serve customers and remind employees of their responsibility to act as good stewards in spending funds. Our employees understand if they do not meet performance expectations, their pay will be negatively impacted. Having performance based compensation helps the

Company ensure that employee performance aligns with the interests of customers and investors.

As both Mr. Wathen and I testify, having a compensation plan that has an element of variable or at-risk compensation is a very common practice in utilities and general industry. Also, it is important to note that this is the same program that the Commission reviewed and approved in Gulf's last base rate proceeding.

Q. What is Gulf Power's total compensation philosophy?

A. The Company's compensation philosophy targets total compensation at the median or 50th percentile of the market for comparable positions. Total compensation consists of base pay and variable or "at-risk" pay. This median philosophy means that 50 percent of companies pay more than Gulf Power and 50 percent pay less than Gulf. While the "at-risk" portion of total compensation is targeted at the 50th percentile, employees are provided an opportunity to receive higher pay if higher levels of performance are achieved. Likewise, if performance is poor, the pay will be less than the 50th percentile. The actual pay employees earn each year is based on performance. As a result, in a given year, actual pay may be more or less than the market based on individual and business performance.

Through the use of objective third-party compensation surveys, a market value is determined for jobs at Gulf Power, based on the relevant market.

The relevant market is determined by where Gulf Power competes for talent. For example, administrative and craft employees are recruited in the local market, professional jobs are generally recruited in the southeast and management jobs are recruited nationally. Each job is then assigned a grade and corresponding salary range. Southern Company regularly monitors and measures the total compensation of jobs to ensure Gulf's compensation is competitive and cost effective for the Company and customers.

Q. Please explain the "at-risk" or variable component of Gulf's total compensation approach and why it is important.

A. Variable pay is "at-risk" pay because the amount, if any, is only paid if certain company goals are reached, and it must be re-earned each year. The variable pay component consists of short-term and long-term pay that work together with base pay to provide market based total compensation. As I stated earlier, the Company believes variable pay goals should focus on customer expectations while ensuring the Company has the financial stability to meet those expectations.

All employees have the same goals, but the pay "at-risk" increases, as their level of responsibility in achieving performance goals increases. Each Gulf job is assigned a portion of their pay "at-risk" because it enhances employees' focus on the correct goals. The portion "at-risk" (target) is a percent of the employee's base salary based on the market value of their job. Targets rise from 5 percent to 60 percent, depending on how much influence the employee can exercise over Company strategy and decision-making. The more influence they have on the strategic direction of the Company, the more of their pay will be "at-risk". For example, executives and senior leaders have more influence on the Company's strategic direction, so they will have more pay at-risk than an employee who has less decision-making authority. One important feature of variable pay is that it does not add to the Company's fixed labor cost. If Company goals are not met, then variable pay is reduced accordingly.

Q. What are the short-term and long-term components of variable pay?

A. The short-term component is the Performance Pay Plan, in which all employees participate. The long-term components are Stock Options, and the Performance Dividend Program, which is being phased out and replaced by the new Performance Share Program. The long-term components are available to employees at exempt grade level 7 and higher (management). As with the short-term plans, payouts are tiered, based on employee level, to reflect the greater impact these employees have on day-to-day decision-making and long-term strategy.

Q. What types of goals have to be met to pay short-term at-risk compensation?

A. Three goals are used: Southern Company Earnings per Share, Gulf Power Return on Equity and Gulf Power Operational Goals. The goals used in 2011 are set forth in detail on Exhibit SRK-1, Schedule 4. (The 2012 goals have not been set.) In addition, for any variable compensation to be paid, Southern Company must first achieve earnings per share that equals the dividend paid in the prior year. Financial and operational goals are commonly used in variable compensation plans. The use of both types of goals benefit the customer by ensuring Gulf remains a strong Company with the availability of working capital at reasonable rates, to make the significant investments necessary in infrastructure and by ensuring customer needs are in focus on a day to day basis through operational goals.

Q. Now that you have placed Gulf's total compensation program in context, please address the impact on Gulf's work force if Ms. Ramas' adjustments are adopted?

A. It is very important to note that Ms. Ramas does not suggest any corresponding increase in base pay, only dropping variable compensation. The employees of Gulf are provided competitive total compensation based on objective third-party market surveys. If we are not allowed to pay our employees based on the market value of their jobs, it would be extremely difficult to motivate and retain top talent much less attract qualified new employees. The bottom line of this action is a significant across the board total compensation reduction that would be demoralizing to the hard working employees in Gulf Power and most certainly would result in lower morale and increased turnover. As I stated earlier, Gulf Power has a very experienced workforce and their skills would be readily marketable to other utilities, including sister companies and general industry. Our highly skilled workforce is critical to ensuring our customers receive the reliability and service they expect and it would be very disconcerting to lose them based on a decision that is not supported by market data.

Gulf Power employees are the Company's greatest asset and losing experienced workers will jeopardize our overall efficiency and effectiveness. In addition, Gulf's investment in employee training and development would certainly increase to offset the loss of experience. This increase in overall training time for new employees would also mean less overall employee time in the field.

Ultimately, if Gulf were to face increased employee turnover from the adoption of Ms. Ramas' adjustment, it would be Gulf's customers that would be most adversely affected. The loss of a highly skilled and experienced employee base and the demoralization of remaining employees would negatively affect the quality of service that Gulf's customers have come to expect from the Company. This is the contradiction of Ms. Ramas' adjustment – it is meant to serve customers' short-term economic interests, but its effect would be to negatively impact the service of the customers.

IV. DEFERRED COMPENSATION

Q. What is Deferred Compensation referred to by Ms. Ramas on page 40, line 18 of her testimony and who is eligible?

A. The Deferred Compensation Plan is an unfunded plan subject to applicable provisions of the Employee Retirement Income Security Act of 1974 (ERISA). The plan allows participants an opportunity to defer their earned income as well as certain federal, state and local taxes until a specified date or their retirement. Employees who are in an exempt job, grade level 9 (upper management) or above, and have an annual base rate of pay of at least $100,000 are eligible to participate.

This plan provides mutual benefits for the participants, the customer and the Company. The plan provides participants with a vehicle for retirement and tax planning. The Company benefits by offering a competitive compensation and benefits package that attracts and helps retain talent.

Q. Why does Gulf pay interest on these deferred amounts?

A. The plan provides a market interest rate to compensate participants for the opportunity cost of deferring their income into the future.

Q. How is the interest rate determined for the deferred amounts?

A. The interest rate is established by the Plan Prospectus as "the Prime Rate as published in the *Wall Street Journal* as the base rate on corporate loans posted as of the last business day of each month by at least seventy-five percent (75%) of the United States' largest banks."

Q. Ms. Ramas recommends removing $362,309 for interest on Deferred Compensation. Do you agree with this recommendation?

A. No. Participants should receive interest for the compensation they are deferring, and the budgeted interest rate was derived from Moody's Analytics May 2010 Money Market Rates, Prime Rate, which was the most current information available to use at the time the 2012 budget was prepared.

V. SCS EARLY RETIREMENT

Q. What is the charge for SCS Early Retirement referenced by Ms. Ramas on page 41, line 4 of her direct testimony?

A. This expense is specifically associated with benefits provided to a closed group of former SCS employees who terminated early as part of early retirement initiatives, during the 1980's and 1990's, that were intended to lower overall SCS costs, including those attributable to Gulf's customers.

Q. How was the allocation for this charge determined?

A. The allocation to Gulf Power reflects the SCS billing allocation at the time the severances occurred.

Q. Do you agree with Ms. Ramas' recommendation to remove $50,340 for SCS Early Retirement from the Company's request?

A. No, this expense is not different from the expense for other SCS benefit programs, and so it should be included in the cost of service.

VI. SUPPLEMENTAL PENSION

Q. In his testimony, Mr. Meyer recommended that the supplemental pension expense of approximately $1,780,000 should be disallowed. Please describe the supplemental pension plan and explain why Gulf Power has the plan.

A. The Supplemental Benefits Plan and Supplemental Executive Retirement Plan were established to provide participants total retirement income benefits from company-sponsored sources, comparable to what other employees receive as a percent of base plus incentives. Contrary to what Mr. Meyer concludes, these plans do not "provide substantially greater benefits than the average employee." In fact, without these plans, some management employees would receive significantly less pension, as a percentage of their pay, than other employees.

Supplemental pension consists of two unfunded defined benefit pension programs that integrate with the tax-qualified pension - the Supplemental Benefit Plan (SBP) and the Supplemental Executive Retirement Plan (SERP). The benefit provisions of these plans largely mimic those of the company's tax-qualified pension:

a) SBP provides benefits, calculated under the formulas of the tax-qualified plan, which the tax-qualified pension cannot pay due to various legislated pay/benefit limits.

b) SERP provides for benefits that the tax-qualified pension and SBP would have provided if a portion of annual incentives were counted when computing benefits, using the formula that subtracts a fraction of Social Security from the benefits payable. This is necessary, because a more significant portion of total compensation for these individuals is made up of variable "at-risk" compensation and only base pay is included in that tax-qualified pension calculation.

Employees who are in an exempt job, grade level 9 (upper management) or above, and have an annual base rate of pay of at least $100,000 are eligible to participate.

Q. If Mr. Meyer's supplemental pension plan adjustment were adopted, what effect would it have on Gulf's employees?

A. Without the Supplemental Benefit Plan, employees in management would receive a proportionately smaller pension benefit, than non-management employees, simply because of IRS limitations on tax-qualified plans. The same thing is true for the SERP because the compensation program design adversely affects the pension benefits of management employees, absent the SERP.

The presumption that this expense should be borne by the shareholders is incorrect, since providing fair and equitable benefits to Gulf's employees, at all levels, benefits ratepayers by ensuring the retention of experienced management, who effectively and efficiently manage the Company.

VII. CONCLUSION

Q. Please summarize your testimony.

A. The total compensation program utilized by Gulf is common practice throughout utility and general industry and is in line with the market, as shown by both my and Mr. Wathen's analyses. Additionally, the compensation program was approved in Gulf's last rate case, and the plans have undergone only very minor changes since that time. The approach of using base and variable, or "at-risk", compensation ensures all employees are focused on the customer and have a strong stake in making sure customer service and reliability are paramount, while managing costs effectively.

If adopted by the Commission, the adjustments proposed by Ms. Ramas and Mr. Meyer would have a serious adverse impact on Gulf's compensation competitiveness, Gulf's ability to retain and attract employees, and ultimately on our customers.

The Company's approach to compensation and the use of variable compensation aligns the interests of the customers, the employees and the shareholders. The operational and financial goals work together to assure decision-making is done in a manner that balances our commitment to serving customers in the current year with providing investors with a fair rate of return, which ultimately ensures we have the capital necessary to serve customers in the future.

Deferred Compensation is a part of a well-designed compensation package. It allows some employees to defer compensation and achieve tax savings while allowing the Company the use of those funds at low cost, and the charge for SCS Early Retirement is simply a benefit cost and is rightly allocated to Gulf Power.

The supplemental benefit programs serve to provide all employees with equitable benefits. The plans do not provide benefits for management that are above and beyond what other employees receive, but instead provide a vehicle to deliver make-whole pension benefits to employees who are receiving proportionately less benefits due to IRS limitations on a large portion of their total compensation being paid as variable compensation.

Absent a very significant increase in base pay, which is not proposed by Ms. Ramas, every one of the dedicated employees of Gulf will take a significant pay cut, if her proposed adjustments to variable compensation are made. Total payroll will be reduced by more than 13 percent with individual employees seeing cuts from 6 to 64 percent.

Ms. Ramas and Mr. Meyer have failed to adequately justify their arguments for the recommended exclusions. The expenses at issue are reasonable, were approved by the Commission in Gulf's last rate case and should again be approved.

Q. Does this conclude your rebuttal testimony?

A. Yes.

BY MR. GUYTON:

Q And did you have occasion to file, along with that rebuttal testimony, an exhibit identified as SRK-1?

A I did.

Q And is the information on SRK-1 true and correct?

A It is.

MR. GUYTON: Commissioners, that's previously been identified as Exhibit 160.

CHAIRMAN GRAHAM: Okay, duly noted.

(Exhibit 160 marked for identification.)

BY MR. GUYTON:

Q Ms. Kilcoyne, would you please summarize your testimony.

A I will. Good afternoon, Mr. Chairman and Commissioners. Customers are at the center of everything that we do. In her testimony Ms. Ramas suggests that the variable or at-risk element of Gulf's compensation program is detrimental to customers. This is not based on any objective analysis of market pay or compensation pay practices.

The design of Gulf's total compensation program clearly benefits customers because the at-risk portion of pay is only awarded to employees if goals are met. The design of the program ensures that employees are focused on both financial and operational goals that align the interests of customers, employees, and investors.

In order to provide safe, reliable, cost-effective service to our customers, Gulf must have a compensation program that will attract and retain a highly skilled, highly motivated work force. Our compensation program is designed to be market-competitive, with pay at the median or fiftieth percentile of the market. That includes both base pay and variable pay.

Variable compensation is not extra compensation, it is a key part of total compensation. This design aligns the interests of employees with our customers and investors. If performance goals are not met, all employees' pay is reduced.

It is also in the interest of customers, employees, and shareholders that employees act as financial stewards and that the company be financially sound. The ability for Gulf to access capital markets to raise funds at lower costs needed to provide service is in the interests of customers. It is important that we serve customers by ensuring that the company's financial integrity is not in jeopardy.

Gulf has an experienced, highly skilled, dedicated work force that provides exceptional service to our customers. The company makes a significant investment in training to ensure that employees are equipped to do their jobs in an outstanding manner.

It takes many years to train employees in this business, which is complex, technical, and dangerous. Our employees are highly marketable in the utility and other industries.

The current design of our compensation program has allowed us to be very successful in attracting and retraining our very capable work force. Disallowing the at-risk portion of pay would essentially reduce total compensation by almost 14 percent. A reduction in pay of this magnitude would result in the loss of many of these valuable employees and would potentially affect our ability to provide -- to provide superior customer service to our customers.

It is also essential that Gulf Power provide equitable benefits to all employees. The supplemental pension plans simply provide avenues for some management employees to receive benefits to replace those affected by certain IRS or plan limitations on the tax qualified pension plan. Otherwise, these employees would receive a proportionally smaller pension benefit than non-management employees.

There's been very little change made to our compensation program since it was approved by the Commission in the last rate case. A compensation program which incorporates both base and variable pay components is very common among other utilities and general industry because of the ability to consider the interests of all stakeholders, namely the customers, employees and shareholders.

Again, our customers are at the center of everything that we do. Our highly skilled and dedicated employees work hard each and every day to serve the customers of Gulf Power with the best service and the highest reliability.

To disallow the variable portion of our compensation program would potentially be detrimental to our company's performance and jeopardize the interests of all concerned, especially our valued customers, as well as our shareholders and outstanding work force. This concludes my summary. Thank you for your attention.

MR. GUYTON: We tender the witness.

CHAIRMAN GRAHAM: Mr. Sayler?

CROSS EXAMINATION

BY MR. SAYLER:

Q Good afternoon. Ms. Kilcoyne, right?

A Kilcoyne. Good afternoon.

Q My name is Erik Sayler. I'm with the Office of Public Counsel and we represent your customers. In several places in your rebuttal testimony and also in your opening summary you refer to our witness, Ms. Ramas, advocating reductions to the paid compensation of Gulf Power employees, correct?

A That's correct.

Q And on page four you essentially say that Ms. Ramas advocates for a 13 percent reduction in the total compensation paid to Gulf's work force, is that correct?

A That's correct.

Q And similarly, on page seven, you indicate that the compensation that Ms. Ramas proposes to eliminate would reduce the pay of every employee in amounts that range from 6 percent to as much as 64 percent, is that correct?

A That's correct.

Q Could you -- do you have a copy of Ms. Ramas' testimony?

A I do.

Q All right. Can you point to any place within Ms. Ramas' testimony where she states that the compensation paid to Gulf employees should be reduced?

A She has stated that the at-risk or variable portion of pay should be disallowed.

Q All right. Can you point where she states that Gulf should discontinue its incentive plans?

A No. Again, she states that that should be disallowed in this rate hearing.

Q And that's disallowed for ratemaking purposes, is that correct?

A That's correct.

Q And for ratemaking purposes it's really who pays, is it the company, the shareholders, or the customers, is that right?

A That would be my understanding.

Q Okay. And you would agree that Ms. Ramas believes that the company and not the customers should be paying for the incentive comp plans, is that correct? Excuse me, funded by the shareholders.

A That would be my assumption from reading her testimony, that's correct.

Q Now, I believe earlier you just stated that she is not advocating that they not get paid the incentive compensation, but it's really the fact that the shareholders should be paying that, is that correct?

A That's correct, and I would disagree with that position.

Q Would it be your testimony that if this Commission requires the -- excuse me, let me back up. The incentive compensation plans consist of the performance share program, the stock option program, and the Performance Pay Program, is that correct?

Q I didn't hear what you said first. Would you repeat that?

A The incentive compensation or at-risk pay plans that Gulf Power has for its employees consists of three different plans: Performance Share Program, the Stock Option Program, and the Performance Pay Program?

A That's correct.

Q Okay. Now, would it be your testimony that if this Commission requires the Performance Share Program costs be funded by the shareholders as a result of this case and not paid for by the Gulf customers, would it be your testimony that Southern Company or Gulf would terminate the Performance Share Program?

A Hopefully we won't be faced with that decision, but that would be something that we would have to consider. We have -- that is part of our total pay program that we have communicated to our employees. We feel like it is beneficial to our customers so we would have to make a decision going forward of how we would adequately compensate our employees. Remember, our pay is at the median of the market, including the long-term at-risk plans.

Q So is it your testimony that they would or would not terminate the program?

A I would not make that decision. That would be something that we would have to consider. Hopefully we would not have to do that. Again, it is in the best interests of our customers for our employees to be invested not only in the operational goals but also in the financial goals, which are part of the total program.

Q All right. I'm just trying to ask mostly yes and no questions, and if you don't know then --

A Okay.

Q -- so we can kind of move things along.

A Sure. My pleasure.

Q The same question, but for the Stock Options Program.

A My answer would be the same. I do not know. We would have to make a decision in going forward of how to look at the total design of our compensation programs.

Q Okay. The same question for the Performance Pay Program.

A My answer would be the same. We would have to look -- we've made a commitment to our employees --

CHAIRMAN GRAHAM: Ms. Kilcoyne, you don't have to repeat it each time.

THE WITNESS: Okay, thank you.

BY MR. SAYLER:

Q Would you turn to page four of your testimony?

A Page four?

Q Yes, ma'am, lines -- starting 13 through 16.

A Yes, 13 through 16 on page four. I'm there.

Q Actually, my apologies, if you'll move down to lines 20 through 22.

A Yes.

Q You state on these lines that, quote, with Ms. Ramas' proposed compensation adjustments, the total compensation in 2012 would decline to $103,333,012, is that correct?

A That's correct.

Q Can you explain how you determined that Ms. Ramas' compensation adjustments resulted in that 103 million dollars and change for total compensation?

A If you disallowed the at-risk portion of our pay, then that's how you would arrive at that number.

Q And would that be a variable payroll, as well, or is that something different?

A Correct.

Q Okay, variable. Thank you. Now, does her 103,333,012 take into account recommendations regarding the number of test year employees?

Q State that again, if you would, please.

Q When she made her adjustment for the 103 million -- excuse me -- did that take into account the number of test year employees?

A Correct. That would be a total compliment of 1489.

Q Okay. My understanding is that it was not. Can you cite to me anywhere in her testimony in which she recommends that the total compensation paid to employees should be reduced to $103,333,012?

A If you disallow the variable compensation, then that would take you in '12 to the 103,333,012.

Q All right, thank you. Would you turn to page six of your testimony, please, lines three to five.

A Lines three through five?

Q You testify, the adjustments made by Ms. Ramas, if accepted, would impede Gulf's ability to attract and retain employees that we need to meet our company's needs. Is that correct?

A That's correct.

Q Can you explain how requiring the shareholders to fund the Stock Option Plan, Performance Share Plan, and the Performance Pay Program, would impede Gulf's ability to attract and retain employees? I mean, if the shareholders are paying for it, how is that going to impede the ability to attract those competent employees in management?

A Our position would be that it's not appropriate for the shareholders to fund -- for that obligation to be shifted. Our position is that if you look at our total compensation program, we have operational goals and financial goals.

The operational goals are specifically designed to address the needs of the customer. Along with that, the financial goals look at the long-term viability of the company. And by us being financially stable, it allows us to access capital markets, to get funds, to serve our employees.

So if you look, it's a circle of being able to provide -- have a company that's financially sound, to raise funds to have the money to deliver services to our customers. And we need to be able to attract employees to do that. It's a highly technical business and we need the employees that can deliver services to the customers.

Q Just for clarity of the record, when I refer to incentive compensation plan, I'm just referring to those three different compensation plans.

A And we would call it variable at-risk --

Q Variable?

A -- as opposed to incentive, yes.

Q Okay. Now, it is true that the incentive compensation plan is kind of weighted; one-third are operational goals and two-thirds are, for lack of a better word, shareholder-related goals like ROE and earnings per share, is that correct?

A That's correct.

Q Would you turn to page seven, lines seven through ten?

A Yes.

Q Here you state the compensation Ms. Ramas proposes to eliminate would reduce pay of every Gulf employee in amounts that range from 6 percent up to 64 percent.

Can you explain how requiring shareholders to fund the Stock Option Plan -- excuse me -- just fund these incentive compensation plans would result in a reduction of pay to these employees?

A Again, you'd have to make -- the company would have to make a decision on how to fulfill its obligation to the employees and pay that pay. If you do not pay the variable or at-risk portion of our total compensation, then you would in effect reduce employees' pay by those amounts, that range of amounts.

Q Isn't it true that an electric utility in the great general scope of things is -- the purpose of an electric utility is to provide power to customers and, if it's a privately owned one, to make a profit for its shareholders, is that correct?

A Absolutely our obligation is to serve our customer.

Q And if that is kind of the premise for a utility, isn't it in the interests of the shareholders to make sure that they hire the best and the brightest to run their company so that they can continue making their profits?

A I would agree with that, yes.

Q And if this Commission decided not to -- or to apportion their share -- or to deny -- excuse me, let me rephrase that.

If this Commission decided to require that the company pay for all the incentive compensation to the employees, isn't it still in the best interest of the company and the shareholders to still pay that incentive compensation to those employees for all the reasons that you've stated in your testimony, to maintain that profit margin?

A At the risk of repeating myself, I think you have to go back and look at, one, your obligation to employees, our obligation to serve our customer. It is in our best interest to make sure this company is financially sound. Employees are invested in that, that's to the benefit of our customer, and we would have to decide as a company how do we -- how do we ensure that we have the appropriate compensation plans to compensate and then be able it attract and retain our employees.

Q Would you turn to page eight, lines 17 through 19. Here you indicate that Ms. Ramas is makikng an adjustment to, quote, abandon variable compensation. Is that correct?

A Would you give me the lines again?

Q Sure, page eight, line 19.

A Line 19, yes.

Q Here you state essentially that Ms. Ramas, without any analysis, is advocating the abandonment of variable compensation, is that correct?

A That's correct.

Q Can you point to anywhere in her testimony where she recommends that the company, quote, abandon variable compensation, end quote?

A I think there's various places in her testimony where she states that she would recommend that it be disallowed.

Q But would you agree that that's in the context of the shareholders should be paying for it, not the customers?

A Yes, I believe it's her position that the shareholders should pay. Again, we would disagree with that position.

CHAIRMAN GRAHAM: Mr. Sayler, we need to be moving along. I think she's already verified the fact that we're talking specifically about shareholders paying and not it being paid.

MR. SAYLER: Yes, sir.

CHAIRMAN GRAHAM: I think you've made that point about four or five times.

MR. SAYLER: And -- yes, sir.

BY MR. SAYLER:

Q On page nine of your testimony, lines 16 through 17, your testimony addresses the financial goals where it states that Gulf's earning a fair rate of return on equity helps maintain the company's financial integrity, is that correct?

A That's correct.

Q And you also indicate two lines later that meeting the requirements of the shareholders or the investors is also in the interest of the customers, is that correct?

A That's correct.

Q Now, do you agree that if the company's management and employees help achieve the targeted ROE and targeted earnings per share that are part of your incentive compensation plans, that that directly benefits the Gulf shareholders?

A Yes, but it also benefits our customers, again, for the reasons I state there, that our ability to access funds in order to -- at a reasonable cost to serve our customers is in their best interest. So I see, again, that this is all linked.

Q Okay. I'm going to be directing my questions now specifically to your Performance Pay Program.

A Okay.

Q Would you agree that the amount of Performance Pay Program costs incorporated in the test year assumes that Gulf will exceed the return on equity contained in its target goals?

A State that again.

Q Would you agree that the amount of Performance Pay

Program costs, the PPP costs, incorporated in the test year assumes that Gulf will exceed the return on equity contained in its target goals?

A I was not involved in the development of budgets for the test year.

Q Okay. Would you agree that Gulf's return on equity as measured under the plan will be greater than the 2011 target level of 12 percent? Is that correct?

A Again, I was not involved in the development of the budgets.

Q Since you were not involved with creating these budgets, then, it would be true that you do not know why Gulf assumed that its return -- achieved return on equity as measured under the plan will exceed its targeted level in 2011 and 2012, is that correct?

MR. GUYTON: I object to the question because a factual premise hasn't been established.

CHAIRMAN GRAHAM: Restate the question. Or I didn't hear it the first time.

BY MR. SAYLER:

Q Okay. My question is this: The witness has just testified that she has not participated in developing the various -- from the two prior questions -- so my question was, you know, if Gulf is -- never mind, I'll just move on.

CHAIRMAN GRAHAM: Okay, thank you.

BY MR. SAYLER:

Q For purposes of developing the performance pay plan costs in the test year, Gulf has assumed that the operational goals will be achieved at a better than targeted level, is that correct?

A I have read that. Again, I'm not involved in the development of the specific goals. Just to explain, from a human resources standpoint, we're involved in the design of the compensation program.

Q Okay, I've got a new topic.

A Okay.

Q Are you the one who then decides that the Gulf return on equity target for performance -- excuse me, let me rephrase that. Are you the one that decides the return on equity target for the Performance Pay Program goals?

A Not the specific ROE target for Gulf Power, no, I'm not.

Q All right. Do you decide what the Southern Company earnings per share goal should be?

A I do not.

Q Who makes the final determination regarding the targeted ROE percentage in the Performance Pay Program?

A Final goals are approved by the compensation and succession planning committee of the Southern Company Board.

Q Okay. And it is that committee that you just spoke about that makes that final determination regarding those goals?

A The final approval of all goals are made by that committee, yes.

Q Okay. Is it still correct under the current Performance Pay Program that no payments will be made under the plan if Southern Company's earnings per share are not higher than the dividend per share paid to Southern Company shareholders in the prior year?

A That is correct.

Q Do you agree that the earnings per share achieved by Southern Company is -- excuse me. Do you agree that the earnings per share achieved by Southern Company is impacted not only by Gulf's operations but also by the performance of all the other subsidiaries of Southern Company, including operations outside of Florida?

A Yes.

Q Southern Company's earnings per share are also impacted by non-regulated operations conducted by Southern Company and its subsidiaries, is that correct?

A Yes.

Q And the dividends paid out by Southern Company are impacted by entities other than Gulf Power and its Florida operations, is that correct?

A That would be correct.

Q I have a hypothetical for you, if that's all right.
A Sure, let's try it.
Q If an event occurs at one of Southern Company's other operations outside of the state of Florida, regulated or unregulated, which causes Southern Company's earnings perfect share in a given year to be less than the prior year dividend paid to shareholders, then Gulf employees would not receive any payment under the Performance Pay Program during that year, is that correct?
A That's correct, if you're -- yes, that's correct.
Q All right. And this would be regardless of whether or not the Performance Pay Program costs are factored into base rates being collected from Gulf's customers in the state of Florida, is that correct?
A If I understand your question correctly, that would be right.
Q Let me repeat it just so --
A Okay. Okay.
Q And this would be -- this would be true regardless of whether or not the Performance Pay Program costs factored into base rates being collected from Gulf's customers in the state of Florida, is that correct?
A I believe that to be correct.
Q Okay. Continuing with the same hypothetical. If

such an event occurs and there is no payout to Gulf's employees under the Performance Pay Program, Gulf's Florida employees would not be paid at market average level in that year as a result of those events that occur at Southern Company operations outside of the state of Florida, is that correct?

A That's correct, but I would just point out to you that there are benefits to Gulf Power as there are with our other subsidiaries of being a part of the broader Southern Company.

Q My next question is essentially what would happen to those monies collected from Florida ratepayers to pay for that Performance Pay Program not paid to the Gulf employees?

A On page ten of my testimony I address the trigger. You would have those funds available to use in other parts of the operation. That would be at Gulf Power's discretion to use. They would have those funds available to them.

And the benefit of having the trigger would be that you have that -- a limited amount of money that you would be able to fund the operations of the company. The employees may not get the PPP that year, the variable compensation, the short term.

Q But would those funds flow up to Southern Company operations in other jurisdictions or increase the earnings per share or dividend payments of Southern Company?

A No, those would be at Gulf Power.
Q They're retained within the Florida operation?
A Yes.
Q Okay.
A They would remain in the Florida operations. If I misstated that, I misunderstood your question. No, they would remain in the Florida operations, there in their budget, you just would not pay that under the variable pay program.
Q Okay. Now, continuing with the same hypothetical, if that happened and the Performance Pay Program was not paid out in that year would that have an adverse impact on Gulf's ability to retain and attract qualified employees in Florida?
A Potentially. I would tell you that, again, employees are aligned with the goals of the company, they understand they are -- it is in their best interest for us to achieve all of our financial goals.
One year, if something occurs, then I think that just shows that we truly have an at-risk program, that our employees are invested in the Southern Company and Gulf Power in making sure that we are -- our performance is at a certain level. So they are personally invested in the company being financially and operationally successful.
Q So the short answer to my last question was yes, right?

A   Short answer would be yes. But, again, I think you have to look at the total picture and not just take that quick snapshot of one year.

Q   On page -- excuse me, staying on page 11, on page 11, line 21, you characterize or you state that Ms. Ramas characterizes verbal compensation as extra pay. Do you see that?

A   Yes, I do.

Q   Can you point to me anywhere in her testimony that indicates variable compensation is extra pay?

A   I couldn't give you a specific line, but it appears that you make -- that the assumption is made that base pay is at market so that our variable pay is on top of that, which is not the case.

If you take away the variable pay, then we do in fact fall below market. Our pay is targeted at the median, fiftieth percentile of the market, with variable and base pay combined.

Q   So that extra pay statement in your testimony is inferred from her testimony? Because you can't point to anywhere in her testimony where she calls it extra pay, can you?

A   I would have to go back and look specifically. But I would characterize it as something that's in addition to the base pay, marketable base pay.

Q I'm just letting you know I'm not going to have her find it in her testimony.
A Yeah, I didn't have that marked.
Q Is it true that the total amount included in the test year for stock-based compensation expense allocated to Gulf from Southern Company Services is $2,259,631?
A Can you point me to where you're looking at that number?
Q Sure. And do you happen to have a copy of the interrogatory responses the company provided to Office of Public Counsel?
A Yes, sir.
Q If you will turn to Citizen's Ninth Set of Interrogatories.
A What number?
Q 282.
A 282?
Q For the record, that's part of Staff's Exhibit 119. If you can just confirm that 2,259,631 number.
A On page two of two of 282, $2,259,624, is that correct? Is that what you're looking at?
Q I saw 2,259,631. But you said how much?
A The number I have on page two of two, stock-based compensation allocated to the company by SCS, I have $2,259,624.

Q I'll accept your number. We're only seven bucks off.
A That's close enough for an HR person.
Q For government work is often what people say. And are the amounts allocated to Gulf from Southern Company Services included in the variable -- the variable payroll?
A Excuse me?
Q Are the amounts allocated to Gulf from Southern Company Services included in the variables payroll? Perhaps it would be helpful to look at your response to Citizen's interrogatory question 184.
A I could not answer directly on any of the expenses or budgeted amounts. I would not be involved in the development of those numbers. That would go back specifically to Gulf around budgets.
Q Okay. Do you have a copy of interrogatory 184?
A I do.
Q Would you just take a moment and look at it and look at page three.
A Page three?
Q Yes. And for the record, that's in Staff Exhibit 115. And then after this question we'll move on to deferred comp.
A Okay, I'm on page three. Under variable payroll?
Q Yes, ma'am. Would you like me to read the

question again?

A If you would, please.

Q Are these amounts allocated to Gulf from Southern Company Services identified in this response included in the variable payroll identified in the response to Citizen's Fourth set of interrogatories?

MR. GUYTON: I'm sorry, I need to object. I don't understand the question. You're talking about these amounts, and I don't know which --

BY MR. SAYLER:

Q Okay, these amounts shown in Citizen's interrogatory number 228, do they correlate with Citizen's interrogatory 184?

A I apologize, I'm -- you said 182 and then 184.

Q Sorry, 282, the first interrogatory I asked you to look at, 282, where we got the 2,259,624 number. And does that correspond with that response in question 184?

A I'll try to hurry. I don't think I have 282.

Q Just a moment ago, Citizen's Ninth Set of Interrogatories, question 282, I asked you about the total amount included in the test year for stock-based compensation expense, and you gave me a number.

A I thought that was 180 -- just a minute. I'm sorry.

Q How about I'll just move it along and say --

A Okay.

Q -- would you agree that the responses in both of those interrogatory responses are true and accurate?

A I need to look at it before I could -- I need to make sure I'm looking at the same thing that you're looking at. I obviously have gotten --

MR. GUYTON: Mr. Chairman, if it will facilitate matters, Gulf will stipulate that the answers to interrogatories Citizen's 184 and Staff's 282 are accurate.

CHAIRMAN GRAHAM: Thank you.

MR. SAYLER: It was actually Citizen's 282 and Citizen's 184.

CHAIRMAN GRAHAM: He stipulates those, too.

THE WITNESS: Thank you. Sorry.

BY MR. SAYLER:

Q We'll move on. That's all right. If you'll turn to page 24 of your testimony.

A Yes.

Q All right. Here you testify employees who are in an exempt job, grade level nine, parentheses, upper management or above, abd have an annual base rate of at least 100,000 are eligible to participate. And that is participate in the deferred compensation program, correct?

A That's correct.

Q And it's only those employees?

A That is correct.

Q And you indicate on line three to five of your testimony that the plan allows participants an opportunity to defer income -- earned income as well as certain Federal, state and local -- excuse me -- Federal, state and local taxes until a specified date or their retirement.

The question I have for you is, the decision regarding whether or not to defer part of their income is completely discretionary on the participant's choice, is that correct?

A That is correct.

Q And this deferred comp benefit is a benefit to the participant in that they can defer those resulting income tax obligations on that income, correctly -- is that correct?

A Yes, but it's also a benefit to the company because they have those funds available for use.

Q On lines nine and ten you state that the deferred compensation plan provides benefits not only for the participants but also the customer and the company. And when you mean the customer do you mean the customers in the state of Florida or what do you mean?

A Yes.

Q Can you explain how customers benefit when executives -- from an executive's election to defer their compensation instead of receiving it in that year's income?

A Yes, I'll be glad to. One comment I'd make is it's not just executives, it would be other management employees in the company. Again, the dollars that are deferred by the participants in the plan would be funds that are available for the company to use in other ways. So -- and that would be used to benefit the customer in service.

Q How would using funds in other ways be a benefit to the customers?

A They would be -- they could be used in operations that provide service to the customer.

Q Anything to lower the rates?

A Excuse me?

Q Anything -- would that benefit extend to keeping the costs down and the rates down?

A I think any time we are able to provide the kind of service operation performance that we provide that continues to increase the efficiency of our system is of benefit to the customer.

Q Another new topic. On page 25 you discuss Southern Company Services early retirement.

A Yes.

Q Just to clarify, it is your position that Gulf's Florida customers should pay for the costs in their rates associated with the early retirement benefits provided to a group of Southern Company Services employees who have not worked for Southern Company Services since the 1980s and nineties, is that correct?

A That's correct. Those costs were built in at that time. I've stated earlier, I believe, that the --

Q Thank you. Yes or no. And are Gulf's current customers receiving any benefit today from these SCS employees who terminated or left employment in the eighties and nineties? How are they being benefit today -- benefited today?

A I would say this is just a cost of doing business, that those costs are still being paid.

Q I'm hitting the home stretch. If you'll return back to page five of your testimony.

A Page five?

Q Yes, ma'am. On page five you testify, lines five through eight, the impact -- and that is the impact of the Commission requiring the shareholders to pay the variable compensation and then the shareholders deciding or electing not to pay that compensation -- if that were true, then the impact would be even more significant for the employees that have more pay at risk since their total compensation is more dependent upon the overall company performance, is that correct?

A That's correct.

Q Okay. And the overall company performance includes achieving earnings per share and ROE goals, is that correct?

A That is correct.

Q And you would agree that the performance of those employees with the most at-risk pay, their performance tends to benefit the shareholder more than the customer; would you agree?

A No, I would not agree.

Q Would you agree that the employees with the most at-risk pay or incentive comp pay are usually management employees and executives and those executives are directly accountable to and selected by the Board of Directors, is that correct?

A Say it -- would you just repeat that, please.

Q Sure. Would you agree that the employees with the most at-risk pay or most incentive compensation pay are usually upper management executives?

A Yes. It progresses as you go up in the organization. That is correct.

Q And those upper management executives are usually accountable to and selected by the Board of Directors? I mean, the higher up you go in the organization the more likely the Board of Directors hired you, is that correct?

A I would not make that generic statement. I would say at the highest levels in the organization that would be true. But I think your statement seems to be very broad.

Q Okay, fair enough. And bringing it in for a landing, are you familiar with this Commission's decision in the Progress Energy and FP&L rate case recommendations and also decisions?

A I am not.

Q You are not?

A I am not.

MR. SAYLER: Okay. Commissioners, I would like -- I don't think we necessarily need to take official recognition of Commission orders, but I just want to say that I would like to point out that we will be -- in our briefs we'll be referring to those decisions in the FP&L rate case and the Progress Energy rate case.

CHAIRMAN GRAHAM: Okay.

MR. GUYTON: And we'd point out that Commissioner -- or former Commissioner Deason addresses those in his rebuttal testimony that you're about to hear.

BY MR. SAYLER:

Q And following those decisions in the FP&L and Progress Energy rate cases, did Progress Energy and FP&L stop paying incentive compensation to their employees?

A I do not know.

MR. SAYLER: Thank you very much for your time.

THE WITNESS: Sure.

CHAIRMAN GRAHAM: FIPUG?

MR. MOYLE: Thank you.

CROSS EXAMINATION

BY MR. MOYLE:

Q Good afternoon.

A Good afternoon.

Q I'm Jon Moyle, representing FIPUG. I just have a few topics I want to discuss with you.

A Okay.

Q You would agree that the interests of the consumers and the interests of the shareholders are not always aligned, correct?

A In what context?

Q A general context. I mean, you have some testimony that you believe in the compensation program that there's an alignment of interest, but as a general proposition, I mean, evidenced by the last three days, the consumer interests, the ratepayer interests, don't always align with the company interests, correct?

A I think in terms of our delivery of our product to our customers that we are aligned with our customers.

Q Okay, but I'm just -- for a general proposition, like we've heard a lot of discussion about return on equity. Are interests aren't aligned with respect to what would be the appropriate return on equity for the company, correct?

MR. GUYTON: Objection, this is argumentative. The witness just answered the question that she thinks the interests are generally aligned.

CHAIRMAN GRAHAM: She was specific about what she thought -- she was specific about where she thought the interests were aligned. So I guess outside of that --

BY MR. MOYLE:

Q Okay. I'm sorry, let me just start over.

A Okay.

Q Do you believe that the interests of ratepayers and the interests of Gulf Power are aligned 100 percent, all of the time, on every issue?

A I don't think you could say that about anybody anywhere, any time, regardless of the situation, that you'd always be completely aligned. So I think that's a little bit --

Q So that would be a no?

A It would be a no, but I think the question is a little --

CHAIRMAN GRAHAM: That's all right, that's good enough. No.

BY MR. MOYLE:

Q And I'm not trying to play games, I'm just trying to understand, you know, a base question with respect to other answers that flow from a credibility standpoint.

Let me ask you this. With respect to risk pay, is it called risk pay because there's risk to the employee or risk that the PSC may not approve it, or why is it called risk pay?

A At-risk pay?

Q Yeah.

A Because if our employees do not -- if the company and employees do not achieve our goals, then that pay is at risk. If we do not achieve those goals, you do not get that pay.

Q Okay. So you've got to meet certain parameters, you meet the parameters, then you get the money, essentially?

A Correct, based on your individual performance, also.

Q Would it also be correct to call that bonus pay?

A No.

Q I mean, it sounds like a bonus to me.

A No, absolutely not.

Q And why would that not be a bonus, if you meet certain performance objectives on this Performance Pay Program, why would it not be a bonus?

A A bonus is something in addition to your pay. The way our plan is designed -- again, remember, I'll say again, we're at the median of the market with base and variable pay.

So in my compensation experience, a bonus would be something on top of what your reasonable rate of pay would be. That would be something in addition.

This is their pay. So if they do not achieve goals, they do not get that pay. So if they have not met customer needs over the course of the year, they do not receive that pay.

Q So it's your testimony that this payment structure does not in any way, shape, or form constitute bonus pay?

A Absolutely not.

Q You were asked some questions by OPC about -- about the -- what happens to the money if you don't make the payments. Does it get returned to ratepayers, does it go into the working capital or general operations fund. And I think you answered that it stays with the company, right?

A Correct. That's my understanding, yes. Again, I'll say again, I'm not a -- I'm not involved in the budgets, finance of the company, so that's my understanding.

Q Fair enough. If the last ten years has there been any instance in which the numbers, the dividend numbers for performance pay, have not been hit?

A When you say performance pay have not been hit -- we have paid -- Gulf Power specifically has paid below the target pay, in -- I believe it's 2009 plan year, it was below 100 percent, if that's what you're referring to.

Q Is that the only time that it's been below plan?

A I haven't looked at anything past just a few years. It would have been below 100 percent that year.

Q Okay. You were in the room yesterday when Mr. McMillan testified?

A I was not in the room, no.

Q Did you hear his testimony?

A I heard most of his testimony remotely.

Q Okay. And the question -- I asked him these questions. I don't need to ask them of you again. But given that there has been an increase in full time equivalence with Gulf Power, an increase in salaries, an increase in O&M of 1 percent or less customer growth and approximately a 20 percent increase in base rates, do you have a concern that having the ratepayers fund this performance program sends the wrong message to businesses and customers who are suffering from the effects of the great recession?

A I'm not sure I really understand the point of your question.

Q There are a lot of customers in your area that have suffered economically, correct?

A Correct.

Q And now, today, your testimony is designed to convince this Commission to have ratepayers fund your Performance Pay Program, correct?

A The variable pay component is part of the total compensation program. So paying a competitive market rate allows us to attract and retain employees for our business that in fact deliver --

CHAIRMAN GRAHAM: Ms. Kilcoyne, you don't have to restate that each time. We understand that.

THE WITNESS: Okay. I just want to make sure I'm clear.

BY MR. MOYLE:

Q So is your testimony designed to ask this Commission to go ahead and have ratepayer money fund the Performance Pay Program?

A We believe that's the correct thing to do, yes.

Q I guess after reciting what Mr. McMillan testified to yesterday -- never mind, strike that. Well, don't you have a concern that that may send kind of -- that some ratepayers might see that as sort of sending the wrong message that when everybody is tightening their belts that Gulf is in asking not only for rates for increased O&M and increased salaries and increased FTEs, but also to fund a Performance Pay Program?

A I can speculate on what I think -- I think our customers value the service that we provide to them, and us having a highly qualified staff allows us to meet the needs of the customer. And we do that, again, through our total compensation program.

Q You're not aware of any ratepayers in your service territory, in the Gulf service territory, getting annual pay raises or performance bonuses in the last four or five years, are you?

A I haven't done a study to know exactly how -- what the pay practices are of all the companies.

Q And I'm just asking you anecdotally, I mean, you know, kind of knocking around in your community, you're not aware of many businesses that have been giving pay raises and performance payments during the great recession, correct?

A Our market data would tell us that we are competitive in the market and at the median, and we do survey a lot of companies.

Q This issue that we're talking about is approximately worth 4.5 million, isn't that right, in terms of -- that was the calculation I did based on your testimony on page four. Ms. Ramas made adjustments to take it to 103.3 and Gulf -- is that 107.8?

A What was your question?

Q How much are you seeking from the Commission in terms of increased rates to compensate for the incentive pay program or the Performance Pay Program, if you know?

A I can give up the number that we've calculated for '12 in variable -- in variable compensation, the total.

Q And what is that number?
A That includes everything.
Q Yes.
A 16,464,470.
Q I'm sorry?
A 16,464,470. That's our total projected variable payroll. Again, I want to be clear, that includes everything.
Q And OPC is suggesting you get how much money?
A If I look at Ms. Ramas' testimony, she's suggesting that we disallow -- that the variable pay programs be disallowed, so that would take us back to -- for '12 it would be 103,333,012 that I have in my testimony on page four.
Q Okay. I guess what kind of struck me is it seems, if I understand, it's Gulf's position is we should get every last dollar associated with this Performance Pay Program, correct? I mean, you want full recovery for the Performance Pay Program, is that a correct statement of your position?
A Yes, we believe that that is appropriate, for the variable pay program to be included in our base rates, that's correct.
Q Okay. And Ms. Ramas and OPC has taken the position that we don't have a problem with your Performance Pay Program, we just think it ought to be funded by

shareholders and not ratepayers; that's their position, in essence, correct?

A As I understand it, that's correct.

Q And when I heard you answering a question from OPC, you said that the pay program, the Performance Pay Program, was keyed on one-third operational goals and two-thirds shareholder goals, is that right?

A It's one-third operational --

MR. GUYTON: Objection, asked and answered. And this is about the third time through, that we've been through the performance goals.

CHAIRMAN GRAHAM: I'm not sure if I heard the one-third, two-third but --

BY MR. MOYLE:

Q It is one-third, two-third?

A I would state it's one-third operational, one-third Gulf ROE, and one-third Southern EPS.

Q All right. And do you think, given the ROE and the Southern goals, and the one-third operational goals, do you think it would be fair to split this so that shareholders pay for two-thirds and ratepayers pay for one-third of this program?

A I haven't done a study. I haven't given that consideration, so I wouldn't agree with you at this point.

Q I'm sorry, you would or would not?

A I would not agree with what you're stating, no. I won't repeat myself, but, again, we feel like our program is designed to benefit the customer. Everything we do revolves around our customer.

Q But just from a sense of fairness with respect to it would you agree that maybe if there's one-third that's Southern Company dependent, and OPC asked you some questions about if something blows up in Mississippi, that could affect, you know, that portion -- do you think it would be fair to fund it one-third out of the shareholders and two-thirds out of the ratepayers or no?

A No, I believe the way we have it, that we're funding the program, is appropriately now.

MR. MOYLE: Thank you.

CHAIRMAN GRAHAM: Major Thompson? Mr. Wright? I'm sorry.

MR. LAVIA: No questions.

CHAIRMAN GRAHAM: Staff?

MS. KLANCKE: We just have a few.

CROSS EXAMINATION

BY MS. KLANCKE:

Q Would you please turn to page 21 of your rebuttal testimony?

A Okay.

Q On lines 12 through 14 you specify that, quote, the long-term components are stock options and the performance dividend program which is being phased out and replaced by the new performance share program. Do you see that?

A I do. That's correct.

Q What was the basis for this change in these programs? What was the impetus behind it?

A Looking at the -- we every year look at our programs, our market. We felt like looking at those factors that the performance share program was a more appropriate vehicle for us to deliver that long-term compensation, so we phased out the performance dividend program.

Q And that phase out has been complete at this time?

A No, we'll actually make the last -- the stock options that were paid on were frozen in 2010. The last payout of that program will be in '13.

Q Are there going to be any savings associated with this change in plans or will the compensation levels remain the same?

A It depends on how we perform of whether or not the performance share program -- again, that links back to performance of the company as to whether or not those shares actually end up being -- how valuable they are. So how well we perform will determine, which is again why we like to -- or why we've designed our programs in that manner, so that the performance is linked to how the company performs.

MS. KLANCKE: We have no further questions for this witness.

CHAIRMAN GRAHAM: Commissioner Balbis?

COMMISSIONER BALBIS: Thank you, Mr. chairman. I have a quick question. You indicated that some, if not all, of the at-risk or variable compensation is based upon the performance of Gulf's parent company, is that correct? Some aspects of performance.

THE WITNESS: Yeah, EPS, right.

COMMISSIONER BALBIS: And you indicated that Gulf's customers receive a benefit from this in that it allows you to attract or retain key employees. Wouldn't Gulf's customers gain an additional benefit if those incentives were tied to Gulf Power's performance?

THE WITNESS: They are. Specifically and directly on the operational goals, then you have Gulf's ROE and the Southern's EPS. Gulf has the benefit, of course, of being part of the larger Southern Company. So I would say, in the long term, Gulf's customers do benefit from Southern being successful.

COMMISSIONER BALBIS: But I'm confused. I thought that the operational goals only pertained to the PPP program, or the Performance Pay Program.

THE WITNESS: I'm sorry, I thought you were talking about those three components. I misunderstood your question, then. I'm sorry.

COMMISSIONER BALBIS: All of the at-risk or variable compensation, whether it's the PPP program, the stock program, or the others, only -- the operational goals only pertain to the Performance Pay Program?

THE WITNESS: Correct. Correct. Yes, yes, I'm sorry, I misunderstood your question.

COMMISSIONER BALBIS: The rest are solely based upon parent company performance and metrics, correct?

THE WITNESS: The award -- yes, it would be -- the employee's payout or their allocation is determined by how Southern does. That's correct. If our stock improves, then, yes, they would earn more if Southern is more successful, correct. Yes.

COMMISSIONER BALBIS: And so the question is, for those programs that are not -- there's no Gulf operational component to those programs, wouldn't Gulf's customers get an additional benefit if you incorporated into those programs Gulf performance measures?

THE WITNESS: I don't know. We'd have to look at that. That's an interesting -- since our stock is Southern Company stock, we've never looked at it in that way.

COMMISSIONER BALBIS: Okay. And I think you asked

-- or answered Mr. Moyle, he asked if any at-risk or variable pay was paid to Gulf employees in 2009 and 2010 and you indicated it was, but not at a full 100 percent, is that correct?

THE WITNESS: That's correct. I believe in 2000 -- I can give you the year. I believe the 2009 plan year, which would have paid in March of '10, was lower than 100 percent.

COMMISSIONER BALBIS: Why was it lower than 100 percent?

THE WITNESS: It was the achievement of goals at that time. In the plan year of '09 the total award achievement was 68 percent.

COMMISSIONER BALBIS: Of the possible 100 percent?

THE WITNESS: The target would have been 100 percent, that's correct.

COMMISSIONER BALBIS: Okay, thank you.

CHAIRMAN GRAHAM: Commissioner Brown.

COMMISSIONER BROWN: Thank you. Good afternoon.

THE WITNESS: Good afternoon.

COMMISSIONER BROWN: As a follow-up to Ms. Klancke's question, are there any other changes, other than the performance dividend program, for the incentive programs as part of Gulf's filings?

THE WITNESS: No. Our performance pay plan --

COMMISSIONER BROWN: Of the existing programs.
THE WITNESS: Our performance pay plan is the same.
COMMISSIONER BROWN: Do you happen to know how many employees fall within grade levels seven through 15 under the Performance Pay Program, thereby being eligible to receive a target award of 25 percent to 60 percent?
THE WITNESS: I don't believe I have that number with me.
COMMISSIONER BROWN: Will Mr. Deason have that number?
THE WITNESS: Excuse me?
COMMISSIONER BROWN: Would Mr. Deason have that number?
THE WITNESS: I don't -- I don't think so.
COMMISSIONER BROWN: Who would have that number?
THE WITNESS: We can get that number for you pretty quickly, if you'd like for us to.
COMMISSIONER BROWN: I'd be curious.
THE WITNESS: Okay. We can certainly do that.
COMMISSIONER BROWN: Thank you. For any of the variable pay programs are the employees given a contract with the terms of their incentive compensation?
THE WITNESS: I wouldn't call it a contract. We communicate what the goals are, what their target awards

would be, so they understand how their pay is calculated. And we provide quarterly updates to them on how the -- how the company is performing, so they know what their target is.

COMMISSIONER BROWN: The question I'm really getting at is, is there a presumption of an expectation on the employee's part that they're going to receive part of that incentive as part of their overall compensation?

THE WITNESS: I think our employees are very clear that they know what their target is and they know that if they do not perform -- if we do not meet our customer needs, then that pay is at risk. They are very clear on that, yes.

COMMISSIONER BROWN: Okay. And you say that it's communicated to the employee. That's the written documentation to --

THE WITNESS: It's written in plan documents. The reason I'm hesitant is we don't have employment contracts, specifically, with employees. But I think there is an expectation. They know that -- they know what the goals are, they know what their target award would be, so there is an expectation.

And again, we feel like that that is a strong motivator for performance, that they understand those three components and know if they perform then that target amount is available to them.

COMMISSIONER BROWN: How many employees are eligible to participate in all three incentive programs?

THE WITNESS: Grades -- and we'd have to get the numbers -- grades seven and above are eligible to participate in the long-term portion, which is stock option and performance shares. All employees, including our bargaining unit, are included in the PPP program.

COMMISSIONER BROWN: Okay.

THE WITNESS: Not temporaries, contractors, of course. Our full and regular -- full and regular employees are eligible to participate in the short term.

COMMISSIONER BROWN: Okay, thank you.

CHAIRMAN GRAHAM: Ms. Kilcoyne, I have a quick question.

THE WITNESS: Okay.

CHAIRMAN GRAHAM: Commissioner Balbis asked a question about when you did not hit the target, which was '09?

THE WITNESS: Yes.

CHAIRMAN GRAHAM: You said 68 percent, and you said that the target is roughly 100 percent?

THE WITNESS: That's our target. That's what we plan.

CHAIRMAN GRAHAM: Now, if you go over and above that target and say you hit 110 percent do they get an added bonus -- is 100 percent the cap, or do you go above that?

THE WITNESS: No, they would get the benefit of the stronger performance. Again, that's an indicator of performance. That would be the number that's used for funding their award, that's correct.

CHAIRMAN GRAHAM: Okay. So 100 percent, you said, is -- 100 percent would put them basically where average should be. So if you're paying 110 percent, then that extra 10 percent would be a bonus?

THE WITNESS: I wouldn't characterize it that way, again, because that would also take into account how other companies perform. We would compare to the market. We could -- looking at the market and performance of other companies, we could pay out over 100 percent and actually still be below market. But that's why we target 100 percent in looking at the market.

CHAIRMAN GRAHAM: Is there a ceiling on the -- on the variable?

THE WITNESS: 200 percent, you go to 200 percent on the --

CHAIRMAN GRAHAM: Okay, redirect?

REDIRECT EXAMINATION

BY MR. GUYTON:

Q I have a few questions. Let's start there. Is there a floor on the variable pay, as well?

A Zero, yes.

Q So it can range from zero to 200 percent?

A Correct.

Q And the target is at 100 percent?

A That's correct.

Q Would you turn to your exhibit SRK-1, please, Schedule 1. This is a follow-up to Commissioner Brown's question. I believe the information on this schedule may answer her question.

Would you look at management grades seven and up. Does that give the number of employees that would be eligible for -- or the number of employees from grades seven up?

A It does, and I apologize. I interpreted your question to say how many level sevens do we have. I'm sorry. I apologize.

Q And that number would be what?

A 119, grades seven and above.

Q You were asked by one of the Commissioners about your long-term incentive programs being solely based on performance of the parent company. Do you recall that line of questioning?

A Yes, yes.
Q Does Gulf Power Company raise equity capital in the markets?
A Yes.
Q Gulf or Southern?
A Southern raises equity capital. I'm not a financial person, so I may not answer that appropriately, so --
Q Okay, you understand that Southern Company raises equity capital in the market?
A Yes, that's correct.
Q Do you know if Gulf raises equity capital in the market?
A I would say that yes, they do. We have to have -- Gulf would have to have that to fund their operations, correct.
Q You were asked about whether or not you were asking the Commission to fund your PPP plan. Is the company asking the -- is the company asking the Commission to fund its total compensation program in this case?
A Base pay is also a part of the total compensation, yes.
Q And so PPP is just a part of that total compensation?
A That is correct.

Q You were asked whether executive management was accountable to the Board of Directors. Do you recall that?
A I think so, yes.
Q Are they accountable to the Board of Directors for the provision of customer service by Gulf Power Company?
A Yes, the Board of Directors would also be very interested in customer service.
Q Have the targets for the 2012 PPP plan, have they been established yet?
A They have not.
MR. GUYTON: That's all I have. Thank you. We would move Exhibit 160.
CHAIRMAN GRAHAM: Move top of page 27, 160, into the record. Is that the only exhibit?
(Exhibit 160 admitted in evidence.)
MR. GUYTON: I believe so. We'd call Mr. Wathen to the stand.
CHAIRMAN GRAHAM: Ms. Kilcoyne, thank you very much for your testimony.
MR. GUYTON: May Ms. Kilcoyne be excused?
CHAIRMAN GRAHAM: If there's no objections, yes.
MR. GUYTON: Thank you.
THE WITNESS: Thank you.
Thereupon,

DAVID J. WATHEN

was called as a witness on behalf of Gulf Power Company, and having been previously duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. GUYTON:

Q Have you previously been sworn?

A I have.

Q Would you please state your name and business address for the record.

A David J. Wathen. My business address is 3500 Lenox Road, Atlanta, Georgia.

Q And by whom are you employed and in what capacity?

A I'm employed by Towers Watson as a Director in the Atlanta Executive Compensation Practice Leader.

Q And Mr. Wathen, did you have occasion to file or did Gulf have occasion to file your rebuttal testimony in this case consisting of 13 pages?

A Yes, I did.

Q Do you have any changes or corrections to that rebuttal testimony?

A No, sir, I do not.

MR. GUYTON: We'd ask that Mr. Wathen's rebuttal testimony be inserted into the record.

CHAIRMAN GRAHAM: We'll insert his direct -- I'm sorry -- rebuttal testimony into the record as though read.

GULF POWER COMPANY

Before the Florida Public Service Commission
Rebuttal Testimony and Exhibit of
David J. Wathen
Docket No. 110138-EI
In Support of Rate Relief
Date of Filing: November 4, 2011

Q. Please state your name and your business address.

A. My name is David J. Wathen. My business address is 3500 Lenox Road, Suite 900, Atlanta, GA 30326.

Q. By whom are you employed?

A. I have been employed by Towers Watson since 1996 and my position is Director, Atlanta Executive Compensation Practice Leader. Towers Watson is a leading global professional services company, which has 14,000 associates throughout the world, who offer solutions in the areas of employee benefits, talent management, rewards, and risk and capital management.

Q. Please explain the business of Towers Watson in providing compensation services.

A. Towers Watson advises organizations throughout the globe on all aspects of their compensation programs with the goal of paying people appropriately and enabling organizations to attract, retain, motivate, and engage employees efficiently and cost-effectively. Typical areas of consulting assistance include pay philosophy development, variable or at-risk compensation plan design, total compensation benchmarking, and compensation structure development.

Q. Why do companies such as Southern Company and Gulf Power Company retain firms such as Towers Watson for compensation services?

A. Companies retain the services of compensation consultants like Towers Watson because they need access to the expertise and resources that consulting firms have to offer regarding current and emerging market practice, program design and market competitiveness. Towers Watson has extensive experience serving clients in the energy services industry, having served more than 100 energy services industry organizations last year. Because we invest heavily in our energy services industry capabilities, we have rich competitive industry information that enables Southern Company and Gulf to benchmark against similar companies in the U.S. Given Towers Watson's breadth and depth of resources, we are frequently engaged by companies to conduct competitive assessments of total rewards programs including compensation levels by position, at-risk compensation plan design, pay structures and other consulting services.

Q. What are your responsibilities as the Director, Atlanta Executive Compensation Practice Leader at Towers Watson?

A. I manage Towers Watson's executive compensation consulting practice in Atlanta, which includes 12 professional and administrative staff. My key areas of responsibility include:

- Managing, supporting and executing major executive compensation projects and business development initiatives to retain current clients, expand existing relationships and increase market share, projects entail assisting senior management and/or Boards of Directors in managing all aspects of their compensation programs;
- Contributing to the development of plans and budgets, delivering planned performance and ensuring the Executive Compensation practice achieves defined goals;
- Integrating and building team resources into an effective client service delivery team, developing and executing strategic staffing plans and attracting and maintaining engagement and retention of key talent; and
- Overseeing all aspects of local delivery of Towers Watson products and services for the Atlanta Executive Compensation practice and collaborating with other lines of business to develop local market strategies to deepen, broaden and build profitable relationships.

In addition to my leadership and consulting responsibilities, I have been a guest speaker on executive compensation to professional and academic organizations including the Atlanta Area Compensation Association, Emory University, National Association of Stock Plan Professionals, Society of Corporate Secretaries and Governance Professionals and Vanderbilt University.

Q. Please state your prior work experience and responsibilities.

A. Before joining Towers Watson, I was employed as a Project Manager/Systems Support Specialist by Schlumberger Industries from 1990 to 1994, where I trained and supported utilities in the use of computerized meter reading systems. I joined Towers Perrin (predecessor to Towers Watson; Towers Watson reflects the merger of Towers Perrin and Watson Wyatt) in 1996 as a project manager in the compensation practice and was elected a Principal of the firm in 2007. Over my tenure with the firm I have worked with clients in numerous industries (i.e., consumer products, financial services, energy services, high tech, manufacturing, real estate and transportation) and before assuming my current role, I have taken on ever increasing roles and responsibilities, such as:

- Project manager: manage the day-to-day activities of multiple client projects covering competitive benchmarking studies, at-risk compensation plan review and design, proxy analysis, market trends review, etc.;
- People manager: responsible for providing appropriate training and career growth opportunities for associates and conducting performance management and pay planning;
- Consultant: manage multiple small to mid-size client relationships and/or projects, responsible for development and delivery of client studies;

- Senior consultant: manage multiple large, complex client relationships and/or projects, oversee project managers, responsible for development and delivery of client studies.

Q. Please share your educational background.

A. I graduated from Vanderbilt University in 1990 with a B.A. in Economics and earned an M.B.A. with an emphasis in Human Resources from The Owen Graduate School of Management at Vanderbilt University in 1996.

Q. Gulf Power has offered you as an expert witness on corporate public utility compensation programs. What qualifications do you have to testify as an expert on corporate and public utility compensation programs?

A. In my 15 year career with Towers Watson, I have assisted management and Boards of Directors at numerous companies in designing and assessing all aspects of their compensation programs. Since joining the firm in 1996, I have consulted with numerous utilities and currently serve as the leader of the firm's utility industry compensation practice. I have conducted competitive assessments of total compensation levels and at-risk compensation plans for numerous public utilities and currently provide compensation consulting services to several utility clients located across the U.S.

Q. What is the purpose of your rebuttal testimony?

A. I and two other witnesses, Stacy Kilcoyne and Terry Deason, rebut the testimony of Office of Public Counsel (OPC) witness Donna Ramas in which she proposes adjustments to Gulf's projected 2012 test year budget for variable or at-risk compensation.

Q. What exhibits are you sponsoring?

A. I am sponsoring Exhibit DJW-1, consisting of the following three schedules:

- Schedule 1, Historical Market Base Salary Merit Increases for Gulf Power Employees Compared to Utility and General Industry Practices
- Schedule 2, Competitive Market Assessment by Gulf Power Job Level
- Schedule 3, Competitive Market Assessment by Gulf Power Job Level with At-Risk Compensation Component Excluded

Q. What was Towers Watson asked by Gulf Power to do?

A. Towers Watson was asked to assess the competitiveness of Gulf's current total compensation philosophy and programs and present its assessment in response to Ms. Ramas.

Q. What was the purpose of that analysis?

A. The purpose of the analysis was to review the competitiveness of Gulf's current compensation programs relative to market practices, specifically focusing on the following aspects of Gulf's program:

- Total compensation philosophy,
- Annual merit increases,
- Compensation benchmarking process,

- Competitive market positioning of total pay (base salary and at-risk compensation) and
- At-risk compensation programs design.

Q. Have Towers Watson and you performed similar analyses in the past?

A. Yes. Towers Watson and I have conducted similar competitive compensation studies for other utility clients.

Q. What are the conclusions of your analysis?

A. Overall, our analysis indicates that Gulf's total compensation programs are comparable to and competitive with market practices of other similarly sized utilities. Gulf, like all the companies it competes with for talent, has to provide a competitive total compensation opportunity delivered via programs that benefit employees, customers and shareholders. Gulf achieves this goal with its balanced and competitive base salary and at-risk compensation programs. My experience working with both utilities and general industry companies indicates the programs at Gulf fall well within market norms and are not excessive in design or level of pay. The compensation programs covered in our competitive review are summarized below.

Compensation Philosophy

Gulf's compensation philosophy targets base salary and at-risk compensation at the 50th percentile of similarly sized utilities. Towers Watson examined the proxy disclosures for 19 publicly-traded utilities comparable in size to Southern Company (revenues ranged from ½ to 2-times Southern Company revenues of $17.5 billion) and 13 publicly-traded utilities comparable in size to Gulf (revenues ranged from ½ to 2-times Gulf revenues of $1.6 billion). When developing a competitive benchmarking peer group, the competitive range of ½ to 2-times revenues is a standard practice in our business and is also utilized by Institutional Shareholder Services (ISS), a noted proxy advisory firm. Based on our review, Gulf's total compensation philosophy aligns well with peer practices as a majority of the utility peers (16 of 19 utilities comparable in size to Southern Company and 12 of 13 utilities comparable in size to Gulf) target the market 50^{th} percentile for some or all pay elements. Our consulting experience also suggests that Gulf's 50^{th} percentile pay philosophy is comparable to typical market practice found in general industry.

<u>Annual Merit Increases</u>

Based on a review of average base salary merit increases provided to all eligible employees at Gulf from 2001 to 2011 and competitive market data from WorldatWork Salary Budget Surveys from 2004 to 2011, historical average merit increases provided to all employees at the Company have typically been below market levels for 9 of the last 11 years compared to utilities and 8 of the last 11 years compared to general industry. It is important to note that given the severe economic decline experienced in 2009, Gulf did not provide merit increases to any employee or a general increase to its bargaining unit employees. Details of this analysis are included in Schedule 1 of Exhibit DJW-1.

Compensation Benchmarking Process

Towers Watson also reviewed Gulf's process for determining market competitive compensation levels for each employee group (management, professional employees, non-exempt employees and employees covered under a collective bargaining agreement). We found the process used by Gulf to be consistent with utility and general industry market best practices.

Compensation Competitive Market Positioning

After reviewing Gulf's benchmarking process, we then assessed the competitiveness of compensation levels based on Gulf's stated total compensation philosophy. To conduct this analysis we reviewed data provided to us by Gulf and examined Towers Watson's 2010 Energy Services Compensation surveys. These surveys are comprised of compensation data from over 100 U.S.-based energy services companies. Towers Watson has been conducting these surveys for over 20 years.

We determined that Gulf's compensation by job level aligns with the Company's total compensation philosophy of targeting base salary, target total cash compensation (target TCC = base salary + target short term at-risk compensation) and target total direct compensation (target TDC = target TCC + long-term at-risk compensation) at the 50th percentile of the market for comparable positions. See Schedule 2 of Exhibit DJW-1 for details of this analysis.

At-Risk Compensation Programs

Towers Watson next assessed the design of Gulf's at-risk compensation plans: Performance Pay Program and long-term at-risk compensation programs.

In assessing the competitiveness of the Performance Pay Program, we examined market data from the following market perspectives: proxy disclosures for 19 publicly-traded utilities comparable in size to Southern Company (revenues ranged from ½ to 2-times Southern Company revenues of $17.5 billion), 13 publicly-traded utilities comparable in size to Gulf (revenues ranged from ½ to 2-times Gulf revenues of $1.6 billion) and 15 energy services industry companies in Towers Watson's Annual Incentive Plan Design survey. Our review suggests that Gulf's Performance Pay Program design is comparable to and competitive with short-term at-risk compensation plan designs of the market perspectives examined. Also, it is important to note that Gulf puts equal weighting on all performance measures for all program participants (1/3 weight on corporate EPS, 1/3 weight on business unit ROE and 1/3 weight on operational goals) to emphasize the equal importance of all performance measures and ensure employees have a vested interest in achieving all goals.

The competitive review of Gulf's long-term at-risk compensation program examined proxy disclosures for the same proxy peers noted earlier in my testimony and data from Towers Watson's 2010 Energy Services Long-Term Incentive Plan Report, which presents plan design data for 95 energy services industry participants. Based on our review, we found the Company's long-term at-risk compensation program design, reflecting annual grants of stock options and performance shares to be competitive with the market perspectives examined. Gulf's program differed from market practice in the following areas:

- Vehicle Mix – Gulf's use of stock options and performance shares reflects a stronger performance focus than most utility peers. For those peers that use two long-term incentive vehicles, performance shares and time-vested restricted stock are the most commonly used vehicles,
- Award Eligibility – Gulf grants long-term at-risk compensation at lower levels in the organization than typical market practice. Broader award eligibility at Gulf is intended to ensure more employees have a long-term performance focus.
- Maximum Performance Level – Gulf requires higher relative total shareholder return (TSR) performance to deliver a maximum performance share award than typical peer practice (90^{th} percentile Company relative TSR performance versus 75^{th} percentile relative TSR performance for peers),
- Relative Peer Groups – Gulf uses two relative performance peer groups in determining performance share awards. The peer groups

are the Philadelphia Utility Index and a 9 company custom peer group. Typical utility practice entails the use of a single relative peer group or index.

As part of Southern Company's ongoing review of market best practices, Gulf discontinued awards under the Performance Dividend Program in 2010. This program was no longer competitive with utility peer market practice and the last possible payment of awards will be in March 2013.

In summary, we find the form, mix and levels of total compensation at Gulf to be consistent with the Company's stated total compensation philosophy and competitive with market practices of similarly sized utilities. It is through these market-competitive compensation programs that Gulf is able to attract and retain employees with the knowledge and skills needed for continued success.

Q. How does your analysis relate to Ms. Ramas' compensation testimony?

A. Ms. Ramas recommends disallowance of all at-risk compensation at Gulf; however, our analysis concludes that Gulf needs to maintain the market competitive at-risk compensation plans. The elimination of at-risk compensation, without any sort of replacement compensation, would result in total compensation at Gulf that is below market competitive levels and it will adversely impact the Company's ability to attract and retain employees. See Schedule 3 of Exhibit DJW-1 for details of this analysis.

Also, it is important to note that there is the possibility of unintended consequences with the elimination of all at-risk compensation at Gulf. In order to remain competitive, Gulf could be forced to increase fixed pay (i.e., base salary) to non-competitive levels in order to attract and retain talent, which would be financially irresponsible from a pay-for-performance perspective.

In an environment where utilities have aging workforces and the need to replace critical skills will only grow as employees retire, it is essential for Gulf to be able to attract and retain qualified employees. As noted in Towers Watson's competitive assessment, Gulf's at-risk compensation programs are market competitive. Gulf invests considerable time and thought in the design of its at-risk compensation plans to insure they are not only providing a competitive total compensation opportunity but doing so in a manner that best serves the interests of both customers and shareholders.

Q. Why do you not address Ms. Ramas' complement or head count adjustment?

A. Essentially because I am not qualified to address it. Whether workforce is necessary or essential is best left to the company to determine.

Q. Does this conclude your testimony?

A. Yes.

BY MR. GUYTON:

Q Mr. Wathen, did you also have occasion to file with your rebuttal testimony Exhibit DJW-1?

A Yes, sir.

Q And is the information in DJW-1 true and correct to the best of your knowledge and belief?

A Yes, sir.

MR. GUYTON: Commissioners, that's previously been identified as Exhibit 161.

(Exhibit 161 marked for identification.)

BY MR. GUYTON:

Q Would you please summarize your testimony -- your rebuttal testimony for the Commission.

A I will. Good afternoon, Commissioners. My testimony will cover our competitive assessment of Gulf Power's compensation programs. As the leader of the Atlanta Executive Compensation Practice and leader of Towers Watson's utility industry compensation team, in my 15-year career I have worked with numerous utilities in assessing and designing their compensation plans and currently today work with several utilities in providing them compensation consulting services.

Companies like Gulf Power retain consultants like Towers Watson given our expertise and resources we have regarding current and emerging market trends and competitive pay data.

Towers Watson has extensive experience serving energy services industry clients and has worked with over 100 organizations last year. We invest heavily in our energy services industry capabilities and have robust competitive industry data that enables Gulf Power to benchmark against similar companies in the U.S.

Given Towers Watson's breadth and depth of resources, Gulf Power engaged Towers Watson to conduct a competitive assessment of the company's current compensation programs relative to market practice in order to rebut the testimony of the Office of Public Counsel Witness Donna Ramas, in which she proposes adjustments to Gulf Power's projected 2012 test year budget for variable or at-risk compensation.

Specifically in our competitive review we focused on five main program components: The total compensation philosophy, annual merit increases, the compensation benchmarking process, competitive market positioning of total pay, and at-risk compensation program design.

Overall, our market analysis indicates that Gulf Power's total compensation programs are comparable to and competitive with practices of other similarly-sized utilities. Gulf Power, like all the companies it competes with for talent, has to provide competitive total compensation opportunity delivered via programs that benefit customers, employees, and shareholders. Gulf achievers this goal with a balanced, competitive base salary, and at-risk compensation program.

In my experience in working with utilities and general industry companies -- in my experience in working with utilities and general industry companies indicates that programs at Gulf Power fall well within market norms and are not excessive in design or level of pay.

To the specific pay components that we assessed, we identified that Gulf's targeted compensation philosophy of targeting pay at the fiftieth percentile of comparably-sized utilities to be competitive with market practices.

Likewise, our review of average base salary merit increases provided to all eligible employees identified that from 2001 to 2011 average merit increases at Gulf Power typically fell below market levels for both utilities and general industry companies.

We found the process used by Gulf Power in benchmarking market competitive pay levels to be consistent with general industry and utility market best practices.

In turn, we determined that Gulf Power's compensation level -- compensation by job level aligns with the company's total compensation philosophy of targeting base salary and at-risk compensation at the median of market for comparable positions.

Likewise, Gulf Power's pay for performance or short term at-risk compensation plan and the current long-term at-risk compensation plan, which currently reflects annual grants of stock options and performance share awards, is also comparable with designs of other utilities.

In her testimony Ms. Ramas recommends disallowance of all at-risk compensation at Gulf Power. However, our analysis concludes that Gulf Power needs to maintain the market competitive at-risk compensation plans.

The elimination of at-risk compensation, without any sort of replacement, would result in total compensation at Gulf Power that is below competitive market levels and impact the company's ability to attract and retain employees with the knowledge and skills needed for continued success. This concludes our summary.

MR. GUYTON: We tender the witness.

CHAIRMAN GRAHAM: Mr. Sayler?

MR. SAYLER: Thank you, Mr. Chairman.

CROSS EXAMINATION

BY MR. SAYLER:

Q Good afternoon, Mr. Wathen.

A Good afternoon.

Q Is it Wathen?

A Wathen.

Q Wathen. Thank you. Sorry. Erik Sayler, I work with the Office of Public Counsel and represent Gulf Power's customers.

If you'll turn to page ten of your testimony -- and I apologize for asking kind of a longish question. I hope I don't get an objection for a compound question, but hopefully it will speed things along.

When you made your comparison of Gulf's performance pay plan, you examined market data from several market perspectives, and that included 19 publicly traded utilities of comparable -- comparable in size to Southern Company, 13 publicly traded utilities, and 15 energy services companies, is that correct?

A That is correct, yes.

Q And doing simple math, that's 47 separately traded companies, is that -- or separately analyzed companies, is that right?

A Correct.

Q Now, how many of the plans -- how many of the plans you reviewed were for operating subsidiaries that are part of larger holding companies, such as Gulf is to Southern?

A For the two proxy peer groups, the 19 company and the 13 company, they were publicly traded entities, so they were not operating units.

Q Okay.

A For the 15 company sample out of the Towers Watson annual incentive plan design survey, it again is comprised mostly of stand-alone entities, not operating subs.

Q So how many of your plans compared operating subs like Gulf?

A To the best of my knowledge, I don't believe that there were any.

Q And in your testimony on lines 16 through 19 you suggest that Gulf's performance pay plan is designed -- excuse me, strike that.

Let me just move on to my next question. Were you aware that under Gulf's Performance Pay Program there's no payout in a given year if Southern Company's earnings per share in that year do not exceed the prior year's dividend payment made by Southern?

A Yes.

Q And were you aware of that when you made your analysis?

A Yes.

Q Okay. Of the companies you reviewed, which involved operating subsidiaries of larger companies, how many of those incorporated a provision in which there would be no payout under the plan if the parent company's earnings per share does not exceed the prior year's dividends?

A Almost 50 percent of the peers that we looked at had what we call a circuit breaker. And in this case a circuit breaker which requires some achievement of financial performance before they fund the plan.

Q Okay. Of the 47 plans that you reviewed, how many of those had return on equity goals at a target level that exceeded the return on equity that had been authorized by the regulatory commission as part of its rate proceeding?

A I do not specifically know the answer to that question.

Q For the plans you reviewed, how many of those had one-third or more of the plan goals that were tied to earnings per share achieved by the parent company?

A Of the various -- of the 47 or so entities that we looked at, over 80-plus percent had performance goals that reflect a mixture of financial and operational performance. The mix that reflects the exact same mix as Gulf Power's of a third, a third, a third, did not identify any, but it tends to vary greatly when you look at the weightings.

Q All right. If you were to -- were any of the two-third, one-third variety?

A I specifically don't recall.

Q And two-third meaning two-thirds tend to be earnings per share with ROE component, as opposed to the operational plan.

A Again, I specifically don't recall the exact breakdown of the weightings.

Q And on page 12 of your testimony, line 17.

A Yes.

Q Is it your understanding that Ms. Ramas has suggested that the performance pay plan be eliminated?

A My assumption was, given that she wanted it to be disallowed, my assumption was that it would not be continued.

Q All right. And are you aware that disallowed in ratemaking parlance means -- it just means the customers don't pay for it?

A Correct. But given that she was silent on it, the assumption I made was that there would not be one.

Q Okay. If a regulated entity earns in excess of its authorized return on equity, should this result in -- should this result in additional funds that could be used to pay the incentive compensation costs?

A I can't speak specifically to that question.

Q All right, turn to page 11 of your testimony, lines 19 through 23, where you talk about maximum performance level.

A Yes, sir.

Q You state that Gulf requires higher relative total shareholder return performance to deliver a maximum performance share award than typical peer practice. Do you see that?

A Yes.

Q Does your statement mean that Gulf's plan is focused more on the shareholder return than its peers?

A No, the measure in the performance share plan, the primary measure is total shareholder return. And in this case, what Gulf requires in order to pay out a maximum award is relative total shareholder return performance at the ninetieth percentile of the defined peer group, whereas most of the peers with a similar type design require a seventy-fifth percentile payout.

Q So that means Gulf's plan is not more focused on shareholder return than other plans, is that correct?

A Gulf's design is comparable in that it has the same measure, a relative total shareholder return metric, but they require a high performance hurtle to pay out at maximum.

MR. SAYLER: Well, thank you for your time.

CHAIRMAN GRAHAM: Ms. Kaufman?

MS. KAUFMAN: Thank you, Mr. Chairman.

CROSS EXAMINATION

BY MS. KAUFMAN:

Q Good afternoon, Mr. Wathen.

A Yes, good afternoon.

Q I just have one or two questions for you, and I want to follow up with a question Mr. Sayler asked you in regard to your discussion of Ms. Ramas' testimony at page 12.

A Yes, ma'am.

Q And I think that you said you had assumed that she meant that the compensation programs would not continue if her recommendation was followed, is that correct?

A No, my assumption was, given that she was silent on it, and not knowing what the direction was, that was the assumption that I made, that they were going to be, correct.

Q Right. So let me ask you this. You explained to us in your testimony your view of the benefits that flow from these compensation plans. Would you agree with me that the same benefits would flow if such plans were funded, say, two-thirds by the Southern Company and one-third by Gulf Power?

A I can't speak to that. That would be a company decision as to what they would do with the programs going forward, depending on how they were funded.

Q But if you assume that they would move forward on that basis, your goals of attracting excellent employees and the other things you mentioned in your summary would be met, regardless of the source of funding of the compensation programs, correct?

A If the company decided to go forward with that, I do think that they would still have the same opportunities to provide, yes.

MS. KAUFMAN: Thank you.

CHAIRMAN GRAHAM: Major Thompson? Staff?

MR. YOUNG: No questions.

CHAIRMAN GRAHAM: Commissioners? Rebuttal? I'm sorry, redirect?

MR. GUYTON: We have no redirect. We would move Mr. Wathen's Exhibit 161.

CHAIRMAN GRAHAM: We'll move exhibit 161, page 27, into the record.

(Exhibit 161 was admitted in evidence.)

CHAIRMAN GRAHAM: Would you like to excuse this witness?

MR. GUYTON: Yes, sir, I would, and thank you for reminding me.

CHAIRMAN GRAHAM: Thank you, sir. Thank you for your testimony.

THE WITNESS: Thank you.

MR. MELSON: Gulf calls Terry Deason.

CHAIRMAN GRAHAM: This witness will not be excused. He's got to stay until the end.

MR. MELSON: The witness thanks you. I'm not so sure about the company.

Thereupon,

J. TERRY DEASON

was called as a witness on behalf of Gulf Power Company, and having been previously duly sworn, testified as follows:

DIRECT EXAMINATION

BY MR. MELSON:

Q Mr. Deason, would you state your name and address for the record, please.

A Yes, my name is Terry Deason. My address is 301 South Bronough Street, Suite 200, Tallahassee, Florida.

Q And I forgot to ask, have you previously been sworn?

A I have.

Q Thank you. By whom are you employed and in what capacity?

A I'm employed by the firm Radey, Thomas, Yon and Clark as a special consultant.

Q Did you prefile rebuttal testimony in this docket dated November 4th, 2011, consisting of 63 pages?

A I did.

Q And did you also file supplemental rebuttal testimony on November 29th consisting of 12 pages?

A I did.

Q And do you have any changes or corrections to any of that testimony?

A Yes, I do. I have three minor corrections. The first correction is found on page eight.

Q Is this of the first piece of testimony?

A Yes, this is the rebuttal. Page eight, line 18, there's a docket number listed there that is the incorrect docket number. The correct docket number is 080317-EI.

The second correction is also in the rebuttal testimony, and this correction is found on page 32, and it is found at line 24. After the word "yes" you need to delete the word "it" and replace it with the phrase "any unfunded portion."

And the third correction is in the supplemental rebuttal testimony, and it is on page five, and it is line 16. There's a reference to a rule. That reference, one digit is incorrect. The correct rule reference should be 25-6.0425.

Q And with those corrections, if I were to ask you the same questions today, would your answers be the same?

A Yes, they would.

MR. MELSON: Mr. Chairman, I'd ask that both the rebuttal testimony and the supplemental rebuttal testimony be inserted into the record as though read.

CHAIRMAN GRAHAM: We will insert Mr. Deason's rebuttal and supplemental rebuttal testimony into the record as though read.

GULF POWER COMPANY

Before the Florida Public Service Commission
Rebuttal Testimony and Exhibit of
J. Terry Deason
Docket No. 110138-EI
In Support of Rate Relief
Date of Filing: November 4, 2011

Q. Please state your name and business address.

A. My name is Terry Deason. My business address is 301 S. Bronough Street, Suite 200, Tallahassee, Florida 32301.

Q. By whom are you employed and in what capacity?

A. I am employed by the law firm Radey Thomas Yon and Clark as a Special Consultant specializing in the fields of energy, telecommunications, water and wastewater, and public utilities generally.

Q. Please describe your educational background and professional experience.

A. I have over thirty-four years of experience in the field of public utility regulation spanning a wide range of responsibilities and roles. I served a total of seven years as a consumer advocate in the Florida Office of Public Counsel (OPC) on two separate occasions. In that role, I testified as an expert witness in numerous rate proceedings before the Florida Public Service Commission (Commission). My tenure of service at the Florida Office of Public Counsel was interrupted by six years as Chief Advisor to Florida Public Service Commissioner Gerald L. Gunter. I left OPC as its Chief Regulatory Analyst when I was first appointed to the Commission in

1991. I served as Commissioner on the Commission for sixteen years, serving as its chairman on two separate occasions. Since retiring from the Commission at the end of 2006, I have been providing consulting services and expert testimony on behalf of various clients, including public service commission advocacy staff and regulated utility companies, before commissions in Arkansas, Florida, Montana, New York and North Dakota. My testimony has addressed various regulatory policy matters, including: regulated income tax policy; storm cost recovery procedures; nuclear cost recovery procedures; austerity adjustments; depreciation policy; subsequent year rate adjustments; appropriate capital structure ratios; and prudence determinations for proposed new generating plants and associated transmission facilities. I have also testified before various legislative committees on regulatory policy matters and am a faculty member of the NARUC Utility Rate School. I hold a Bachelor of Science Degree in Accounting, summa cum laude, and a Master of Accounting, both from Florida State University.

Q. Are you sponsoring an exhibit?

A. Yes. I am sponsoring the following rebuttal exhibit:

- TD-1, Biographical Information for Terry Deason.

Q. For whom are you appearing as a rebuttal witness?

A. I am appearing as a rebuttal witness for Gulf Power Company (Gulf or the Company).

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my rebuttal testimony is to respond to certain assertions and recommendations made by intervenor Witnesses Chriss, Dismukes, Meyer, Pollock, Ramas, Schultz and Woolridge. The issues I address in rebuttal to these witnesses are: At-risk Compensation; Supplemental Pension Expense; Directors and Officers Liability Insurance; Imputed Revenues; Storm Damage Accrual; Construction Work in Progress; Parent Debt Adjustment; O&M Benchmark; and Customer Impacts.

AT-RISK COMPENSATION

Q. What is the recommendation of Ms. Ramas concerning the amount of at-risk compensation paid by Gulf to its employees?

A. Ms. Ramas refers to at-risk compensation as incentive compensation and is recommending a disallowance of 100% of such compensation. If accepted, the effect of her recommendation would be to deny cost recovery of these costs on a going forward basis.

Q. Are at-risk compensation costs currently being recovered in Gulf's rates?

A. Yes, they are. Gulf's current rates were last established in 2002 in Docket No. 010949-EI. In that case, Gulf's at-risk compensation costs were included in rates and the associated costs have been included as part of above-the-line earnings ever since.

Q. Do you agree with Ms. Ramas' recommendation?

A. No, I do not. Her recommendation to disallow 100% of at-risk compensation costs is inconsistent with sound regulatory policy and basic principles of ratemaking, is contrary to Commission precedent, is based on simplistic assumptions that are not factually correct, and, if accepted, would be detrimental to the long term interests of Gulf's customers.

Q. How is Ms. Ramas' recommendation inconsistent with sound regulatory policy and basic principles of ratemaking?

A. A fundamental tenet of sound regulatory policy is to provide recovery of all reasonable and necessary costs incurred to provide service to customers. And a basic principle of ratemaking is to include all such costs as test year expenses in calculating a regulated company's net operating income. Only if the Commission finds that the expenses in question are unreasonable or unnecessary should they be disallowed in calculating the company's revenue requirement.

Another fundamental tenet of sound regulatory policy is to encourage regulated utilities to be efficient and provide high quality service to their customers over the long term. Sacrificing efficiency or quality of service in the long run to achieve temporary rate reductions is not in the customers' interest. All regulatory decisions have consequences and good regulatory policy results when these consequences are adequately considered.

Ms. Ramas' recommendation violates both of these tenets of sound regulatory policy.

Q. Please explain how Ms. Ramas' recommendation violates the tenet of recovery of reasonable and necessary costs.

A. Quite simply, Ms. Ramas has made no allegations nor has she presented any evidence that the overall compensation paid to Gulf employees, including at-risk compensation, is unnecessary or unreasonable. Neither she, nor any other OPC witness, has presented an analysis of the employment market to determine what amount of compensation is reasonable and necessary to attract the workforce needed to efficiently and reliably run an electric utility. This is in contrast to the testimony of Gulf witnesses who explain that the overall compensation is reasonable, that it is necessary to attract and retain a qualified workforce, and that it is at or near the median of employee compensation paid by other regulated utilities.

The sole basis for Ms. Ramas' recommended disallowance is that the at-risk portion is based on financial and operational goals with which she philosophically disagrees. While acknowledging that the operational goals would benefit the ratepayers, she opines that the financial goals could be detrimental to the level of service provided to customers and concludes that 100% of at-risk compensation should be denied cost recovery. So from this standpoint, the tenet of cost recovery for reasonable and necessary costs is violated because costs are being excluded not because they are unreasonable or unnecessary, but because she has a philosophical disagreement with the basis on which they are paid.

Ms. Ramas' recommendation is further flawed because she likewise makes no analysis of the reasonableness of the net amount of compensation that remains after at-risk compensation is eliminated. She has not provided any evidence that shows the level of compensation that remains will ensure that Gulf is competitive in the market in terms of its ability to attract and retain qualified employees.

Consequently, Ms. Ramas' testimony is totally devoid of any consideration of reasonableness regarding either the overall amount of compensation or of the net amount she has recommended.

Q. You have stated that Ms. Ramas' recommendation is contrary to Commission precedent. How can that be the case when Ms. Ramas has cited to a recent Progress Energy Florida (PEF) decision in which the Commission disallowed incentive (at-risk) compensation costs?

A. First, I would note the decision she references never became final. The case was closed after the Commission issued a subsequent order approving a settlement and stipulation. Further, that non-final decision is inconsistent with previous Commission decisions allowing at-risk compensation.

Q. Has the Commission previously addressed at-risk compensation for Gulf?

A. Yes, in two previous Gulf rate cases cost recovery for at-risk compensation was allowed. Order No. 23573 issued October 3, 1990, in Docket No. 891345-EI, In re: Petition of Gulf Power Company for an increase in its rates and charges, and Order No. PSC-02-0787-FOF-EI issued June 10, 2002, in Docket No. 010949-EI, In re: Request for rate increase by Gulf Power Company. The Commission's explanation at page 45 of this last order is particularly relevant to this present case:

> To only receive a base salary would mean Gulf employees would be compensated at a lower level than employees at other companies. Therefore, an incentive pay plan is necessary for Gulf salaries to be competitive in the market. Another benefit of the plan is that 25% of an individual employee's salary must be re-earned each year. Therefore, each employee must excel to achieve a higher salary. When employees excel, we believe that customers benefit from a higher quality of service.

Q. Has the Commission addressed at-risk compensation for other Florida utilities?

A. Yes. A prior Florida Power Corporation rate case also provided for cost recovery of incentive (at-risk) compensation finding that: "Incentive plans that are tied to achievement of corporate goals are appropriate and provide an incentive to control costs." Order No. PSC-92-1197-FOF-EI issued October 22, 1992, in Docket No. 910890-EI, In Re: Petition for a rate increase by Florida Power Corporation. And in a Tampa Electric Company (TECO) rate case, the Commission found that TECO's total compensation package, including the component contingent on achieving incentive goals, was set near the median level of benchmarked compensation and allowed recovery of incentive compensation that was directly tied to results of Tampa Electric:

> TECO's Success Sharing plan has been in place since 1990 and its appropriateness was approved in the Company's last rate case in 1992. Lowering or eliminating the incentive compensation would mean TECO employees would be compensated below employees at other companies, which would adversely affect the Company's ability to compete in attracting and retaining a high quality and skilled workforce. We therefore decline to do so.

Order No. PSC-09-0283-FOF-EI issued April 30, 2009, in Docket No. 910890-EI.

So the PEF case is really a deviation. Prior to the PEF case, Commission precedent was to allow incentive (at-risk) compensation.

Q. Are there any Florida Court cases relevant to the issue of Commission disallowance of compensation expenses?

A. Yes, two cases are instructive in this regard and both dealt with the Commission's disallowance of executive compensation.

In *Florida Bridge Company v. Bevis*, the Florida Supreme Court reversed a decision of the Commission disallowing a portion of the Company President's salary. The Court observed:

> Indeed, the Commission has made no attempt to determine whether the president's compensation is excessive in view of the services he provides. The arbitrary ratio by which the Commission reduced the salary and expense account[,] the ratio of days physically absent from the home office to the total number of workdays in the test year[,] has no support in logic, precedent, or policy.

363 So.2d 799, 800-01 (Fla. 1978)

The Court found the Commission's action "was arbitrary and constitutes a substantial departure from the essential requirements of law." Id.

The First District Court of Appeal reached a similar conclusion in *Sunshine Utilities of Central Florida, Inc. v. Florida Public Service Commission*, in finding fault with the Commission's disallowance of a portion of the company president's salary:

> In determining whether an executive's salary is reasonable compared to salaries paid to other company executives, the comparison must, at a minimum, be based on a showing of similar duties, activities, and responsibilities in the person receiving the salary.

624 So.2d 306, 311 (Fla. 1st DCA 1993)

Q. How are these cases related to the disallowance of at-risk compensation recommended by Ms. Ramas?

A. They relate to the point I made earlier in my testimony regarding Ms. Ramas' failure to determine whether overall compensation expense is reasonable and necessary. The Florida Supreme Court and the First District Court of Appeal reversed the Commission's decisions because the basis for the disallowances did not address the reasonableness of the salaries as compared to the market.

Ms. Ramas' analysis is similarly flawed because she has made no attempt to compare the total compensation paid to Gulf executives or employees to the market for similar services, duties, activities and responsibilities. Nor has she, or any other witness, presented evidence that the salaries for any executive or employee are excessive. Instead, she recommends a portion be disallowed based on how it is paid: because it is at-risk, rather than base salary, it is subject to disallowance notwithstanding whether the total amount of compensation is reasonable. The focus of any disallowance should be how much is paid, not how it is paid.

Q. How does Ms. Ramas' recommendation fail to encourage efficiency or maintain or improve the quality of service?

A. Her recommendation would have longer term consequences that could affect efficiency and service, and her recommendation takes away a valuable managerial tool that is effective in increasing efficiency and maintaining or improving the quality of service provided to customers.

Q. What do you mean by "takes away a managerial tool"?

A. Accepting Ms. Ramas' recommendation would, by necessity, cause Gulf to rethink its long standing approach to employee compensation. If a significant amount of otherwise valid and reasonable costs were disallowed simply because of the method by which they are paid, Gulf would be justified in implementing a different pay structure. While accepting Ms. Ramas' recommendation would deny Gulf the opportunity to recover necessary costs currently, adopting a different compensation plan with no at-risk pay and a greater reliance on base pay would presumably eliminate the issue in future rate proceedings. But by moving more salary to base pay, employees don't have to re-earn that pay by meeting goals that typically include efficiency and service objectives. A compensation structure that pays employees regardless of performance diminishes management's leverage to motivate and focus employees on appropriate goals.

In essence, the Commission would be substituting its judgment for that of Gulf's management as to how best to motivate and compensate its employees. Consequently the incentive for Gulf's employees to be motivated and productive would be lost.

Q. What would be the longer term consequences of accepting Ms. Ramas' recommendations?

A. There are two primary negative consequences associated with Ms. Ramas' recommendation. First, Gulf has successfully designed and implemented an effective compensation plan which includes at-risk pay that has been relied upon by its employees over many years. Accepting Ms. Ramas' recommendation would place Gulf in the untenable position of either reneging on its obligations to its employees or resigning itself to the situation where it would be denied a reasonable opportunity to earn its authorized rate of return. Denying Gulf a reasonable opportunity to earn its authorized rate of return would have negative impacts on its overall risk profile and cost of capital. This in turn would have negative consequences for Gulf's customers in the form of higher borrowing costs. Reneging on its obligations to its employees would also have negative consequences through dissatisfied and less motivated and productive employees. It also could lead to a loss of high performing employees to other companies where they can be adequately compensated for their level of experience, expertise and performance. Remember that highly skilled and experienced utility workers are in high demand and could readily take their skills elsewhere. This could be particularly problematic for Gulf where its employees are knowledgeable of the Southern Company system and could readily move to one of Gulf's sister companies.

Q. In response to an earlier question, you stated that Ms. Ramas' recommendation is based on simplistic assumptions that are not factually correct. Could you explain?

A. Yes. Ms. Ramas' recommendation is based upon two faulty assumptions. First, she assumes that financial goals benefit only shareholders. Second, she assumes that financial goals would be detrimental to customers through a reduced quality of service. Both of these assumptions are incorrect.

Financial goals also benefit customers. Regulated utilities are profit making entities (hopefully) and must make a reasonable profit to be sustainable and to access capital when needed and on reasonable terms. This is the means by which customers receive the service that they expect and deserve. A utility earning a reasonable profit is beneficial for both its shareholders and its customers. Therefore, financial goals used to establish compensation levels are also beneficial to customers.

Q. Can you give specific examples of how financial goals benefit customers?

A. Yes, I can. Return on equity (ROE) is a fundamental measure of financial performance. It represents the earnings (revenues less expenses) as a percentage of equity investment. It can be increased (or its erosion diminished over time) in a number of ways. First, revenues can be increased by serving more customers with the same amount of expenses and investment. Second, expenses can be reduced by serving existing and future customers more efficiently. Third, assets can be utilized more efficiently so that the denominator in the equation (equity capital) is minimized for each dollar of income that is generated. Each of these scenarios (or a combination of them) will increase the ROE and provide added value to customers by increasing the efficiency of utility operations. This is particularly meaningful for regulated utilities which must keep rates fixed in between rate cases. The fact that Gulf was able to keep base rates fixed for almost 10 years is illustrative of the benefit of financial goals. By meeting its financial goals and doing more with less, ratepayers benefitted by deferral of the need for a rate case.

Q. Are you saying that the financial goals that are a part of Gulf's at-risk compensation were the reason Gulf was able to avoid a rate case for almost 10 years?

A. No, I could not say that with absolute certainty. But I do believe that Gulf's overall compensation plan and the financial goals associated with at-risk compensation played a role in this outcome, an outcome that has created significant and real benefits for customers over many years.

Q. Ms. Ramas also disagrees with the use of financial goals to determine at-risk compensation because it could be detrimental to the level of service provided to customers. Do you agree that this is possible?

A. I agree that it is theoretically possible, but not likely. And in Gulf's case, her theories are not borne out by actual performance. This is another fundamental problem I have with Ms. Ramas' recommendation. Her recommendation is based upon a philosophical supposition with no facts to substantiate her claims.

Q. Please explain.

A. Ms. Ramas' theoretical disagreement is based on her belief that Gulf's management would consciously and consistently make decisions to cut expenses to the point that there is a significant degradation in the quality of service provided to customers. Her belief is unsupported by any facts. First, a full third of Gulf's performance pay program is based on operational goals whose primary focus is service related. For Ms. Ramas' disagreement to have merit, one must assume that the operational goals would be ignored and that financial goals would be met exclusively by cutting expenses that negatively impact the level of service provided. Second, regulation in Florida requires a high level of service and the Commission requires utilities to periodically report performance as measured by generally accepted metrics. The Commission also has the authority to consider the quality of service provided to customers when setting a company's rates. Thus, a failure to provide quality service would have consequences, including adverse financial ones that could overshadow any temporary improvement in a company's earnings. And third, actual experience over the last decade has shown that Gulf's financial goals have not negatively impacted the level of service provided to customers.

Q. Going back to your statement that this Commission's precedent is to provide cost recovery for at-risk compensation, why has this been the precedent in Florida?

A. While the Commission reviews each utility's compensation costs on the facts unique to that utility, the Commission has consistently recognized that at-risk compensation is an accepted and desirable way to achieve corporate goals and to control costs for the benefit of customers. The Commission has also determined that at-risk compensation is an appropriate component to include within overall compensation to judge whether the overall compensation paid to employees is reasonable. This is precisely the decision that was made for Gulf in its last rate case in Docket No. 010949-EI where the Commission declined to make any disallowance of Gulf's at-risk compensation costs. Additionally, I am aware of no time where the Commission has denied cost recovery of 100% of at-risk compensation on non-factual, philosophical grounds, as is being proposed by Ms. Ramas.

I believe there are a number of reasons for this precedent. First, the Commission's policy is consistent with the basic tenets of sound regulatory policy that I described earlier. Second, the Commission has recognized that having good management at utilities is essential for regulators to achieve their mission of having safe, reliable and reasonably-priced service delivered to customers. The Commission has further understood that management needs sufficient tools and incentives to achieve these goals and that regulators should not attempt to "micromanage" their regulated utilities. And third, the Commission has appropriately recognized that not all issues in a rate proceeding are a simple situation of "us vs. them", where every issue has a clear winner and a clear loser. While at-risk compensation has been and is currently being characterized as an "us vs. them" issue, in reality it is not. Incorporating at-risk pay as part of an overall compensation plan is a good example of a "win-win" situation.

Q. What do you mean by a "win-win" situation?

A. Including at-risk pay as part of an overall compensation plan enables all stakeholders to win. Shareholders get to invest in a company with employees motivated to achieve appropriate corporate goals. Management gets to apply compensation tools that they think are best to motivate and fairly compensate employees. And most importantly, customers pay no more than a reasonable amount in their rates but get a work force that is motivated to be efficient, to reduce costs where possible, and to maintain a high level of safe and reliable service.

SUPPLEMENTAL PENSION EXPENSE

Q. What is the nature of supplemental pension benefits?

A. Supplemental pension benefits provide total retirement benefits for qualifying employees that make their benefits comparable to other employees as a percentage of overall compensation. This is necessary because tax laws limit the amount of benefits which get preferential tax treatment. In other words, these benefits put qualifying employees on parity with all other employees. The supplemental pension benefits are not additional benefits as described by Mr. Meyer. Gulf simply has to incur greater expense to provide comparable benefits, because of the applicable tax laws.

Q. What recommendation does Mr. Meyer make with regard to supplemental pension expense?
A. Mr. Meyer recommends that supplemental pension expense be 100% disallowed for cost recovery, stating that the regular pension plan offered to all employees should be sufficient.

Q. Do you agree with Mr. Meyer's recommendation?
A. No, I do not.

Q. Why do you disagree?
A. First and foremost, Mr. Meyer is incorrect in his characterization of the benefits as being additional. Second, his conclusion that the regular plan should be sufficient for all employees is based on supposition and not fact. Like Ms. Ramas' recommendation to disallow 100% of at-risk compensation, Mr. Meyer does not present any evidence or analysis as to why the amounts in question are unreasonable and not needed. He arbitrarily concludes that the regular pension plan should be sufficient with

no analysis of the level of pension benefits needed to recruit and retain top managers.

Q. Mr. Meyer states that the IRS may not allow the recognition of supplemental pension expense for tax purposes. Is this relevant?

A. No, it is not. It is not unusual for there to be differences between amounts that are deductible or non-deductible for tax purposes and expenses that are recoverable or non-recoverable in rates. One is not dispositive of the other. For example, the IRS allows bonus depreciation to be entirely deductible in the year taken; however, the Commission only allows depreciation expense consistent with Commission-prescribed depreciation rates. Likewise, the IRS does not allow the deduction of the current year's storm damage accrual. However, the Commission allows the annual storm damage accrual to be recovered in rates as it is booked.

Q. Was supplemental pension expense included in Gulf's last rate case?

A. Yes. The final order in the case refers to a stipulation stating there was no adjustment to be made to pension expense. Order No. PSC-02-0787-FOF-EI issued June 12, 2002, in Docket No. 010949-EI, In re: Request for rate increase by Gulf Power Company. In a prior Gulf case relating to the tax savings refund in 1988, the Commission rejected OPC's recommendation that supplemental pension benefits be disallowed:

> We believe that the supplemental benefits plan should be considered as part of the total compensation package for the

employees, and that the compensation plans for Gulf employees appear to be reasonable. It also appears reasonable that highly paid employees should not be discriminated against due to tax considerations. Therefore, we will make no adjustment for the supplemental benefits plan in this tax savings docket.

Order No. 23536, issued September 27, 1990, in Docket No. 890324-EI, In re: Petition of Gulf Power Company for approval of "Tax Savings" refund for 1988.

DIRECTORS AND OFFICERS LIABILITY INSURANCE

Q. What is the recommendation made by Mr. Schultz regarding Directors and Officers Liability (DOL) Insurance?
A. Mr. Schultz is recommending the disallowance of 50% of the cost of DOL insurance premiums.

Q. Do you agree with this recommendation?
A. No, I do not.

Q. Why not?
A. I disagree for reasons similar to the points I made with regard to at-risk compensation. The amount requested by Gulf for DOL insurance is

reasonable and is an ordinary and necessary cost of doing business for any publicly-held company, and as such the entire amount should be recovered in rates.

Q. Why are DOL insurance premiums a necessary and reasonable cost of doing business?

A. DOL insurance is necessary to attract and retain knowledgeable, experienced and capable directors and officers. DOL insurance is purchased for the purpose of protecting the company and its directors and officers from normal risks associated with managing the company. Qualified and capable directors and officers would be reluctant to assume the responsibilities of managing a publicly-held company without the assurance that their personal assets would be shielded from legal expenses, settlements or judgments arising from shareholder lawsuits. The assets of the Company are likewise protected from lawsuits that could divert capital to cover any losses. Increasing scrutiny of corporate governance and the related risk exposure of directors and officers make insurance a necessity in maintaining a high quality board and senior management team. Adequate liability coverage gives directors and officers the level of comfort necessary to enable them to make forward-looking decisions that will provide operational and cost-efficiency benefits for customers.

Q. Mr. Schultz argues DOL insurance primarily benefits shareholders. Do you agree with that?

A. No, I do not. DOL insurance helps to retain and recruit qualified and competent directors and officers that provide needed expertise in running a utility, both financially and operationally. Having a well-run utility benefits ratepayers and having adequate liability coverage helps assure the delivery of safe and reliable service at a reasonable cost.

Q. Mr. Schultz states that there are Commission cases that have allowed recovery of premiums for DOL insurance, have disallowed recovery, or have required the expense be shared with stockholders. Can you comment on those cases?

A. Yes. It appears to me that where there has been an adequate explanation of the need for the insurance and a reasoned analysis of the need, full recovery has been authorized. The Commission's rationale in the People's Gas case and in the Tampa Electric case is instructive regarding the need for DOL insurance:

> DOL Insurance has become a necessary part of conducting business for any company or organization and it would be difficult for companies to attract and retain competent directors and officers without it. Moreover, ratepayers receive benefits from being part of a large public company, including, among other things, access to capital. In addition, DOL Insurance is necessary to protect the ratepayers from allegations of corporate misdeeds.

Order No. PSC-09-0411-FOF-GU, page 37 issued June 9, 2009, in Docket No. 080318-GU, In re: Petition for rate increase by Peoples Gas System.

> We find that DOL insurance is a part of doing business for a publicly-owned company. It is necessary to attract and retain competent directors and officers. Corporate surveys indicate that virtually all public entities maintain DOL insurance, including investor-owned electric utilities.

Order No. PSC-09-0283-FOF-EI, page 64 issued April 30, 2009, in Docket No. 080317-EI, In re: Petition for rate increase by Tampa Electric Company.

Q. Does Mr. Schultz claim DOL insurance is not a necessary and reasonable expense?

A. No, he does not. Implicit in his recommendation that 50% of the premium cost be recovered is an acknowledgement that it is a necessary and reasonable business expense.

Disallowing a reasonable and necessary business expense, or requiring the company to share part of the expense, is nothing more than a backdoor approach to reducing the allowed ROE. Funds that should go to shareholders as a fair return on investment instead are diverted to cover costs that should otherwise be recovered in rates.

IMPUTED REVENUES

Q. What do you mean by imputed revenues?

A. Imputed revenues do not represent real revenues or payments for actual services rendered. Instead they are amounts used for regulatory purposes to assign a benefit from one entity to another.

Q. Does Ms. Dismukes recommend the use of imputed revenues for Gulf?

A. Yes, Ms. Dismukes recommends that the Commission assess a two percent compensation payment on the revenue of Southern Company's unregulated companies to be allocated to Southern Company's regulated companies. She calculates the amount applicable to Gulf to be $1.5 million. Of course, the Commission cannot compel an actual payment of $1.5 million from the unregulated companies to Gulf, thus the $1.5 million would be "imputed" for regulatory purposes.

Q. If accepted, what would the $1.5 million of imputed revenues mean for Gulf?

A. It would mean that Gulf would not receive any actual cash from the unregulated companies but would nevertheless have the amount of its going forward revenues reduced by a comparable amount (net of any associated taxes). This would mean that there would be less actual revenue per year for Gulf to pay actual expenses or invest in infrastructure to serve customers.

Q. Would this have financial implications for Gulf?
A. Yes, and the financial implications would be real, not imputed. All other things being equal, Gulf's actual achieved ROE would decline, its interest coverage would decline and it would be more prone to go to capital markets to cover short term cash needs such as for restoring service after a hurricane.

Q. What is Ms. Dismukes' stated purpose for her recommendation?
A. Ms. Dismukes' stated purpose is to compensate the regulated operating companies for intangible benefits the unregulated companies allegedly receive from the regulated companies. Of course, there is no real compensation to Gulf. The real effect is a reduction in customer rates simply because Southern Company obtained and deployed capital to enter unregulated markets and those investments have created additional revenues for the Southern Company.

Q. So under Ms. Dismukes' recommendation a portion of the real benefits of Southern Company's investment in unregulated businesses would flow to Gulf's customers, correct?
A. Yes, that would be the end result. And while it was the Southern Company that made the investment and is at-risk for its capital investment and while customers have made no investment and are not at-risk should the unregulated businesses fail, customers would still receive benefits equal to two percent of the unregulated companies' revenue.

Q. Ms. Dismukes references a 1988 order of the Commission involving United Telephone Company of Florida, Order No. 18939 in Docket No. 870385-TI. Should this order be used as a basis to impute unregulated revenues to Gulf?

A. No, it should not. The language quoted by Ms. Dismukes is incorrect. The decision for United Telephone was relevant only to unique facts and circumstances applicable to the telephone industry at that time. The Commission in subsequent orders "backed away" from the United decision, such that the United decision does not represent the policy of the Commission. In addition, the United decision pre-dates the Commission's adoption of Rule 25-6.1351, which sets forth the Commission's policy on cost allocations and affiliate transactions.

Q. How did Ms. Dismukes misquote the United order?

A. On page 23, lines 9 through 15 of her testimony, Ms. Dismukes quotes the fourth paragraph from page 10 of Order No. 18939. She relies upon this paragraph to conclude that the Commission embraced the concept of imputing revenue as an ongoing policy. What Ms. Dismukes fails to mention is that the Commission, on its own motion, struck this paragraph from the order. In its Order on Reconsideration No. 19734, dated July 27, 1988, the Commission stated:

> Our first modification to Order No. 18393 will be to delete the entire fourth paragraph on page ten of the order. We believe this paragraph contemplates a policy much broader than the

one which may be drawn from our requirement of the compensatory payment in this docket. Accordingly, the paragraph will be stricken from the order.

Q. What were the unique facts and circumstances that led to the Commission's original decision to impute revenues to United Telephone Company?

A. It should be recognized that the decision was not part of a comprehensive rate proceeding, rather the issue before the Commission was an application of United Telephone Long Distance, Inc. (UTLD) for a Certificate of Public Convenience and Necessity to enter the inter LATA MTS and WATS (long distance) market. The telephone industry was entering a new era of competition following divestiture and the distinction between long-distance (competitive) and local service (regulated) was important. The local exchange companies (LECs) were permitted to enter the long distance market only after they opened up their local exchange central offices to equal access. Equal access permitted other competitors to enter the long distance market by gaining nondiscriminatory access to the LECs central offices.

Q. Was the Commission aware of the unique nature of the UTLD's application?

A. Yes, the Commission was very aware of this and knew that its decision was laying a framework for the furtherance of competition in the telecommunications industry. In Order No. 18939, page 3, the Commission stated:

> UTLD's application is significant because it represents the first instance in which a major local exchange company established a separate but wholly owned subsidiary to provide long distance service. It also represents the first instance in which a LEC-affiliated IXC will participate in equal access conversion. Therefore, UTLD's application raises significant public policy questions regarding both structural and functional separation, cost allocation, and the possibility that UTLD may enter the intraLATA competitive market against UTF in the event the toll monopoly currently reserved for the local exchange companies is eliminated.

Q. What was UTLD's corporate structure and how was it proposing to enter the long distance market?

A. UTLD was a wholly-owned subsidiary of United Telephone Company (the regulated entity). UTLD was not planning to obtain any financing on its own and was planning to have no assets or facilities of its own. It planned to have only one full-time employee with the majority of its functions being performed by United Telephone Company employees. UTLD's business plan was to resell long distance services to customers within the certificated service territory of its parent, United Telephone Company.

Q. Did the Commission have concerns with UTLD's proposal?

A. Yes. The Commission was concerned that UTLD, by virtue of its close association with the incumbent legacy telephone provider, would gain an unfair competitive advantage in this newly opened market. On page 6 of Order No. 18939, the Commission stated:

> We view the IXC market as a developing one, with the potential to be highly competitive. As such we must ensure that the actions we take do not give any one IXC an undue competitive advantage.

Q. Did the Commission require an imputation based on total revenue as Ms. Dismukes is proposing for Gulf?

A. No, the Commission recognized that the services UTLD planned to provide were inextricably linked with those of United Telephone Company. Thus, the Commission allowed the revenue of UTLD to be reduced by the access charges UTLD had to pay to reach the local network.

Q. Let's contrast the facts and circumstances leading to the Commission's decision for United Telephone Company in 1985 and Ms. Dismukes' recommendation to impute revenues to Gulf in 2011. Are the unregulated subsidiaries used by Ms. Dismukes wholly owned subsidiaries of Gulf?

A. No.

Q. Do the unregulated subsidiaries used by Ms. Dismukes rely on the employees and facilities of Gulf to provide their respective services?

A. No.

Q. Do the unregulated subsidiaries used by Ms. Dismukes provide services that were previously provided by Gulf on a regulated basis and are they inextricably linked?

A. No.

Q. Does the Commission have a responsibility to insure that the unregulated companies used by Ms. Dismukes do not receive a competitive advantage over other entrants in a new market being opened to competition for the first time?

A. No.

Q. In subsequent decisions, has the Commission acknowledged the unique facts and circumstances of the United case?

A. Yes, it has. In declining to impose a compensation payment requirement in BellSouth Advanced Networks (BSAN), the Commission, in Order No. 20828 stated:

> This situation is different from that found in UTLD's certification proceedings. No evidence in this case was provided regarding the logo of BSAN, the reliance of BSAN on the Southern Bell name, the immediate access of BSAN to Southern Bell financing, or the ability

of BSAN to capitalize on a trained skilled workforce. Using the UTLD proceeding as a guide, the basis for imposing a compensation payment on BSAN at this time has not been clearly established.

Q. Has there ever been a case involving an electric utility in Florida where the Commission approved an imputation of revenue from an unregulated company to the regulated electric utility?

A. No, not to my knowledge. It is not the Commission's policy to make such an imputation.

Q. What is the Commission's policy on cost allocation and affiliate transactions?

A. The Commission's policy is found in Rule 25-6.1351, F.A.C.

Q. Does Rule 25-6.1351, F.A.C. require or contemplate the imputation of revenues from unregulated subsidiaries to a regulated utility?

A. It does not.

Q. Should the Commission accept Ms. Dismukes' recommendation to impute revenues from unregulated companies to Gulf?

A. No. Ms. Dismukes' recommendation is not supported by the facts, violates principles of good regulatory policy, is contrary to the Commission's existing policy, and would penalize Gulf for merely being part of the Southern Company system.

STORM DAMAGE ACCRUAL

Q. What is a storm damage accrual?

A. It is the annual amount credited to the storm damage reserve. It has a corresponding debit entry to an expense account and is a cost of providing service. Therefore, it is included in a company's rates. It is based upon anticipated future costs and spreads these costs evenly from year to year to minimize potential rate swings for customers.

Q. What is the storm damage reserve?

A. It is the net amount within Account No. 228.1 set aside to cover actual restoration costs from storms. The annual accrual adds to the reserve balance while actual storm-related costs reduce the reserve. The reserve provides a "cushion" to absorb the sometimes severe fluctuations in storm-related costs from year to year.

Q. Does the inclusion of a storm damage accrual in rates add to a utility's earnings?

A. No, it does not. It is an expense that is used exclusively to provide for future storm restoration costs. It does add to a company's cash flow.

Q. Does the reserve provide any benefit to Gulf's customers in addition to covering storm restoration costs?

A. Yes, it is a reduction to Gulf's rate base and reduces rates proportionately.

Q. Have Florida's utilities always used storm reserves to cover storm restoration costs?

A. Yes, the reserve has always been part of the accounting for storm costs. However, most of the annual costs were covered by commercially available insurance on transmission and distribution facilities. After Hurricane Andrew, such insurance was no longer cost effective and the Commission chose to implement a self-insurance plan by annual accruals to the reserve. In essence, the annual accrual took the place of insurance premiums that were previously included in rates as a cost of providing service.

Q. What is the amount of annual accrual that Gulf is requesting to be included in rates?

A. Gulf is seeking an annual accrual of \$6.8 million based on a targeted reserve of \$52 million to \$98 million. Gulf's current accrual is \$3.5 million and was based on a targeted reserve of \$25.1 million to \$36 million, which was established by the Commission in 1996.

Q. On what basis did the Commission establish Gulf's existing annual accrual and targeted reserve?

A. In 1995 the Commission required Gulf to prepare and submit a storm damage study. That study determined the long-term average damage costs to be \$1.3 million annually. The Commission determined Gulf's study to be adequate and set the annual accrual at \$3.5 million to allow the reserve to grow to an acceptable level. The Commission stated:

> Our primary concern is that the accrual amount be sufficient to cover annual damages and promote growth in the Accumulated Provision for Property Insurance account balance. Although, the study recommended an increase in the annual accrual of $0.4 million, Gulf did not request said increase. Assuming Gulf's estimate of $1.3 million in annual losses is accurate, then an annual accrual amount of $3.5 million will be adequate to cover those losses and provide for reasonable increases to the Accumulated Provision for Property Insurance account balance.

Order No. PSC-96-1334-FOF-EI issued November 5, 1996, in Docket No. 951433-EI, In Re: Petition for approval of special accounting treatment of expenditures related to Hurricane Erin and Hurricane Opal by Gulf Power Company.

Q. Does Gulf's requested accrual contemplate an increase in its actual reserve?

A. No, Gulf is conservatively asking for only the expected average annual loss of $6.8 million which is reflected in its current study.

Q. What do witnesses Meyer, Pollock and Schultz recommend for Gulf's annual storm damage accrual?

A. There is a wide spread among their recommendations. Mr. Meyer recommends an increase from $3.5 million to $5.0 million to recognize that costs and expected storm damages have increased since the accrual was last set some 16 years ago. Mr. Pollock recommends that the reserve accrual of $3.5 million remain unchanged. And Mr. Schultz recommends an 83% reduction to $0.6 million.

Q. On what basis should the annual accrual be set?

A. The starting point should be the expected annual average storm loss coupled with an evaluation of the adequacy of the existing level of the reserve. The Commission should then make a determination whether the accrual should be set at the expected average annual storm loss, above it, or below it. If the Commission believes the current reserve is inadequate to protect customers from most storm events or a series of storm events, the annual accrual should be set at an amount higher than the expected average annual loss. On the other hand, if the Commission believes the current reserve is more than adequate to protect customers from most storm events or a series of storm events, the annual accrual should be set at an amount lower than the expected average annual loss. Only if the Commission makes a determination that the existing reserve is either inadequate or more than adequate, should the annual accrual be set at an amount other than the expected average annual loss.

Q. Is this what Gulf is proposing?

A. Actually, no, it is not. Gulf believes the reserve target should be increased from its existing level. However, Gulf is not proposing an annual accrual above the expected average annual loss. Under this approach, the existing reserve level is expected to neither increase nor decrease from its current level. In this regard, Gulf's approach is conservative.

Q. How should the expected average annual loss be determined?

A. It should be based on a statistically valid study that looks at both the expected frequency of all potential storm events and the expected dollar amount of storm losses to be incurred from each event.

Q. Do witnesses Pollock and Schultz agree with this basis to determine the expected average annual loss?

A. No, they do not. They suggest that the expected average annual loss should be limited to only small storms.

Q. Do you agree with their approach?

A. No, I do not for two basic reasons. First, it is inconsistent with Commission policy and second, it is not logical to intentionally eliminate storm events that will eventually impact customers.

Q. How is the approach suggested by witnesses Pollock and Schultz inconsistent with Commission policy?

A. Remember that the Commission's current use of the storm damage reserve is the result of the Commission's decision to implement a self-insurance approach to protect customers from storms. Prior to Hurricane Andrew, the utilities and the Commission relied upon commercially available insurance to cover costs from all storm events, not just small storms. And the premiums for this insurance coverage were appropriately included in rates, with no distinction made between the amount of the premiums applicable to Category III and larger hurricanes and that applicable to smaller storms. Following Hurricane Andrew, Florida Power & Light (FPL) was required to submit a storm study to implement its self-insurance mechanism. FPL's study included a statistical analysis of the expected annual damage and included Category I through V storms. FPL calculated its average annual loss to be $20.3 million and further concluded that even if the accrual were set at the $20.3 million the resulting reserve would not cover losses from all potential catastrophic storms. FPL took a conservative approach and requested an initial annual accrual of only $7.1 million.

Q. What did the Commission ultimately decide?

A. The Commission found that FPL's study was sufficient to determine the expected average annual loss. However, in response to concerns expressed that an increase above the $7.1 million was needed to grow the reserve balance and to reduce dependence on special customer assessments (surcharges), the Commission accepted an agreement to increase the annual accrual to $10 million.

Q. So the Commission decided to set the annual accrual for FPL at an amount lower than the amount indicated in the study?

A. Yes, that is correct. The Commission used its discretion and the facts applicable to FPL at that time to set the average accrual at an amount lower than the study's indicated expected average annual loss. What is significant is the Commission's acceptance of the methodology that included all hurricanes (Categories I through V) and recognition that even doing so does not provide protection from all potential storm events or a series of storm events. Also significant is the Commission's decision to minimize dependence on surcharges to customers. In contrast, Mr. Pollock and Mr. Schultz intentionally limit protection to only Category II and smaller storms and encourage a dependency on customer surcharges.

Q. How is this illogical?

A. We know that higher intensity storms will eventually impact Gulf's territory. It would be illogical to ignore this reality and increase dependence on surcharges. Going back to the insurance analogy, their proposal would be like a homeowner insuring his or her house against small hurricanes, but not the larger ones. While the frequency of larger hurricanes is less, if and when one hits, customers would have a proportionately higher cost to pay at that time, a time when they could least afford it.

Q. Are there any other concerns you have with the approach taken by Mr. Pollock and Mr. Schultz?

A. Yes, there are. Both Mr. Pollock and Mr. Schultz place too much reliance on recent history. In fact, Mr. Schultz's recommendation of $0.6 million is based on an average of the last eight years (excluding larger storms) of $576,000. Using only recent history and excluding larger storms skews

Mr. Schultz's recommendation to the point that it is unreasonable. Likewise, if one were to only use the last eight years and include the large storms of 2004 and 2005, the average annual cost is approximately $19 million, greatly exceeding the $6.8 million indicated by Gulf's study. Under either approach, using only an average of recent history can lead to grossly understated or overstated estimates of expected average annual storm costs. This is not surprising, given the large fluctuations possible in year-to-year storms.

Q. Both Mr. Pollock and Mr. Schultz opine that customers would rather pay later for actual storm costs than to pay in advance for storm accruals. Do you agree?

A. I do not disagree that given an option, customers would generally prefer to pay later rather than currently. However, I do not agree that an appropriate annual storm cost accrual is the same as paying in advance.

Q. Why is an appropriate annual storm cost accrual not the same as paying in advance?

A. A storm reserve is an accounting technique that provides a uniform and systematic means of matching costs to revenue recovery so that such costs will not be concentrated in a particular year. When customers receive service they are not only receiving the electrons flowing through their meter, but also the reasonable expectation that their service will be restored as quickly and safely as possible should an interruption occur from a storm or other event. This is part of the package of services customers are currently receiving and should properly be included in cost of service. To a great extent, it is analogous to purchasing insurance coverage through a monthly premium. Even though a claim may not be filed, the premium is still a current cost of providing service.

Q. In addition to smoothing out rate impacts and properly matching costs and revenues, what other benefit does an appropriate annual storm reserve accrual provide?

A. It provides assurances to customers and the investment community that sufficient resources will be available to quickly and safely restore service following a storm. Following a storm, when a utility is striving to obtain outside assistance and goods and services from vendors, securing eventual payment should not be an impediment to service restoration.

Q. Was this a consideration when the Commission first decided to implement a self-insurance mechanism for storms?

A. Yes, it was. At the Commission's Agenda Conference where FPL's self-insurance plan was approved, the Commission expressed the need to recognize the storm accrual costs as legitimate costs and to offer comfort to the investment community that the Commission's approach would maintain the operational and financial integrity of the company.

Q. Should the Commission place greater reliance on surcharges as a means to recover storm costs?

A. No, the Commission should not. Both Mr. Pollock and Mr. Schultz argue that surcharges are not only permissible but should be preferred. It is not in the customer's interest to be overly dependent on surcharges. An appropriate annual storm reserve accrual will lessen the likelihood of any surcharge being imposed. And when one is absolutely necessary, an appropriate annual storm reserve accrual will lessen its amount and thus the burden imposed on customers. While an appropriate annual storm reserve accrual may slightly increase rates currently, it can and will provide greater benefits to customers when they need it the most.

CONSTRUCTION WORK IN PROGRESS (CWIP)

Q. What is CWIP?

A. CWIP is Account 107 which includes the total of work order balances for electric plant that is in the process of being constructed.

Q. Is CWIP a necessary part of providing quality utility service?

A. Yes, it is. A well managed utility focused on providing quality and cost effective service will deploy capital to construct new and/or modernize existing facilities to meet these objectives.

Q. Recognizing that CWIP is a necessary part of providing quality utility service, should it be permitted to earn a return?

A. Yes, it should.

Q. How should this be accomplished?

A. It should be accomplished in one of two ways. First, balances in CWIP could be allowed to accrue an Allowance for Funds Used During Construction (AFUDC). The Commission has adopted Rule 25-6.0141, F.A.C., which sets forth the calculation of AFUDC and the eligibility requirements of those construction projects which qualify. The second way is to allow CWIP in rate base.

Q. Is there a fundamental difference between the two approaches?

A. Yes, there is. Accruing AFUDC adds to the capital costs of a project. The return is an accounting entry only and is actually realized when the capital asset is included in rate base and is depreciated. Including CWIP in rate base avoids increasing the capital cost of the project through AFUDC and earns a return in rates while the project is being constructed.

Q. What are the main reasons why a CWIP project would not qualify for AFUDC?

A. There are two main reasons. First, if the project's construction period is less than12 months, it does not qualify. Second, if the project is allowed in rate base, it does not qualify for AFUDC.

Q. What are witnesses Chriss and Ramas recommending for CWIP for Gulf?

A. Both Mr. Chriss and Ms. Ramas recommend that $60.9 million of CWIP be excluded from Gulf's rate base and be denied a return.

Q. How is a return being denied?

A. The $60.9 million represents short-term construction projects which do not qualify for AFUDC. If they are not included in rate base, Gulf will be denied an opportunity to earn a return on capital that it has deployed to adequately meet its customers' need for service.

Q. Mr. Chriss and Ms. Ramas justify their recommended disallowances on the grounds that the $60.9 million is not used and useful. Do you agree with their rationale?

A. No, I do not. First, it needs to be understood that an accounting classification does not mean that invested amounts are not providing benefits to customers. Customers expect and deserve to have facilities in place to serve them when needed and to modernize existing facilities when it is cost-effective and/or improves service. In fact, if Gulf did not make these investments, it could be sanctioned by the Commission for not doing so.

Second, capital projects take time to construct, some longer than others. Costs are incurred to carry these projects to their ultimate completion. A project with a construction time of less than 12 months still incurs these carrying costs and these costs should be recognized in setting rates. Not doing so would be analogous to a bank not having to pay interest on CDs of less than 12 months. Obviously, investors expect a return on capital for the entire time that it is invested, not for just when it exceeds 12 months.

Third, labeling an investment as "not used or useful" does not mean that it should automatically be excluded from rate base and denied the opportunity to earn a return. The Commission pursuant to Rule 25-6.041, F.A.C., and its orders recognizes that CWIP can be allowed in rate base. Even long-term projects that otherwise would qualify for AFUDC can be included in rate base to maintain a utility's financial integrity.

Q. How is financial integrity threatened by large amounts of CWIP?

A. A large construction program can put financial strains on a utility, even if AFUDC is allowed. AFUDC is a non-cash accounting entry with delayed realization of earnings. With insufficient cash flows bond ratings can be threatened. In addition, denying both AFUDC and rate base inclusion, as Mr. Chriss and Ms. Ramas suggest, would only exacerbate potential negative financial impacts.

Q. Has the Commission allowed the inclusion in rate base of CWIP which is ineligible for AFUDC?

A. Yes, the Commission did so in Gulf's last rate case. The Commission has acknowledged that short term construction projects are a necessary part of providing quality service and should be allowed in rate base as opposed to accruing AFUDC.

Q. Has the Commission ever conducted an investigation into the proper accounting and ratemaking treatment for CWIP?

A. Yes, the Commission conducted such an investigation in Docket No. 72609-PU and issued its findings in Order No. 6640 dated April 28, 1975.

Q. What were the Commission's findings?

A. The Commission reaffirmed its previous findings that there should be two (and only two) options for CWIP. The Commission stated:

> The Commission's currently prescribed accounting treatment of AFDC was established by Order No. 3143 in Docket No. 6655 issued in 1962. It provides the companies with two options:
>
> a. Charge AFDC on CWIP and not include CWIP in rate base.
>
> b. Not charge AFDC and include CWIP in rate base.
>
> Further, we hereby conclude that the amount of CWIP includable in the rate base should be equal to or less than the normal average amount of CWIP outstanding over a reasonable period of time and that CWIP amounts in excess of this level should receive AFDC.

Q. Did the Commission address the proper treatment of construction projects with shorter construction times?

A. Yes, the Commission did and generally referred to such projects as "blanket work orders", recognizing that such projects were generally not great in individual dollar amounts, and were routine or recurring in nature. Such projects were accounted for on a blanket work order basis.

Q. What did the Commission decide for these type projects?

A. The Commission recognized that such projects generally do not receive AFUDC and thus should be included in rate base. The Commission stated:

> Due to the differences in operating characteristics of the various companies, we deem it inappropriate and impractical to attempt to set a standard for the dollar amount or time span that would be used to determine the eligibility of certain construction projects as blanket work orders. However, since blanket work orders do not receive AFDC and thus are permitted under our optional provisions of being included in the rate base, we believe the levels set by the companies should be reviewed by this Commission for purposes of testing their reasonableness.
>
> It should also be emphasized that in order to be eligible for inclusion in the rate base, blanket work orders should not receive AFDC at any time, either in the past or future.

Q. Has the $60.9 million of CWIP that Gulf is requesting to be included in its rate base ever accrued AFUDC?
A. No, it has not and therefore, should be included in Gulf's rate base.

Q. Ms. Ramas attempts to justify her position by stating that short term projects still provide the Company a return by either increasing sales or decreasing operating costs. Do you agree with her rationale?
A. I do not agree. While I appreciate her implicit acknowledgement that a return should be earned, a closer look at her statement reveals the fallacy of it. The only way that a project can increase sales is to be completed and closed out of CWIP and placed in plant in service. Her so called "return" through increased sales does nothing for the time period that it was under construction. Likewise, a construction project that decreases costs cannot achieve its purpose until it is completed. So, very desirable projects that ultimately increase sales or reduce costs would be denied recovery of a return during their construction time. Regulation should be encouraging the deployment of capital for such projects, not denying a return as Ms. Ramas suggests. Accepting Ms. Ramas' suggestion would constitute bad regulatory policy.

Q. Ms. Ramas characterizes the increased revenue and the reduced costs from the construction projects as a "return" to Gulf. Do you agree?
A. No, I believe a better characterization is that these projects are providing customer benefits. And if these projects provide customer benefits, they should be allowed to earn a return during construction.

Q. Ms. Ramas further justifies her recommendation to deny a return on these projects because they constitute only 19% of total CWIP. Do you agree?

A. No. I agree that denying a return on 19% of total necessary and reasonable costs is better than denying a return on 100% of total necessary and reasonable costs. However, the principle is being violated regardless of whether it is 19% or 100%. Ms. Ramas' recommendation is analogous to a bank paying interest on only $81,000 of $100,000 invested in CDs, because $19,000 is invested in CDs maturing in less than 12 months.

Q. Mr. Chriss asserts that there should be a match of costs and benefits. Do you agree?

A. I believe in the principle of matching cost and benefits. It is for this reason that I disagree with his recommendation to deny a return on construction projects that are needed to meet customer demands and/or improve service. If a return is denied, a mismatch occurs.

PARENT DEBT ADJUSTMENT

Q. What is a parent debt adjustment?

A. It is a ratemaking adjustment wherein an amount of debt issued by the parent is imputed to the capital structure of the regulated utility for purposes of calculating the amount of income tax expense to be included in rates. It is premised on the presumption that debt issued by the parent is invested in the equity of the regulated utility, i.e., that double leverage exists. Therefore, it essentially is a double leverage adjustment.

Q. What do you mean by the term "double leverage"?

A. Leverage is a financial term used to describe a situation where debt is used to finance an enterprise. Debt is generally a fixed-obligation source of capital and it can be used to "leverage" returns on equity capital. It introduces an element of risk to meet the fixed obligations, but when combined with equity capital in appropriate proportions can enhance the equity return.

Double leverage refers to a situation where a parent entity issues debt to invest in a subsidiary that also issues its own debt, hence the leverage is doubled. This practice introduces even more risk for the consolidated operations of the parent and subsidiary. Given the increased risk, the amount of debt so issued needs to be evaluated to insure that there is not an over reliance on debt capital. This is also true for regulated utilities and regulators should make an evaluation of the amount a debt that is prudent to finance regulated operations.

Q. Does the Commission have a policy of making double leverage adjustments?

A. No, the Commission has a policy of <u>not</u> making double leverage adjustments. The Commission has shown a distinct preference for using the actual capital structure of the regulated utility as long as the actual capital structure ratios are not imprudent on their face. The Commission has found that the funding source of funds invested in a regulated utility's equity is not relevant and that making double leverage adjustments can distort the true cost of equity capital for a regulated utility.

Q. Why then does the Commission make a parent debt adjustment?
A. The Commission makes an exception for the calculation of income tax expense. It deviates from its general policy against double leverage adjustments to recognize the tax deduction of interest on parent debt that is presumed to be invested in the equity of the regulated utility. Even though the debt exists at the parent level and ratepayers are not obligated to pay the interest in their rates, the tax deduction is nevertheless imputed to the benefit of ratepayers.

Q. So there is a discrepancy between the amount of debt used to determine a regulated utility's cost of capital and the amount of debt used to determine the regulated utility's income tax expense?
A. Yes, that is correct.

Q. How did the Commission's policy on parent debt adjustment come to be?
A. One of the earliest adjustments to recognize the "tax effect of consolidated debt" was made in a 1975 case involving Southern Bell Telephone and Telegraph Company, a subsidiary of AT&T. The Commission used a consolidated capital structure and made the adjustment on the basis of the

accounting principle of consistency which "necessitates that the tax effect of AT&T debt be recognized" when a consolidated capital structure is used to determine revenue requirements. (Docket No. 74805-TP, Order No. 7018 dated December 4, 1975)

This same argument of consistency was used to not make an adjustment in a 1976 case involving General Telephone Company of Florida. In that case, the Commission did not use a consolidated capital structure and concluded that consistency required that no recognition of the tax effect of parent debt be given. (Docket No. 760464-TP, Order No. 7669 dated March 7, 1977) The Office of Public Counsel appealed the Commission's order arguing that a failure to recognize the parent's debt-equity mix in the computation of tax expense permits General Telephone to receive an allowance greater than its actual income tax liability on a consolidated basis. The Florida Supreme Court (Court) remanded the case to the Commission, stating that it was unable to conclude with the majority of the Commissioners that the use of the subsidiary approach for determining cost of capital dictates the use of the same approach for the tax effect calculations. The Court went on to say "Each determination must be based on specific independent findings supported by competent substantial evidence. There was no such independent finding in this case, and what evidence there is in the record supports the consolidated approach as being more accurate." *Citizens of the State of Fla. v. Hawkins*, 356 So.2d 254 (Fla. 1978).

Q. Does the Commission have a rule on parent debt adjustments?

A. Yes, the Commission adopted Rule 25-14.04, F.A.C. (now designated as Rule 25-14.004, F.A.C.) in 1982. When the Commission adopted the rule, it included a provision presuming that the parent debt is invested in the equity of the regulated utility in the same ratios as the parent's overall capital structure. The Commission also included a provision that this presumption is a rebuttable one.

Q. Has the Commission ever considered repealing Rule 25-14.004, F.A.C.?

A. Yes, in Docket No. 870386-PU, the staff of the Commission filed a recommendation concerning the potential repeal of Rule 25-14.004. The technical staff recommended repeal of the rule. Legal staff recommended against repeal.

Technical staff explained that the relevant court cases do not require the rule and it is within the Commission's discretion to make adjustments as the record evidence supports. The technical staff argued that ratepayers should pay the taxes associated with or receive the tax benefit of only the items that are included in the cost of service and net operating income directly attributable to them. Technical staff referred to this as the "cause and effect relationship" and went on to explain the true effect of a parent debt adjustment:

> The effect of the parent debt adjustment is an indirect reduction of equity return, not a correction of income tax

> expense. This equity return adjustment can be directly achieved by reducing the allowed cost of equity or the amount of equity. Either of these adjustments will have the direct effect of also reducing the allowed income tax expense and will be within the cause and effect relationship.

Staff Recommendation at page 5, issued September 8, 1988 in Docket No. 870386-PU, Repeal of Rule 25-14.004, Florida Administrative Code, Effect of Parent Debt on Federal Corporate Income Tax.

Technical staff further explained why the rule is inappropriate and unnecessary:

> The parent company debt adjustment necessarily assumes that the debt of parent company funds the equity of the utility subsidiary. This is known as double-leverage. We believe that the capital structure found reasonable by the Commission should determine the interest used for tax purposes. This is known as interest reconciliation. It makes no sense to use one interest amount for capital structure and another for tax purposes. In developing capital structure, the parent subsidiary relationship is reviewed. **The key is the reasonableness of the utility's capital structure.**
> [Emphasis added]

All parties in proceedings before this Commission are offered the opportunity to provide expert testimony regarding the appropriate level of income tax expense, capital structure and rate of return. All appropriate adjustments may be made without invoking Rule 25-14.004. Because Rule 25-14.004 is unnecessary, it should be repealed.

ID. at 7-8

In Order No. 20206 dated October 24, 1988, the Commission chose not to repeal Rule 25-14.004. In a one paragraph order, the Commission simply stated: "We do not wish to revisit the rule at this time."

Q. You mentioned the rebuttable presumption in Rule 25-14.004, F.A.C. Did Gulf rebut this presumption in its direct testimony?

A. Yes, Mr. Teel explained why it is incorrect to presume that debt issued by the Southern Company is invested in the equity of Gulf.

Q. Does Dr. Woolridge address the presumption and Mr. Teel's rebuttal of it?

A. Yes, Dr. Woolridge cites a previous Commission order and concludes that Mr. Teel's rebuttal is not persuasive because it is impossible to "trace dollars". He further concludes that because there is debt that exists at the parent level that the parent debt adjustment is appropriate for Gulf.

Q. Do you agree with Dr. Woolridge's conclusion?

A. No, I do not agree. Dr. Woolridge essentially argues that the presumption can never be rebutted. His concluding statement on the subject is quite revealing. He concludes with this statement: "Therefore, in the absence of an all equity capital structure at the parent level, a PDA is appropriate for Gulf Power." With this view point, the presumption can never be rebutted. This is inconsistent with the clear language of the Rule.

Q. Dr. Woolridge also refers to the impossibility of tracing dollars. Do you agree with this argument?

A. I find his reasoning curious. While stating it is impossible to trace dollars, he ignores the reality that the presumption in the Rule and his own conclusion are exactly that, a tracing of dollars from parent debt (Southern) to subsidiary equity (Gulf). I agree that these dollars from Southern to Gulf cannot be traced or proven with certainty, hence the presumption. However, if one is to rebut the presumption which is based on tracing, one has to engage in similar "tracing" to show that the dollars were not, or more likely not, to have been invested in Gulf's equity. By his dividend analysis, Mr. Teel shows that it is more likely that the Southern debt was not invested in Gulf's equity. Dr. Woolridge makes no such analysis to rebut Mr. Teel's assertion. He simply relies on arguments that say the presumption can never be rebutted.

Q. Dr. Woolridge cites the Indiantown case, Order No. PSC-00-2054-PAA-WS, for the proposition that the parent debt adjustment was not rebutted. Do you agree?

A. Yes, I do agree that in the Indiantown case, the parent debt adjustment was not sufficiently rebutted and that an adjustment was made. This case does not stand for the proposition that the presumption can never be rebutted. It does stand for the proposition that each case rests on its own unique set of facts.

Q. Were there any unique facts in the Indiantown case relevant to the parent debt adjustment?

A. Yes, the Commission was concerned with the high equity ratio that existed at the regulated utility level.

Q. What was the equity ratio and why is it relevant?

A. The equity ratio was 80.17%. Remember that a parent debt adjustment is essentially a double leverage adjustment. The higher the equity ratio, the more likely that the regulated utility's capital structure is inappropriate and the likelihood that parent debt supports the high equity ratio, i.e., that there is in fact double leverage taking place.

Q. Has the Commission ever recognized the appropriateness of a utility's capital structure and chosen not to make a parent debt adjustment?

A. Yes, it has. In Docket No. 040247-WS involving St. James Island Utility Company, Order No. PSC-04-0755-PAA-WS issued August 5, 2004, the Commission stated:

> In this case, we do not approve a parent/debt adjustment. The parent company, St. Joe, is capitalized with an equity ratio of 60%, whereas St. James' proposed capital structure consists of 40% equity and 60% debt. We find the utility's proposed capital structure to be reasonable and note that the parent company has significantly more equity.

Q. Does the Southern Company (unconsolidated) have significantly more equity than Gulf?

A. Yes, it does.

Q. Does Dr. Woolridge express an opinion on the appropriateness of Gulf's capital structure?

A. Yes, he does. Dr. Woolridge uses Gulf's recommended capital structure and finds it to be in line with its recent capital structure as well as the consolidated capital structure of Southern Company.

Q. Did the Commission make a parent debt adjustment for Gulf in its last rate case?

A. No, it did not.

Q. If the Commission were to make a parent debt adjustment for Gulf in this case, while concluding that Gulf's recommended capital is appropriate, what would be the result?

A. Once the Commission makes a determination as to Gulf's rate base, revenues, expenses, capital structure, and capital costs which it deems to yield reasonable results, then the addition of the parent debt adjustment will reduce Gulf's achieved net operating income and return on equity. This could preclude Gulf from realizing its authorized return on equity.

Q. You earlier quoted from technical staff's recommendation regarding possible repeal of Rule 25-14.004, F.A.C. Do you agree with those opinions?

A. Yes, I do. I particularly agree with technical staff's "cause and effect" rationale and their conclusion that the real issue is the reasonableness of a regulated utility's capital structure.

Q. Why is that?

A. Remember that a parent debt adjustment is essentially a double leverage adjustment. It implies that the regulated utility should have issued more debt than it actually did. If the regulated utility's capital structure and the amount of debt it actually issues are found to be reasonable, the need for a parent debt adjustment is substantially diminished, if not totally eliminated.

Q. Should the reasonableness of Gulf's regulated capital structure be a consideration in determining if the rebuttable presumption in Rule 25-14.004, F.A.C. has been met?

A. Yes, it should. The reasonableness of Gulf's capital structure further substantiates Mr. Teel's arguments that Southern's debt is not invested in Gulf's equity and that Gulf's capital structure can be used to correctly determine Gulf's cost of providing service.

O&M BENCHMARK

Q. Mr. Chriss, on behalf of the Florida Retail Federation, suggests that Gulf Power should have used the Commission's O&M Benchmark in its budgeting process. Do you agree?

A. No, I do not. That is not the purpose of the O&M Benchmark.

Q. What is the purpose of the O&M Benchmark?

A. The Commission's O&M Benchmark is simply a tool or indicator used by the Commission to flag certain expenses for careful review. It is not intended to be a floor or a ceiling for O&M expenses. Commission orders have consistently confirmed the O&M Benchmark is an analytical tool used as part of the Commission's overall evaluation of a utility's O&M expenses in a rate case proceeding.

Q. Should the Commission be concerned if Gulf actually used the O&M Benchmark to set its budgets?

A. Yes, it should. The Commission should expect and, in fact, require Gulf and all other regulated utilities to budget for forecasted demands, workloads and costs that are reasonably necessary to provide reliable and cost-effective service. A strict adherence to a regulatory guideline like the O&M Benchmark cannot be a substitute for an effective and dynamic budgeting process that considers customer expectations, changes in technology, changes in fuel costs, and changes in environmental and other regulatory requirements, just to name a few.

IMPACT ON CUSTOMERS

Q. Do witnesses Chriss and Pollock address the impact on customers of Gulf's proposed rate increase?

A. Yes, they do. They address customer impacts, the state of the economy, and the competitiveness of Gulf's rates. Mr. Pollock states: "the Commission must ensure that Gulf's request for a rate increase minimizes the impact on all customers." Mr. Chriss, while acknowledging that costs are required to provide reliable and adequate service, which include a reasonable return, states: "However, the Commission needs to ensure that service is provided at the lowest possible cost."

Q. Do you agree with their exhortations?
A. I agree that customer impacts are important and should be a primary consideration. I further agree that regulation should make decisions and adopt policies which encourage utilities to be efficient and provide high quality service in a cost-effective manner. In this way, customer impacts can be minimized. However, the Commission should not deny the recovery of needed and prudent costs or unnecessarily defer recovery of needed and prudent costs in an effort to minimize customer impacts because of the state of the economy or to keep rates artificially low as a means to enhance economic development.

Q. Why do you add this qualification to the exhortations of witnesses Pollock and Chriss?
A. The primary responsibility of setting a utility's rates is to provide rates which give a utility a reasonable opportunity to completely and timely recover all prudent and necessary costs incurred to provide service. This is true regardless of the state of the economy or the desire to stimulate economic development. To deny a regulated utility this opportunity would be contrary to good regulatory policy, would be unsustainable and would be harmful to customers in the long-term.

Q. How would rates so set be unsustainable?
A. The true economic cost of providing service has to be recovered. This is economic reality. If not, service will suffer and the regulated utility would not be able to obtain capital to adequately serve existing customers and

meet demands of new and growing customers. This is what I mean by being unsustainable.

Q. Why are sustainable rates needed even in an economic downturn?
A. Regulated utilities have an obligation to serve all customers on reasonable terms. This is one of their fundamental obligations under the regulatory compact and a fundamental reason why their access to capital on reasonable terms must be preserved. Regulated utilities do not have the ability to curtail service offerings or exit unprofitable markets during an economic downturn, as competitive firms do. To the contrary, regulated utilities must obtain and deploy capital when customers demand it, not when it may be economically advantageous or convenient to do so.

Q. Why are sustainable rates needed to enhance economic development?
A. While industrial and commercial customers are legitimately concerned with the cost of electric service, they are equally concerned with the reliability of their service and assurances that their electric utility has the means to modernize equipment, respond to changes in technology and deploy capital to build needed infrastructure to serve them as they grow. Unsustainable rates will not meet these needs and expectations.

Q. Can Gulf play an important role in the economic recovery in Northwest Florida?
A. Yes, Gulf has been and continues to be a leader in economic development efforts in Northwest Florida. As contained in the testimony of

Gulf witnesses, Gulf made a conscious decision to delay its request for a rate increase as long as it could without jeopardizing its financial integrity. A rate increase is now necessary to position Gulf to provide cost-effective, quality electric service to its customers. Gulf needs to be positioned to meet the growing needs of Northwest Florida as economic trends improve.

Q. Does this conclude your testimony?
A. Yes, it does.

GULF POWER COMPANY

Before the Florida Public Service Commission
Supplemental Rebuttal Testimony of
J. Terry Deason
Docket No. 110138-EI
In Support of Rate Relief
Date of Filing: November 29, 2011

Q. Please state your name and business address.

A. My name is Terry Deason. My business address is 301 S. Bronough Street, Suite 200, Tallahassee, Florida 32301.

Q. By whom are you employed and in what capacity?

A. I am employed by the law firm Radey Thomas Yon and Clark as a Special Consultant specializing in the fields of energy, telecommunications, water and wastewater, and public utilities generally.

Q. Did you file rebuttal testimony in this docket?

A. Yes.

Q. What is the purpose of your supplemental rebuttal testimony?

A. The purpose of my supplemental rebuttal testimony is to respond to the supplemental direct testimony of OPC witness Donna Ramas and to address the proper ratemaking treatment for Gulf Power's Crist Unit 6 and Crist Unit 7 turbine upgrades.

Q. What position does Ms. Ramas take with regard to the turbine upgrades?
A. Ms. Ramas recommends that the full annualization of the turbine upgrades be disallowed. She would limit recovery to the 13-month average of the turbine upgrade costs.

Q. Why does Ms. Ramas recommend disallowance of the full annualization of the turbine costs?
A. Ms. Ramas takes the position that annualizing the turbine costs would result in a mismatch of test year investment, revenues and costs, because the turbines are not to be completed until May and December of the test year.

Q. Would this be the result of Gulf's proposed treatment of the turbine upgrade costs?
A. No, it would not. Gulf is <u>not</u> proposing to achieve rate recovery before the turbine upgrades are completed.

Q. How does Gulf's proposal accomplish this?
A. Gulf has proposed two alternative approaches. Gulf's primary proposal is to include the turbine upgrade costs in the test year as if they were in service for the entire test year and then issue a credit through the Environmental Cost Recovery Clause (ECRC) for the difference. Gulf's alternative proposal is to include the turbine upgrades at their 13-month average amounts in the test year and then to implement a subsequent year adjustment to recognize the full annualized costs on a going-forward

basis. Under either approach, there is no mismatch in test year investment, revenues and costs.

Q. Why is Gulf's primary proposal to issue a credit through the ECRC particularly relevant for the turbine upgrade costs?

A. The costs for Gulf's initial turbine upgrade are currently being recovered through the ECRC. The subsequent turbine upgrades could also receive similar treatment, because they too are integral to environmental compliance projects at Crist Units 6 and 7. However, to be in compliance with an apparent change in Commission policy concerning the recovery of similar type projects, Gulf stipulated to have the turbine upgrade costs afforded recovery through base rates and be included in its pending rate case. The timing of the recovery of the turbine upgrade projects would not be an issue if they were to be recovered through the ECRC.

Q. What then is the issue in regards to the timing of the turbine upgrade costs in the rate case?

A. As I earlier stated, under either of Gulf's proposed treatments, there is no mismatch in the 2012 test year. The real issue is the recovery of turbine upgrade costs subsequent to the 2012 test year. Ms. Ramas would limit recovery to only the 13-month average test year amounts. This ignores a substantial portion of the investment in these upgrade projects on a going-forward basis. This, in turn, results in a mismatch in investment, revenues and costs starting in 2013. Thus, in an attempt to eliminate an imaginary mismatch in the 2012 test year, Ms. Ramas' position would cause an actual mismatch to occur beginning in 2013.

Q. How would there be a mismatch starting in 2013?

A. Rates would not reflect the full investment in the turbine upgrade projects beginning in 2013. In addition, there would be a further mismatch in costs and benefits.

Q. What would be the mismatch in costs and benefits?

A. The turbine upgrade projects were undertaken in conjunction with environmental compliance projects to help offset their parasitic load and to increase the overall efficiency of the plants. The upgrades benefit customers by reducing fuel costs from what they otherwise would be. Therefore, while customers would be receiving the full benefits of the upgrades through lower fuel costs, Gulf would be receiving a return on only a portion of its investment that generates the fuel savings. This is a mismatch of costs and benefits.

Q. Ms. Ramas asserts that Gulf's proposed treatment would be inconsistent with Commission policy. Do you agree?

A. No, I do not agree. Either of Gulf's proposed treatments would be consistent with Commission policy.

Q. How is Gulf's proposed treatment consistent with Commission policy?

A. In addition to matching costs and benefits, the Commission has a policy of setting rates based on costs that are reasonably known to be incurred during the time that rates are to be in effect. The goal is to set rates on a going forward basis that will enable a utility to recover its costs and have a reasonable opportunity to actually achieve its authorized rate of return. The Commission has implemented this policy by various means, including adjustments for known and measurable changes and allowing subsequent year adjustments in rates.

Q. Is the Commission's policy reflected in statute?

A. Yes, it is. Section 366.076(2), Florida Statutes, authorizes the Commission to adopt rules that provide for "adjustments of rates based on revenues and costs during the period new rates are to be in effect and for incremental adjustments in rates for subsequent periods." The Commission adopted Rule 25-6.0435, Florida Administrative Code, to implement this statutory provision.

Q. Has the Commission's policy to set rates on a going-forward basis ever been addressed by the Florida Supreme Court?

A. Yes, it has. The Florida Supreme Court has held that the Commission's authority to grant this type of relief predates and is independent of Section 366.076. In a 1985 challenge to a Commission order granting FPL a rate increase for 1984 and a subsequent year adjustment for 1985, the court found it unnecessary to rule on the constitutionality of the recently enacted Section 366.076, saying:

> We agree that PSC's authority to grant subsequent year adjustments predated the enactment of [section 366.076] and it is therefore unnecessary to address the constitutionality of the chapter.
>
> At the heart of this dispute is the authority of PSC to combat "regulatory lag" by granting prospective rate increases which enable utilities to earn a fair and reasonable return on their investments. We long ago recognized that rates are fixed for the future and that it is appropriate for PSC to recognize factors which affect future rates and to grant prospective rate increases based on these factors.
>
> *Floridians United for Safe Energy, Inc. vs. Public Service Commission*, 475 So. 2d 241, 242 (Fla. 1985) (citations omitted).

Q. The Court uses the term "regulatory lag". What is regulatory lag?

A. Regulatory lag is the difference in time between when a change in rates is needed due to changes in costs and when a rate change can be implemented. Regulatory lag can have the effect of denying a regulated company a reasonable opportunity to actually achieve its authorized return.

Q. If it were adopted, would Ms. Ramas' position result in regulatory lag?

A. It could have that effect. If the full cost of the turbine upgrades is not recognized in this case starting in 2013, Gulf may have to seek recovery through other means. If the other means of cost recovery could not be achieved effective January 1, 2013, then regulatory lag would result.

Q. Even if the other means of rate recovery could be effective by January 1, 2013, would this be the best approach?

A. No, it would not. Consistent with Commission policy, the current rate case is an appropriate vehicle to recognize these costs. Ignoring the costs now and requiring Gulf to seek recovery by other means would only add an element of increased risk and additional regulatory costs. This would not be in the customers' best interest.

Q. Has the Commission previously addressed a situation where significant capital investments were being made during the course of a test year?

A. Yes, in Docket No. 080317-EI, In re: Petition for rate increase by Tampa Electric Company, the Commission was faced with that factual situation. Tampa Electric (TECO) was seeking cost recovery of five separate combustion turbine units, two to be completed in May 2009 and three to be completed in September 2009. TECO sought recovery by fully annualizing the costs of the combustion turbine units in its 2009 test year.

Q. What did the Commission decide for the costs of the five combustion turbine units?

A. The Commission rejected TECO's full annualization of the units, but allowed cost recovery through a subsequent increase in rates. The Commission determined that the costs of the five combustion turbine units should be recovered as part of the rate case and not put off into a subsequent limited proceeding. The Commission further acknowledged that denying cost recovery of the full costs of the five units could deny TECO a reasonable opportunity to actually achieve its authorized return in 2010. In its non-final Order No. PSC-09-0283-FOF-EI, the Commission stated at page 6:

> Under normal circumstances, the Company's pro forma adjustments for the five simple cycle combustion turbine units would have been eliminated from the test year results because we believe it violates the principle of matching revenue, expenses, and rate base for the projected test year. We do not want consumers paying for items that are not in commercial service during the test year. However, the five simple cycle combustion turbine units represent a significant expenditure for the Company if placed into service in the 2009 test period. Thus, as stated, TECO may experience a significant adverse impact on earnings in 2010, and would most likely lead to

it petitioning the Commission for a limited proceeding within a very short period of time after our decision herein.

To avoid a significant cost to consumers and significant length of time to conduct a limited proceeding, we have decided to grant TECO a step increase in rates, effective January 1, 2010, for the cost of the five CT units. ...

Q. You stated that the Commission's Order was non-final. Why did the Order not become final?

A. The intervenors in the TECO case filed a motion for reconsideration of the Commission's decision. The intervenors alleged that they were denied due process since the step increase was not part of TECO's original request. The intervenors further alleged that the step increase violated various statutes and rules and would result in a mismatch of sales and revenues. The Commission denied all aspects of the intervenors' motion for reconsideration and the intervenors subsequently appealed the Commission's decision. The parties then resolved the appeal through a Commission-approved stipulation and thus the Order did not become final.

Q. How do the facts of the TECO case differ from those in Gulf's case?

A. There are two main differences. First, there are no allegations of a lack of due process concerning Gulf's proposed treatment of the upgrade projects: all parties stipulated that the recovery of the cost of these projects should be considered in this docket and agreed on a schedule for the filing of direct and rebuttal testimony addressing that cost recovery. And second, Gulf is not requesting a full annualization of the upgrade projects that would result in rates being collected before the upgrade projects are completed. Gulf's annualization proposal contains a credit through the ECRC which would prevent that potential outcome.

Q. Do you believe the TECO case is instructive on how Gulf's turbine upgrades should be treated?

A. Yes, I do. The TECO case stands for the principle that known and measurable changes, such as increased investments made during the course of a rate case test year, should be reflected in rates such that rates will be designed to recover costs on a going-forward basis. Absent such recognition, a utility could be denied a reasonable opportunity to actually achieve its authorized return. The TECO case further stands for the proposition that limited scope proceedings should not be pursued when the relevant costs can be reasonably included within a full revenue requirements rate case.

Q. Even though Gulf is not requesting full annualization of the turbine upgrades for 2012, has the Commission ever allowed a full annualization of similar costs?

A. Yes, in a rate case involving Florida Public Utilities Company (FPUC), the Commission allowed the full annualization of an investment in a new transformer as opposed to including the rental on a temporary transformer. In Order No. PSC-08-0327-FOF-EI at page 23, the Commission stated:

> Although allowing a full 13-month average recovery of the transformer increases the impact on rates, we believe it is more representative of the future than the inclusion of a rental transformer that will be gone before the rates even go into effect, as FPUC pointed out. Accordingly, we find it is appropriate in this instance to allow recovery of the transformer as if it were in service December 31, 2007.

Q. So either of Gulf's proposed treatments for the turbine upgrade costs would be consistent with Commission policy and precedent?

A. Yes.

Q. Do you have any other policy concerns with Ms. Ramas' proposed treatment?

A. Yes, as I stated earlier, her treatment would deny recovery of a portion of investments that create fuel savings. The Commission has a long history of encouraging such investments and allowing full cost recovery of such costs, either through the fuel adjustment clause or base rates. I am concerned that adopting Ms. Ramas' position would violate this long-standing practice and send the wrong message to utilities and their investors.

Q. What is your recommendation with regard to Gulf's investment in its turbine upgrades?

A. The Commission should approve either one of Gulf's proposals. This would be consistent with Commission policy and precedent. In addition, it would send the correct message to utilities and their investors, that regulation in Florida supports the deployment of capital which generates benefits for customers.

Q. If the Commission accepts Gulf's proposed treatment, Ms. Ramas recommends further adjustments to Gulf's deferred income taxes. Please comment on Ms. Ramas' recommendation.
A. I take no position on the deferred income taxes. However, I do note that her position is inconsistent with a position taken by Dr. Woolridge.

Q. How is Ms. Ramas' recommendation on deferred income taxes inconsistent with Dr. Woolridge's testimony?
A. Dr. Woolridge states that sources of capital cannot be traced. However, Ms. Ramas' recommendation is based on the premise that a portion of the deferred taxes can be traced as being invested in the turbine upgrades.

Q. Does this conclude your testimony?
A. Yes, it does.

BY MR. MELSON:

Q And you had one exhibit to your rebuttal testimony identified as TD-1, is that correct?

A That is correct.

Q And do you have any changes or corrections to that exhibit?

A I do not.

Q And I believe, Mr. Chairman, that's been identified as 162.

(Exhibit 162 marked for identification.)

CHAIRMAN GRAHAM: Okay.

BY MR. MELSON:

Q Mr. Deason, could you give us a brief summary of your testimony, please.

A Yes, I will. Good afternoon, Commissioners. As you know, regulation is a balancing act. For the balance to be reached, it is essential that a utility be given a reasonable opportunity to actually achieve its authorized rate of return. Unfortunately, many of the Intervenor witnesses in this case have taken positions which would deny Gulf Power this most basic opportunity.

A good example of denying Gulf this opportunity is Ms. Ramas' recommendation to disallow 100 percent of at-risk compensation. Her recommendation is not based on an analysis of the amount of compensation that is reasonable and necessary to provide utility service. Rather it's based on a philosophical difference she has with the way the compensation is paid, and not the amount that is paid.

Her position is contrary to basic principles of regulation, is inconsistent with Commission policy, is based on simplistic assumptions that are not factually correct. If adopted, her position would actually be harmful to customers by denying Gulf a needed and effective managerial tool to motivate its employees and provide cost effective and reliable service to its customers.

Another adjustment which would deny Gulf a reasonable opportunity to actually achieve its authorized return is Ms. Dismukes' suggestion to impute $1.5 million of imaginary revenues from unregulated companies. Such an adjustment serves no legitimate regulatory purpose and would penalize Gulf for merely being part of the Southern Company system.

It was Southern that deployed the capital, and it is Southern's investors who are at risk if these unregulated companies fail. Yet Ms. Dismukes would take 2 percent of the unregulated revenue away from those who took the risk and who actually earned it.

The order which Ms. Dismukes incorrectly quotes as a basis for her suggested imputation of revenue had only limited relevancy to the telephone industry in 1985 and has no relevancy to Gulf Power in 2011.

Another adjustment that would deny Gulf a reasonable opportunity to actually achieve its authorized rate of return is Ms. Ramas' suggestion to remove $60.9 million of construction work in progress.

This amount represents projects which are not eligible for an allowance for funds used during construction. If these dollars are not allowed in rate base Gulf would be denied any type of a return on its investments in these projects, projects which are needed to provide reliable service and meet customer demands.

Another adjustment that could prevent Gulf from earning its authorized return is the parent debt adjustment which presumes that debt issued by Southern Company is invested in the equity of Gulf Power. This presumption is a rebuttable one and Mr. Teel does so with his dividend analysis.

Dr. Woolridge asserts that the presumption has not been rebutted because funds cannot be traced. However, the presumption, itself, is a tracing of funds from the debt of Southern to the equity of Gulf. To rebut a presumption that is based on tracing one must analyze the flow of funds to show the most likely source of Gulf's equity investment.

Another important consideration is the reasonableness of Gulf's capital structure. If the amount of

Gulf's debt is appropriate, then it would also be reasonable to conclude that the presumption has been rebutted.

I also respond to other adjustments recommended by Intervenor witnesses, including adjustments to supplemental pension expense, directors and officers liability insurance, and the storm damage accrual.

And finally, in my supplemental rebuttal testimony, I explain how Ms. Ramas' recommendation to ignore a portion of Gulf's investment in the Crist turbine upgrades is contrary to sound regulatory principles and the Commission's policy on such investments.

If accepted, her recommendation would deny Gulf an opportunity to earn a return on its investment in the turbine upgrades, which will be providing fuel cost savings to Gulf's customers. This concludes my summary.

MR. GUYTON: Tender the witness for cross.

MR. McGLOTHLIN: No questions.

CHAIRMAN GRAHAM: FIPUG?

CROSS EXAMINATION

BY MS. KAUFMAN:

Q Mr. Deason, good afternoon.

A Good afternoon.

Q I wanted to ask you a question or two about your comments on the compensation packages that we've been discussing this afternoon.

A Yes.

Q Really I have two questions. First is similar to the question that I asked the prior witness, and that is, if we assume that Gulf ratepayers do not have to pay some portion of the compensation plan but that it is paid by the shareholders, then the benefits that have been described about the compensation plan would still exist, would they not?

A I have to reject the basis of your question. It is impossible to have shareholders pay this compensation to customers. Gulf could not send an invoice to its shareholders and get a check from its shareholders to pay these employees.

It is disingenuous to ask a question about having shareholders pay compensation to these employees. It doesn't happen. When you say have the shareholders pay it, Commissioners, what the Intervenors are saying is we want to reduce the company's achieved rate of return.

It goes back to my summary. These adjustments, all that they do would be deny Gulf a reasonable opportunity to actually achieve its rate of return.

I believe it's been calculated that the amount of at-risk compensation which the Intervenors suggest simply be denied in this rate case amounts to somewhere in the neighborhood of, I believe, $14 million. I believe Mr. Teel has testified that $10 million is equal to a hundred basis points on return on equity.

So if you were to simply disallow this incentive compensation or at-risk compensation, the net effect is to be reducing Gulf's achieved rate of return by 140 basis points. So by example, if you determine --

MS. KAUFMAN: Excuse me, I think the witness is going far beyond what my question was.

CHAIRMAN GRAHAM: I was going to pull his chain five minutes ago. I was waiting on you.

THE WITNESS: Mr. Chairman, I apologize, but given the latitude, I was going to answer the question fully.

CHAIRMAN GRAHAM: Like I said, I let you editorialize until they said that you've gone too far.

BY MS. KAUFMAN:

Q I'll try to do a better -- a better job on that. You also cite in your testimony -- you reference some prior orders of the Commission in regard to these compensation plans. I think you do that on page -- beginning at the bottom of page seven, line 20, and continuing over to the next page.

A Yes, that's correct. I referenced a number of orders. Do you have one in particular?

Q I just want to ask you, in general, about that passage. You talk about 1992 Florida Power Corporation order and then Tampa Electric order, correct?

A Yes.

Q Two separate Tampa Electric orders.

A Correct.

Q Do you have any discussion in here about the recent -- fairly recent Florida Power and Light decision or the Progress Energy decision on compensation?

A I think I do reference the fact that I believe Ms. Ramas referenced the Florida -- I'm sorry, the Progress Energy decision, and I believe that there was also -- I don't believe that she referenced the FPL decision, but I'm also familiar with that. Do you wish me to discuss these decisions?

Q I don't wish you to discuss it, I just wanted to ask you if you, other than in response to Ms. Ramas, have mentioned those two decisions in your testimony.

A Well, yes, and the point that I'm making -- I will be brief -- is that those decisions are a deviation from long established Commission policy, and in my judgment should not be --

MS. KAUFMAN: Excuse me, Mr. Chairman --

CHAIRMAN GRAHAM: Mr. Deason, she just wanted to know if you had referenced it in your rebuttal.

THE WITNESS: Yes, I referenced it.

MS. KAUFMAN: That's all I have, Mr. Chairman.

Thank you.

CHAIRMAN GRAHAM: Major Thompson? Retail Federation? Staff?

MR. YOUNG: Yes, sir, briefly. May we approach the witness?

CHAIRMAN GRAHAM: Sure.

MR. YOUNG: Mr. Chairman, we would ask that this exhibit be marked for identification purposes at this time.

CHAIRMAN GRAHAM: We'll give it number 212. Do you have a title for this?

MR. YOUNG: Yes, parent company debt MFR Schedule C-47 and C-24, Docket Numbers 01094-EI and 110138-EI.

CHAIRMAN GRAHAM: Maybe I should have asked a better question. Do you have a short description?

MR. YOUNG: MFR -- parent company -- Parent Company Debt MFR Schedules.

CHAIRMAN GRAHAM: Thank you.

(Exhibit 212 marked for identification.)

CROSS EXAMINATION

BY MR. YOUNG:

Q Mr. Deason, can you please turn to page 57 of your testimony? And that will be your direct testimony -- excuse me, rebuttal, lines 22 through 24. Can you take a minute to read that to yourself?

A Yes, I've read that.

Q Okay. Here you state a parent debt adjustment pursuant to Rule 25-14.001 -- I mean, 004, excuse me -- Florida Administrative Code was not made in the Gulf's last rate case. Is this correct?

A That is correct.

Q And you have the handout that staff -- the exhibit that staff has been marked and given to you, correct?

A Yes, I have it.

Q Can you take a minute to look at those -- look at that exhibit?

A Okay, I have briefly reviewed it.

Q Okay. Looking at the second page, would you agree that this page is Schedule C-47 from the MFRs in Gulf's 2001 rate case?

A Yes, it appears to be.

Q At the bottom of the schedule in the middle it says not applicable. Do you see that?

A I do.

Q Can you read that?

A The explanation states not applicable. The only debt outstanding for the parent represents commercial paper. Commercial paper is used to meet the short-term cash needs of Southern Company, not as a permanent source for investments.

Q And would you agree with me in the last rate case, as you state in your testimony, that a parent debt adjustment was not made for Gulf, correct?

A That's correct.

Q Now, can you please turn to the next page. This MFR schedule is C-24, correct?

A Yes.

Q Now, while the number assigned in -- while the numbers assigned in C-47 versus C-24 have changed, would you agree that the title of these schedules is parent debt adjustment information, correct?

A Yes, they're both titled Parent Debt Information.

Q Turning your attention to long-term debt, under one, line one.

A Yes, I'm there.

Q What is that number?

A It is 1,250,000,000.

Q And that is long-term debt, correct?

A Correct.

Q And that's at the parent level, correct?

A Yes, it is at the parent level.

MR. YOUNG: No further questions, sir.

CHAIRMAN GRAHAM: Commissioners? Mr. Balbis?

COMMISSIONER BALBIS: Thank you, Mr. Chairman. And thank you, Mr. Deason, for coming today. It's always good to see someone who served as long as you have and not be so debilitated by stress that you can actually function, so it's always good to see you.

THE WITNESS: Thank you.

COMMISSIONER BALBIS: I have, I think, one or two questions, and I want to focus on the variable compensation and incentive pay. And on page seven of your testimony you quote an order. Lines 16 and 17 states: When employees excel, we believe that customers benefit from a higher quality of service.

And I agree with you -- well, I agree with the Commission when they stated that. But my question to you is, the two programs that they have, the Performance Share Program, which is based upon, according to Gulf's information, shareholder returns, and the Stock Option Program, which is based upon price increases in Southern's stock, couldn't hypothetically you could see both of those thresholds met while the performance of the employees may not have changed, is that correct?

THE WITNESS: I would agree that that is a possibility. I think, though, it is also important to look at the sum total of the structure of the at-risk compensation and to make a determination as to whether it achieves the right balance which motivates employees to achieve the goals and provide quality service to customers.

COMMISSIONER BALBIS: And I agree, but in some cases you could have an employee -- say it's a customer service representative that's participating in those two plans that isn't necessarily meeting targets, et cetera, is not answering phone calls in a certain period of time, and yet that portion of their variable compensation is met because Southern Company's stock increased and shareholder value increased. Would you agree with that?

THE WITNESS: That is certainly possible.

COMMISSIONER BALBIS: And, again, a similar question I asked the other witness, wouldn't Gulf's customers receive an additional benefit if there were some sort of correlation between Gulf Power's performance in all of the variable compensation plans and the amounts they receive from that, so some sort of threshold, et cetera, something that includes Gulf Power's performance in all of the variable compensation?

THE WITNESS: I think it is possible that that could be the result. Let me explain, it wasn't the purpose of my testimony to do an evaluation of the exact metrics of Gulf's proposal. I did look at it. I knew that it was similar to what had been approved in the past, which I thought generated positive outcomes for Gulf's customers.

I think it is essential for there to be targets to be reached by employees. Whether Gulf's particular set of metrics are ideal, I'm not sure, but I do know this, Commissioner. This record is replete and complete with testimony that Gulf's compensation is at market, which includes all of the at-risk compensation based upon these metrics, these goals.

And if there were to be a disallowance of that, as recommended by Ms. Ramas, it could have some negative consequences.

So on a going-forward basis would it be possible to tweak these metrics and these goals to make them even more responsive to customers? I'm sure that that is possible, but I'm not sure that justifies a disallowance, as recommended by Ms. Ramas.

COMMISSIONER BALBIS: Okay, thank you. And just moving on to another line of questioning, on page 39 of your testimony, line three, you indicate, concerning storm accrual, if you were to use the last eight years and include the large storms of '04 and '05, the average annual cost is 19 million, greatly exceeding 6.8 million that Gulf is -- that's indicated in Gulf's study, is that correct?

THE WITNESS: That is correct.

COMMISSIONER BALBIS: And I started to have this discussion with one of the other witnesses, but I may have gotten frustrated and stopped asking questions.

But the -- and it goes to the point I was trying to make. If Gulf is putting in 6.8 million annually into that fund, and if you were to look at the recent history of storms, that would be inadequate to cover all the costs associated with recovery, correct?

THE WITNESS: That would be correct.

COMMISSIONER BALBIS: So Gulf would likely resort to some sort of surcharge?

THE WITNESS: If storms of the magnitude of 2004 and 2005 were to reoccur, yes, I think it would be -- the conclusion would be that there would -- the reserve would be depleted and that there would be the necessity of Gulf requesting a surcharge approach to replenish the reserve back to a more appropriate operating level.

COMMISSIONER BALBIS: Okay. So then wouldn't it be logical to take those storms out, since, as you said, Gulf Power would have to go to a surcharge if a storm of that magnitude would hit -- of those magnitudes would hit, wouldn't it be logical to take those storms out to estimate what the appropriate accrual level would be to cover the minor storms?

THE WITNESS: Commissioner, I do not agree with that. And first let me say that the Commission's long history associated with storms, going back to Hurricane Andrew, when it became a necessity to go to a self-insurance plan like we have now through the accrual and the reserve, it was determined that the reserves should not be large enough that it covers all potential storms.

But that did not mean -- and it still today does not mean that you ignore real storms, real storms that can hit, which were evidenced by what happened in 2004 and 2005.

What needs to be done is you need to look at the probability of those storms hitting, not ignoring them totally. And it is my understanding that's what the storm costs -- the storm study does. And that's what the Commission required and approved for Florida Power and Light post-Hurricane Andrew, when we were grappling with the situation of how do we establish a proper accrual and a proper reserve.

It was never intended to ignore the larger storms, it was to include all the storms but to determine what are the probabilities of those storms hitting. Even including the probabilities of those storms hitting does not mean that you're going to guarantee that there's never going to be a surcharge.

This was evidenced by real facts, real history. We implemented that for FPL and when the subsequent hurricanes hit like a decade later, their storm accrual -- I'm sorry, the reserve was depleted and we had to resort to a surcharge or, in their case, a securitization.

So even considering the larger storms does not mean that there's going to be a guarantee that there will never be a surcharge. So I think they need to be considered, but it needs to be part of the probability analysis to include the storms, but design a correct probability of those storms actually occurring.

COMMISSIONER BALBIS: Okay, thank you. That's all I have.

CHAIRMAN GRAHAM: Commissioner Edgar.

COMMISSIONER EDGAR: Thank you. Good afternoon.

THE WITNESS: Good afternoon.

COMMISSIONER EDGAR: And just one question, I think, to follow up. My understanding is that Witness Schultz and perhaps Witness Pollock, in their recommendations for a reduced annual storm accrual amount -- and my understanding of their recommendation is that they are recommending not just a disallowance of a larger annual amount, but a reduction of the annual amount that is currently approved -- that is part of their reasoning is that they say that we would be failing to account for storm hardening measures that have been -- that have taken place since the current annual accrual amount was approved or authorized by the Commission.

I don't think in your written testimony that you really address that point, the storm hardening measures and the fact that that is a policy that the Commission adopted, again, after the current annual amount was approved. Can you speak to that point?

THE WITNESS: Yes, Commissioner. You are correct, I don't specifically address it, but I do note that the Gulf witnesses have said that they recognize that the storm hardening process has been started. It's not yet completed. It is a continuing process.

Fortunately, there's been no actual evidence of the success of that when a storm hits. I'm sure at some point, unfortunately, we will get that information, because a storm will hit.

But I think we need to keep in mind that the accrual, in itself, is an estimate. You do studies. We don't know the exact numbers. We try to reach a balance. So it's not one right number, but there should be a range which is considered to be reasonable.

I'm not so sure that the added precision that one would hope to gain by making an explicit adjustment for storm hardening and making some estimate as to what it would be would actually be a correct refinement of the broader estimate of $6.8 million. So you're adding some refinement, but I'm not sure that really -- it implies a degree of precision that I'm not sure is there.

Second of all, you need to realize, or we all need to realize is that the reserve -- that it is used for other property damages other than storms. So while storms are probably the largest component, it's not the only component. And the accrual that is being proposed of 6.8 million is based upon just storms. So it's already conservative there.

It is also conservative in that it is the estimate of what the storm damages would be. It is not -- and if reality works out exactly as is predicted, the reserve would not grow. You would have -- they would equal. So it's conservative in that the accrual is not meant to build the reserve, it is meant to keep the reserve at the current level. So that is another conservative approach which Gulf is using.

There's also been testimony in this case about the increase in the insurance deductibles and their impacts, which puts more pressure on the reserves, so that if a storm hits, there's going to be less contribution from insurance after the deductibles are met.

And then, too, we have to realize that we're setting rates on a going-forward basis. These rates are going to be effective starting next year. We have based -- the company has based their request upon projections of 2012.

Hopefully these rates are going to be in effect for 2012 and beyond. Hopefully for many years beyond. The storm study, as I understand it, was based upon a period of time. It was not a forward-looking study, based upon 2012 or 2013.

And if I'm incorrect in that assumption, I apologize, but that was my assumption. So there are a number of conservative features already contained in Gulf's approach and the specific request that they're making.

So if the Commission were comfortable that storm hardening is going to result in a 10 percent reduction in storm impacts, and you feel confident in that, maybe you should make the adjustment. I'm just not sure that there's enough evidence in this record to support such an assumption.

COMMISSIONER EDGAR: Thank you.

CHAIRMAN GRAHAM: Commissioner Brown?

COMMISSIONER BROWN: Thank you, Mr. Chairman. Good afternoon, Mr. Deason. It's a pleasure to see you.

THE WITNESS: Thank you.

COMMISSIONER BROWN: Under the performance payment plan -- pay plan -- if an employee's incentive -- and we talked about this a little bit with another witness. But if their incentive is not realized in any given year, what happens to that particular amount in that given year? I know it stays in the Florida budget, but is it reallocated to a different division?

THE WITNESS: Well, that's an interesting question, and I've thought about that, as well. Two-thirds of the performance pay plan is based upon financial metrics, which I have no problem with.

If there's not going to be a payout under the performance pay plan, there's the likelihood that some financial goals have not been met. And if there's zero payout, it probably means that there has been some very poor financial performance.

And if it's that level, it's most likely that there have been some impacts of some sort that have been beyond the management's control to result in performance at that level.

The implication is that somehow there's money in rates that is being diverted from paying people and is being used for something else. If that level of financial performance is actually achieved, or if that is a result, in my way of looking at things, that means the money is not there.

There were cost increases elsewhere that caused the company not to achieve where it needs to be. So it's not like there's some windfall that somehow money is being diverted away from employees and is being used for some other purpose, like higher dividends to shareholders.

I don't think that would be the case, because the earnings, themselves, would not be there to have that result.

COMMISSIONER BROWN: Okay, thank you. And also, I did want to turn your attention to page 21 of your rebuttal testimony. I just want to give you an opportunity to possibly correct something on line two.

This is with regard to the DOL insurance. You say that it's an ordinary and necessary cost of doing business for any publicly held company. I don't think that was your intention. I think -- and correct me if I'm wrong -- is that correct?

THE WITNESS: Let me reread the context, the question and the answer, please. Commissioner, I believe so. Publicly held companies -- companies that issue stock or are a part of a holding company that issues stock, I think it is very ordinary and customary for those type of entities to carry this type of insurance coverage.

COMMISSIONER BROWN: I know Gulf's parent, Southern, is publicly traded, I just wanted to make sure -- and Gulf is not particularly publicly traded. So I didn't know if that was a misstatement.

THE WITNESS: Well, perhaps I need to clarify that. Obviously Southern is the company that actually issues the stock. What I'm implying from that, even though Gulf may not issue stock, it's part of the holding company and its directors and its officers are certainly -- I'm not going to say prone.

It is possible that they could be the subject of a suit, and that the directors and officers are aware of that. And I do agree that people there in those positions look to see if they have that type of insurance coverage.

And if it were not offered, I think it would be true that some qualified people who -- would not be interested in that type of a position. So you would be narrowing the pool of potential candidates.

COMMISSIONER BROWN: Oh, I understand your argument. Thank you.

THE WITNESS: Thank you.

CHAIRMAN GRAHAM: Commissioner Brise.

COMMISSIONER BRISE: Thank you, Mr. Chairman. Thank you, Mr. Deason, for your testimony. I have a question on page eight. I think you began to allude to it, line 20, with respect to the Progress Energy or the PEF decision where you state that the PEF case is really a deviation from Commission precedent.

And I wanted to know -- or I wanted you to expound on that and then also talk about the effect on the company as a result of that decision.

THE WITNESS: Okay, so it's kind of a two-part question, Commissioner?

COMMISSIONER BRISE: Sure.

THE WITNESS: Just give me a second. So you want me to talk about the results for PEF and then talk about the decision, itself?

COMMISSIONER BRISE: Right.

THE WITNESS: Well, as my testimony states, I do think that the Progress Energy case was a deviation from long-established policy of the Commission. And I've referenced orders which I believe substantiate that. But if we were to even go to the Progress decision, I think it would be helpful to read some of the language from that order.

One of the things -- even though I think it's a deviation from policy, I think there are some things interesting in the language of the order.

One of the interesting things is on page 113 of the order, the last paragraph. The Commission is stating, we are concerned that the company, meaning Progress, has placed an emphasis on EPS that has negative consequences. In particular the deferral of certain items of maintenance.

So the Commission had a concern that there were some maintenance that was delayed or deferred, which had some negative consequences. That is a fact specific to that case.

So you can't blindly follow Progress and say it applies to Gulf, unless, Commissioner, you still have a concern that the facts in this case somehow have -- that the tree trimming, which I think maybe was the subject of this, that there's some deficiency in Gulf that would -- that would meet this concern. I'm not sure that evidence is in this case.

Then on page 114 of the order the Commission is referring to a witness who testified, and this witness noted that Florida has recognized the value of incentive compensation plans in the past and has approved their inclusion in rates.

The Commission recognized that, and then the Commission went on to say, we note that the decisions discussed by the witnesses -- by the witness were based on the record in those cases, TECO, FPL, Gulf.

While prior decisions are important, the decision in this case must be based on this record which may be different from those considered previously.

I can't -- I have no qualms with that. And I think the record in this case should be the basis that is evaluated to make that determination.

But to the extent that one were to read into the Progress decision that there's been some finding that at-risk compensation or incentive compensation is bad policy and should not be followed and the Commission should adopt decisions which would give incentives to companies to go away from that type of a compensation -- I'm not sure that was the finding of the Progress case.

So I don't think the Progress case goes that far. And if someone were to interpret that to be the meaning of the Progress case, I would disagree. I think that would be bad regulatory policy to in essence dictate or micromanage a utility, to tell them how they should pay their employees.

I think the Commission should be concerned that the total amount of compensation is fair and reasonable, not the manner in which it is paid. I think that may be crossing the line into micromanaging. It may be taking away, as I mention in my testimony, a very effective managerial tool used by the management of Gulf to properly manage and focus their employees.

The second part of your question dealt with the results in Progress.

COMMISSIONER BRISE: Or impact.

THE WITNESS: This is a difficult question to answer, and I allude to it in my testimony. The Progress case was ultimately decided. The current rates that are being charged by Progress, and their current earnings levels, were the result of a stipulation and settlement.

There were some parts of the settlement which gave Progress some additional flexibility to manage their earnings. It primarily results around the ability to make -- reversing entries to reverse the amount of theoretical depreciation surplus.

So it is difficult to estimate what this decision has resulted in the earnings of Gulf because -- I'm sorry, not Gulf -- Progress, because Gulf -- I mean, Progress has this ability to use this depreciation surplus to manage its earnings.

If it had not been for that ability for Progress, then there may have been some adverse financial consequences. But we can't really say at this point what that may be.

COMMISSIONER BRISE: Okay, another question, if we go to page 60, there is, within your testimony, a discussion about impact on customers. And part of that discussion in there talks about, as Witnesses Chriss and Pollock discuss sort of the financial environment or economic environment that we're in right now.

And Commissioner Balbis asked earlier to another witness the impact with respect to that range of 9.25 and 11.7.

And if you can briefly discuss with us the impact of having the company come in at a low ROE, the impact on customers, versus applying the 11.7 which will also have an impact on the pocketbooks of customers.

THE WITNESS: First, I think we all are concerned about impacts on customers. I've heard Gulf witnesses say it over and over, and I know the Intervenors are certainly concerned about the impacts of any type of a rate increase on their clients. And I understand that.

Having said that, it is important to realize that rates should be set upon the just and reasonable cost to provide the service. Regulation is essentially based upon costs.

Now, to the extent that the economic downturn has affected markets, to the extent it has affected what is deemed to be the appropriate return on equity up or down, for sure, that needs to be captured. That is part of the cost of providing service to customers.

But to arbitrarily make a decision to have a lower rate of return than is determined to be the true cost of equity may have a temporary benefit for customers, but it is not sustainable.

Regulation has to realize that there are true economic costs that have to be recovered. And if a Commission -- a theoretical Commission would just arbitrarily say we think that the cost of equity is X, but we're going to set rates upon X, less some amount, I think that would not be the correct approach to protect customers in the long term.

So I hope I've answered your question. I can't give you a definitive answer as to what the solution should be. It's a difficult question. It's something that regulators have to deal with. It's certainly more difficult given the current financial and economic situation that we're in.

But I think statutorily and by practice and by regulatory policy rates should be based upon just and reasonable costs, which includes a fair return on equity, and beyond that, to give a utility a fair opportunity to actually earn the rate of return which you deem to be fair, just, and reasonable.

COMMISSIONER BRISE: Thank you very much.

CHAIRMAN GRAHAM: Commissioner Balbis?

COMMISSIONER BALBIS: Thank you. Just one quick follow-up on Commissioner Brise's question and your answer. And I know, me, personally, I'm not implying that we are going to make an arbitrary decision on ROE, but, again, we're faced with several expert witnesses that are providing us testimony of the true cost of capital, which results in the return on equity.

So the question for you would be in this situation where we have expert witnesses that have provided testimony on different appropriate levels of ROE, can you indicate, back to the original question on what impact other than reduced revenues to Gulf Power, if this Commission were to base its decision on the testimony on 9.25 percent versus 11.70 percent, the impact to the customers.

THE WITNESS: Commissioner, I believe I understand your question. I think my answer is going to be generally the same, but I would note this. And this may be helpful for you. I would reiterate my answer that rates should be based upon fair and reasonable costs. Return on equity is a cost of providing service.

You need to keep -- I don't mean to be preaching, I apologize. We all need to consider -- regulation as a whole, as a policy, needs to consider the fact that a regulated company such as Gulf Power has an obligation to serve, which means they have to obtain capital, deploy it to meet customers' demand, regardless of whether economics are good, whether it's boom times or bust times, as opposed to a competitive firm which has the ability to curtail services or cut back or to close stores that are not producing a sufficient rate of return because the economy is in a downward position. And then once the economy picks back up, to reopen that store or to enter new lines of businesses.

A regulated company doesn't have that opportunity. A competitive company does have that opportunity. And sure, when economic times are bad, their return on equity may suffer. When economic times are good, their rate of return may soar. A regulated company doesn't have that ability.

Sure, their return on equity is going to fluctuate, and we've seen that with Gulf, which has been kind of going downward. But basically regulation tries to achieve earnings with a much more narrow range.

Now, of course, the key question that you just asked, where in that range do you try to set that. I don't have a magic answer to that.

I would just suggest that regardless of the economic times, it should be based upon what the cost is, and that will serve customers' interests better in the long term.

COMMISSIONER BALBIS: Okay, thank you.

CHAIRMAN GRAHAM: Mr. Deason, since you went down that path, the analogy you were giving about what the utilities have to do is a lot like the analogy that people look at government, where you have a service that you have to provide. And so it doesn't matter if it's boom times or tight times, you still have to provide that service. Would you agree with that?

THE WITNESS: I can see the analogy, Chairman.

CHAIRMAN GRAHAM: So looking at the same analogy, during boom times, you don't see the ceiling come off the top with government, other than maybe the courthouse down the street. But you do see during the down times that government is racketing back, salaries aren't going up, and the belt gets tighter and tighter and tighter.

But yet what you're saying, that analogy, that part of the analogy, should not affect the utility companies.

THE WITNESS: Well, I see the analogy. I am sensitive to that, and I think, Mr. Chairman, you make a very good point. I think the key distinction is that Gulf is not -- it is not a not for profit company. It is a for profit company.

It has been the decision of government and the policymakers of government who have an entity that is for profit to provide a public service, and has put controls on the entity to meet those demands, to meet those services.

It is a difficult question. If the belt needs to be tightened, I think the result is going to be some type of decline in the quality of service. How severe, I'm not sure.

I know government is dealing with the same difficulties. Do you spend money on education and maybe not spend as much on taking care of other people, perhaps disabled people? I'm just using examples, I'm not trying to profess political policy.

There are a number of legitimate and necessary functions of government that the level of service that has historically been provided may have to be curtailed, may have to be reduced, and there are going to be consequences from that. Some people will feel the pain of that.

The question I think the Commission needs to ask, do we want to risk a diminishment of the quality of service that are provided to utility customers. And I'm not saying that if you set the return on equity at 9.25

percent that something catastrophic is going to happen. I think you increase the risks that there could be some decline in the quality of service.

I don't have -- I wish I could give you a specific direct answer and say, you know, here's the -- here's the correct amount, and if we set the rates at this level, everything is going to be fine. I don't think anybody -- nobody has the crystal ball to know that.

But Mr. Chairman, I certainly have empathy for the situation that you're facing, both as a manager or a -- and you have the responsibility to manage a State agency and are feeling the budget constraints which are being placed upon you, and in addition to that you have the burden of trying to make policy decisions which could -- which will have some impact on the services being provided to customers of Gulf Power.

It is a difficult question to answer, and some days I wake up and I'm glad I'm not the one having to make those decisions anymore.

CHAIRMAN GRAHAM: I can't say that I disagree with you, it's just not appropriate for me to make that speech right now. Redirect?

MR. MELSON: No redirect. And we'll move Exhibit 162.

CHAIRMAN GRAHAM: We need to move 162, on page 27, into the record.

(Exhibit 162 admitted in evidence.)

MR. YOUNG: Staff will move 212.

CHAIRMAN GRAHAM: And move 212 into the record.

(Exhibit 212 admitted in evidence.)

CHAIRMAN GRAHAM: With that being said, we have probably strained our court reporter's fingers to the bone. We normally try to wait about two hours. It's been just over two-and-a-half hours, so we're going to take about a ten-minute break, which will put us to 4:30, so we can switch out court reporters, and we'll take a break now.

(The transcript continues in sequence to Volume 12.)

CERTIFICATE OF REPORTER

State OF FLORIDA)
COUNTY OF LEON)

I, LAURA MOUNTAIN, Court Reporter, do hereby certify that I was authorized to and did stenographically report the foregoing proceedings; and that the transcript is a true record of the aforesaid proceedings.

I FURTHER CERTIFY that I am not a relative, employee, attorney or counsel of any of the parties, nor am I a relative or employee of any of the parties' attorney or counsel connected with the action, nor am I financially interested in the action.

Dated this 19th day of December, 2011.

Laura Mountain

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