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Electronic Filing

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b. Docket No. 110138-EI

In re: Petition for increase in rates by Gulf Power Company.

c. Document being filed on behalf of Office of Public Counsel

d. There are a total of 96 pages.

e. The document attached for electronic filing is Citizen's Post-Hearing Statement of Position and Post-Hearing Brief.
(See attached file: 110138.brief.final.pdf)

Thank you for your attention and cooperation to this request.

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

Petition for increase in rates by Gulf Power Company.	))))	Docket No.: 110138-EI Filed: January 9, 2011

CITIZENS' POST-HEARING STATEMENT OF POSITIONS AND POST-HEARING BRIEF

Pursuant to Order No. PSC-11-0307-PHO-EI, issued July 21, 2011, the Citizens of the State of Florida, by and through the Office of Public Counsel ("OPC"), hereby submit their Post-Hearing Statement of Positions and Post-Hearing Brief.

PRELIMINARY STATEMENT

Gulf Power Company will frequently be referred to as "Gulf" or "Company." The Citizens of the State of Florida, represented by the Office of Public Counsel, will be referred to as "OPC." OPC has not included in its brief those issues that have been stipulated or dropped, or those issues on which OPC takes no position.

On December 15, 2011, the Commission directed parties to bifurcate post-hearing briefs so as to defer the briefing of certain issues until after the Commission considers two proposed partial settlement agreements. The first such argument addresses revenue issues 11, 62, 63, and 80; the second addresses cost of service and revenue allocation issues 106, 107, and 108.

In this case, as in the past, OPC has confined its participation to those issues on which the interests of all customer classes are aligned. Of the issues that are the subject of the stipulation that addresses revenue issues, OPC has taken positions only on Issues 62 and 80. OPC has taken no position in any of Issues 106, 107, and 108 and will not address them either during the continued hearing or (if applicable) the separate brief on deferred issues. It should be clear that those who support one cost of service study/revenue allocation approach or another do not speak for OPC. OPC's involvement in the consideration of pending partial settlement agreements is this: If for any reason Gulf concedes revenue issues 62 or 80, OPC will no longer pursue its proposed adjustments; if Gulf does not concede them, OPC will support its adjustments in the second brief.

OPC'S SUMMARY OF ARGUMENT

Gulf says its customers are at the center of its activities. In this rate case, Gulf's customers are at the center of Gulf's efforts to require them to bear unreasonably high costs through the rates they pay. Consider:

- Gulf's extreme request of an 11.7% return on equity capital is skewed by its witness' exclusive, untempered reliance on Wall Street analysts' overly rosy predictions of future stock market performance, overstated measurements of dividends and underlying interest rates, and a proposed second helping of ROE return that is based on a discredited method for contriving the appearance of additional financial risk where none exists. Gulf tries to boost its request by citing and fostering the false narrative of an "off course" Commission that biased and displeased rating agencies propagated following the most recent Florida Power & Light and Progress Energy Florida rate case decisions, despite and in the face of incontrovertible evidence of those utilities' sound post-decision financial conditions;
- Gulf proposes an incentive compensation program that would require its customers to bear the costs of $12.4 million of payments annually to employees for meeting incentives that are tied primarily, not to improved service to customers, but to corporate profitability goals that will benefit shareholders;

- Gulf asks the Commission to include in rate base now the costs of the North Escambia site, when (1) Gulf already has room at Smith, Scholz, Crist, Mossy Head, and Caryville for additional conventional generation, (2) Gulf's speculative, uncertain, and remote nuclear ambition falls far short of demonstrating the intent to construct the Commission has required of utilities that have far more developed plans (and that hold affirmative determinations of need), and (3) placing the site in rate base now would require customers to bear indefinitely 100% of costs of property that surely will benefit non-Gulf participants if a nuclear plant is ever built on the site;

- Gulf combined a framework ("general ratemaking authority") that does not contemplate or permit carrying costs on nuclear site selection costs *at all*, with a separate mechanism (advanced recovery through the nuclear cost recovery clause pursuant to Rule 25-6.0423, F.A.C.) that permits recovery of such carrying costs *only after the utility has requested and received a determination of need for a nuclear unit*, and conjured from this prohibitive mix the illogical and impermissible proposition that customers should pay those carrying costs and site selection costs *now*;

- Gulf stipulated to the transfer of the capital costs of the Crist turbine upgrades from the environmental cost recovery clause to base rates, but in this base rate proceeding is stubbornly trying to replicate a utility-favoring, clause-like treatment of these now ineligible (for the cost recovery clause) costs through a proposal that would unnecessarily and unreasonably distort and convolute the rate case process;

- Gulf asks the Commission to rely on a "storm study" that suffers from the significant doubt cast by its authors' elaborate disclaimers, that introduces thousands of random hypothetical storms to support an excessive annual storm damage accrual, and that includes the impacts of worst-case, catastrophic storms that (if and when they occur) should be the subject of surcharges rather than base rates;

- Gulf wants its customers to subsidize (among other things) the losses that one of its sister companies sustains in the unregulated, competitive wireless telecommunications industry;
- Gulf argued in testimony that, if the Commission determines it has not adequately supported a proposed level of production expenditures, rather than disallow the excess and reduce Gulf's request, the Commission should award the higher amount anyway, so that Gulf can "redeploy" those monies elsewhere in its operations.

Under Florida's regulatory framework, the Commission should develop base rates that will generate revenues sufficient to provide Gulf Power an opportunity to recover its reasonable operating expenses and earn a fair return on its investment in plant. Based on these and other examples developed below, OPC submits Gulf has overreached significantly. OPC has sponsored, and in this brief will support, adjustments that would reduce Gulf's request of $101,608,000 (this includes the stipulation to move certain Plant Crist turbine upgrades from the environmental cost recovery clause to base rates) by $84,417,000 to $17,191,000.

ISSUES AND POSITIONS

Legal

Issue 1: **Does Section 366.93, Florida Statutes, support Gulf's proposal to include the 4,000 acre Escambia Site and the costs of associated evaluations in Plant Held for Future Use as nuclear site selection costs?**

*Rule 25-6.0423, F.A.C., authorizes a utility to defer accounting treatment of nuclear site selection costs and accrue carrying charges until recovered in rates *after* the Commission awards an affirmative determination of need for the unit. However, the rule does not contemplate a situation in which a utility attempts to combine this authority to accrue carrying charges with an effort to short-circuit the determination of need requirement and build such costs into a general rate case. Allowing this would lead, absurdly, to enabling Gulf to collect site selection costs years *in advance of* the extraordinary *advanced recovery mechanism* authorized by the Legislature, without ever having proven the need for the unit that is a prerequisite to collecting carrying charges.*

ARGUMENT

In this case, Gulf Power ceremoniously attempts to marry the extraordinary alternative cost recovery mechanism authorized by the Florida Legislature in Section 366.93, F.S. and implemented by the Commission in Rule 25-6.0423, F.A.C. to the Commission's "general ratemaking authority." Gulf's purpose is to incorporate the site selection costs of its nascent and speculative nuclear power ambition into the revenue requirements that will be borne by current customers. The effort suffers from irreconcilable differences. Under "general ratemaking authority," Gulf has no ability to accrue a carrying charge on the North Escambia property. On the other hand, if Gulf invokes Rule 25-6.0423 to accrue a carrying charge, the same rule states Gulf cannot collect the carrying charge from customers until after the Commission has awarded an affirmative determination of need for the nuclear unit.

In other words, these are *alternative* and *mutually exclusive* cost recovery mechanisms, not *intersecting, mix-and-match* cost recovery mechanisms. To accrue a cost not authorized by general ratemaking powers, but contemplated by the extraordinary alternative cost recovery mechanism, and to then switch from the alternative "collection in advance" mechanism that does not permit collection prior to receipt of a determination of need to a claim for current collection based on "general ratemaking authority," would be to abuse these provisions. Gulf wants to thwart ratemaking policy, not implement it. Rather than offering a logical or plausible interpretation of the pertinent provisions, the proposal merely attempts to short circuit the alternative "collection in advance" mechanism in the hope the Commission will allow Gulf to collect now charges it may *never* be entitled to collect under the provision that both provides the authority for the accrual and prescribes the time and manner of its collection.

The pertinent provisions of Rule 25-6.0423, F.A.C. are these: Subsection (2)(f) defines "site selection costs" as "costs that are expended prior to the selection of a site." Subsection (2)(e) provides that a site ". . .will be deemed to be selected upon the filing of a petition for a determination of need for a nuclear. . . plant pursuant to Section 403.519, F.S." Subsection (3) states that site selection costs ". . .shall be afforded deferred accounting treatment and shall, except for projected costs recovered on a projected basis in one annual cycle, accrue a carrying charge equal to the utility's allowance for funds used during construction (AFUDC) rate until recovered in rates." Subsection (4) says, "After the Commission has issued a final order granting a determination of need for a power plant pursuant to Section 403.519, F.S., a utility may file a petition for a separate proceeding, to recover prudently incurred site selection costs. This separate proceeding will be limited to only those issues necessary for the determination of prudence and alternative method for recovery of site selection costs of a power plant."

Any fair reading of these provisions establishes that Rule 25-6.0423, F.A.C. is inextricably intertwined with the "determination of need" portion of the Power Plant Siting Act. Indeed, the rule states that a site will not be deemed to have been "selected" until the utility files its petition for a determination of need. It follows that if Gulf Power (or any utility) were to invoke subsection (3) of the rule and accrue a carrying charge based on designating property as a nuclear site, it would be unable to reflect those costs in rates through the alternative mechanism the Legislature provided (to "accelerate" recovery that otherwise would not occur until the unit enters commercial service) until after the Commission has granted an affirmative determination of need for the nuclear unit. For the Commission to act otherwise and permit the collection of costs before the site has been officially "selected" would enable any utility to declare a piece of property to be a "nuclear site," regardless of how serious (or non-serious) it is about actually constructing a nuclear unit.

The provision on which Gulf relies to accrue a carrying charge is part and parcel of the extraordinary mechanism the Legislature created to enable utilities to recover nuclear-related costs in advance of the nuclear unit's in-service date. Gulf has no authority under the Commission's "general ratemaking powers" to accrue a carrying charge for its North Escambia site. To authorize Gulf to invoke Section 366.93, F.S. and Rule 25-6.0423, F.A.C. to accrue a carrying charge, on the one hand, then switch to "general ratemaking authority" to avoid the requirement of an affirmative determination of need, on the other, would lead to Gulf recovering nuclear-related carrying costs far in advance of the earliest point envisioned by the Legislature's extraordinary "accelerated recovery" mechanism—a result that is absurd on its face.

The "deferred accounting treatment" to which Rule 25-0643, F.A.C. refers means that, to the extent Gulf has accrued a carrying cost on the North Escambia site, the cost is not and cannot become part of Docket No. 110138-EI. OPC believes the Commission should prohibit Gulf from making the accrual on the grounds a utility must have a nuclear project sufficiently mature to justify the accrual. However, if the Commission permits Gulf to continue accruing a carrying charge, for reasons developed at greater length in response to Issue 24, the accrual must not affect its consideration of Gulf's request to place the North Escambia site in rate base in this case. In other words, because Gulf could not collect the accrued carrying charges unless and until the Commission awards an affirmative determination of need, there is no merit to the argument that the Commission should place the property in rate base to avoid an accumulation of carrying charges over time. The Commission should also make clear that any such accrual does not establish an asset or otherwise assure Gulf of ultimate recovery of the deferred costs, the prudence of which will not be evaluated until after the filing of a petition for determination of need (at which point the site will be "selected" for purposes of possible recovery) and the Commission issues a determination of need (at which time prudent site selection costs, and associated carrying costs, will be eligible for recovery).

Rate Base

Issue 8: **Should the capitalized items currently approved for recovery through the Environmental Cost Recovery Clause be included in rate base for Gulf?**

The Crist turbine upgrades are the only such items that OPC examined specifically and that OPC witness Donna Ramas recommended be treated as base rate – related. That said, as a general matter, and absent any countervailing consideration that would be to the detriment of customers, OPC favors placing capital items in rate base rather than cost recovery clauses.

Issue 9: **Should the Plant Crist Units 6 and 7 Turbine Upgrade Project be included in rate base and recovered through base rates, rather than through the Environmental Cost Recovery Clause? If so, what is the appropriate amount, if any, be included in rate base and recovered through base rates?**

The projects should be included in base rates using the traditional average test year approach. Effectively, Gulf wants to negate the stipulation to move the turbine upgrades from the ECRC to base rates by deforming and contorting the ratemaking process to accomplish the same "annual reset of factor" the upgrades would receive in the cost recovery clause. The Commission should reject the effort. In a base rate proceeding, the utility's operations are viewed, revenue requirements are determined, and rates are set, on an overall rate base/ROR basis. Gulf presents no adequate justification for departing from this process, and there is no prejudice to Gulf in the conventional approach, as Gulf's high earnings following its last rate case demonstrate vividly.

ARGUMENT

Special cost recovery clauses, which operate "outside" of base rates, differ fundamentally from base rates. In a cost recovery clause, the Commission projects the cost of an item that is eligible for the clause annually, the cost recovery factor is set annually, and a true-up mechanism ensures that the utility recovers the cost of the individual item dollar-for-dollar, with precision.

In a general revenue requirements case, the Commission views the utility's operations on an overall basis using a test period. Within that test period, the utility's entire rate base, including its investment in plant, is quantified on a thirteen month average basis. The utility's overall revenues and expenses are quantified for a representative twelve-month period, that being the test period. The Commission establishes a range within which it deems an earned rate of return to be fair and reasonable. After comparing annual expenses with annual revenues, the Commission sets rates designed to provide the utility the ability to realize net operating income that will earn a return on its investment within the established range once the rates become effective. Thereafter, investment levels change, individual expense levels change, and revenues fluctuate; however, the adequacy of rates is gauged by reference to the earned and authorized overall rates of return. In the event of a deficiency or excess in revenues, the Commission can repeat the exercise; however, at no point does it isolate an individual cost and analyze whether the cost of that item has been recovered, for the reason that if the earned rate of return falls within the authorized range, by definition all costs—including any individual item that contributes to the total—have been recovered.

In this case, Gulf stipulated to the removal of the Plant Crist turbine upgrades from the environmental cost recovery clause, but clearly Gulf's heart wasn't in the move. In the rate case, Gulf proposed two alternative ratemaking treatments of the turbine upgrades. Each was intended to achieve the inclusion in rates of the annualized level of investment in the turbine upgrade projects that would have been realized in 2013 had the turbine upgrades remained in the environmental cost recovery clause. Gulf's preferred approach would be to annualize the investment in turbine upgrades (that is, assume all of the investment was present during the entire test year, when in fact much of it would be placed into service in the last month of that year), thereby deliberately overstating 2012 test period rate base, then flow the excess revenues the assumption would generate back to customers in 2012 via the same environmental cost recovery from which the investments, by stipulation, were removed (thus does Gulf literally cling to the cost recovery clause that the stipulation required it to vacate!).

Alternatively, Gulf requests the Commission to authorize a step increase that would achieve the same effect in 2013.

Gulf's cost recovery-like proposals overlook the overriding consideration: The stipulation to move the turbine upgrades to the base rate proceeding derives from the Commission's determination, in another setting, that the turbine upgrades *are not eligible* to be included in a cost recovery clause. Gulf hopes to fashion a treatment that will give the appearance of compliance with the stipulation, but Gulf's aim is to import clause-like treatment into base rates notwithstanding their ineligible status. The Commission should reject the attempt.

Gulf complains that the conventional rate base treatment would deny Gulf full recovery of costs related to the turbine upgrades in 2013, even though Gulf's customers will receive the benefits of fuel savings throughout that year. However, Gulf's argument begs the question of whether the turbine upgrades are base rate-related. The Commission has determined they do not qualify for a special cost recovery clause, and by stipulation those costs have been removed from the clause; that being the case, Gulf has no entitlement to a continuation of clause-like treatment within the rate case.

More fundamentally still, Gulf makes the mistake of assuming that, without some kind of true-up or reset, it cannot recover the costs of the turbine upgrades. That is wrong. If Gulf's earned rate of return during 2013 falls within its authorized range, Gulf will by definition have recovered all costs, including the capital costs, associated with its investment in the turbine upgrades. This is because the turbine upgrades will be within the rate base to which Gulf will relate its net operating income to calculate its earned rate of return.

Gulf also asserts that the Commission should provide dispensation for the turbine upgrades, because they represent a "known change." (TR 2155) This expression found application in the past, when the Commission used historical test periods. Now, Gulf and other utilities have the advantage of projected test periods. Already, the Commission is using data that is applicable to a future period. By asking the Commission to first use a projected period, then also take into account "known changes" by annualizing the rate base treatment of certain projects placed into service during the projected test period, Gulf in essence wants the Commission to go beyond even this utility-favoring tool.

At bottom is Gulf's implied assertion that a conventional base rate treatment of the turbine upgrades is somehow prejudicial to Gulf. That is not true. Earnings do not necessarily deteriorate during the periods in which base rates become effective. For example, the record of this case demonstrates that Gulf enjoyed high earnings and would have exceeded the top of its authorized range for several years immediately following its last rate case had it not sought authority to make "discretionary" accruals to its storm reserve fund. (TR 94) (Those several years of "discretionary" additional accruals—which enabled Gulf to remain at or below the top of its authorized range—probably prevented a proceeding to reduce its rates.) And, in the event Gulf's earnings fall below the authorized range in the future, it will have the right to seek and support an increase in base rates. There simply is no "prejudice" to Gulf involved in applying to base rate –related items, such as the turbine upgrades in question, the tools and techniques associated with a base rate proceeding.

For purposes of this rate case, the turbine upgrade projects should be included in base rates using the traditional thirteen-month average rate base methodology. This results in a $28,020,000 increase in rate base and a $354,000 reduction in net operating income on a jurisdictional basis. (TR 1504). This is based on a thirteen-month average gross plant balance of $29,396,000 and accumulated depreciation of $1,376,000. It also incorporates depreciation expense of $967,000, as well as the income tax impacts of depreciation expense and interest synchronization, resulting in a jurisdictional impact on net operating income of $330,000. (EX 34, Sch. 1)

<u>Issue 10</u>: Has Gulf made the appropriate adjustments to remove all non-utility activities from plant in service, accumulated depreciation and working capital?

No. See OPC's positions on Issues 16 and 17.

ARGUMENT

No. Further adjustments to remove all non-utility activities from plant in service, accumulated depreciation, and working capital need to be made. See OPC's argument on Issues 16 and 17.

Issue 12: **How much, if any, of Gulf's Incentive Compensation expenses should be included as a capitalized item in rate base?**

* None. The projected test year incentive compensation should not be capitalized to rate base and should instead be funded by shareholders. The structure of Gulf's incentive compensation plans focuses on shareholder benefits (earnings per share and rate of return) and should be funded by the shareholders, who are the beneficiaries when the plan goals are achieved. The large emphasis on shareholder benefits could be detrimental to the customer service provided. Consistent with prior Commission practice, the test year incentive compensation expense should be disallowed and should instead be funded by shareholders. The costs should not be funded by the ratepayers, especially in light of today's economic climate. Plant in service should be reduced by $1,217,206 ($1,191,000 jurisdictional).*

ARGUMENT

No incentive compensation should be capitalized. All incentive compensation in rate base should be removed for the same reasons as set forth in Issue 71 the appropriate reduction to plant in service is $1,217,206 ($1,191,000 jurisdictional). See Argument on Issue 71.

Issue 14: **What amount of Transmission Infrastructure Replacement Projects should be included in Transmission Plant in Service?**

The amount of transmission capital infrastructure replacement projects in Gulf's filing, excluding SGIG projects, are substantially higher than average historical levels. Gulf's 2011 budget for transmission infrastructure replacement projects ($15,948,000) is more than double the average historic level from 2003 through 2010 ($7.3 million). This average is higher than normal operating conditions, given the fact that several hurricanes impacted Gulf's service territory, resulting in a higher level of transmission replacement projects during that period. Gulf's budgeted 2011 and 2012 transmission infrastructure replacement projects should be replaced with the average historical actual amount. This results in $8,695,699 reduction to budgeted 2011 transmission capital additions and $2.4 million increase in the 2012 level, for a net decrease to plant of $7,502,049.

ARGUMENT

The total budgeted transmission related capital additions incorporated in Gulf's filing total $66,748,000 for 2011 and $70,902,000 for 2012. (TR 1447) Over the period 2003 through 2010, the average total transmission capital expenditures were $24,718,767, which is significantly less than the projected amounts. (TR 1453) In fact, the budgeted transmission capital expenditures for 2011 are 150.6% higher than the average level for the years 2003 through 2010, and the 2012 budgeted level is 164% higher than that historical period average. (TR 1454) Of the total 2011 transmission capital additions budget of $66.75 million, $17,098,000 is included for the transmission infrastructure replacement projects. Of the total $70.9 million projected for 2012, $6,180,000 is for the transmission infrastructure replacement projects. (TR 1447) While OPC is not recommending adjustments to the vast majority of the budgeted transmission plant expenditures, the portion pertaining to the infrastructure replacement projects should be adjusted.

Gulf's requested amount of transmission capital infrastructure replacement projects for 2011 is excessively high when compared with the average actual expenditure amounts over the preceding eight year period from 2003 through 2010. The average expenditure over the last eight years is approximately $7.3 million and includes transmission expenditures resulting from damage caused by the extraordinary 2004-2005 hurricane seasons. (TR 1455)

Gulf's 2011 budget for transmission capital infrastructure replacement projects of $15,948,000 is more than double the average historic level from 2003 through 2010, and is not a realistic projection. The average historical actual amount, which includes some costs associated with possible future storm seasons, is indicative of going forward capital infrastructure replacement project spending and should be the benchmark by which Gulf's request is compared. A comparison of the actual to budgeted transmission capital expenditures for the first six months of 2011 demonstrates that the projected 2011 transmission capital additions are overstated. The transmission-related capital expenditures were $7.9 million, which means they were 20.85% under budget by the mid-point of 2011. (TR 1457) For these reasons, OPC recommends that Gulf's budgeted 2011 and 2012 transmission infrastructure replacement projects should be replaced with the historical average actual amount. This would result in an $8,695,699 reduction to budgeted 2011 transmission capital additions and a $2.4 million increase in the 2012 level, for a net decrease to plant of $7,502,049. (EX 205)

Issue 16: **Should the wireless systems that are the subject of Southern Company Services (SCS) work orders be included in rate base?**

No. Work Order 46C805 for Wireless Systems relates to capital equipment purchases that were incurred after the conversion to Enterprise Solutions. After the conversion, it became necessary for Georgia Power ("GPC") billing to flow through the SCS Work Order system and then get billed to the individual operating companies. This Work Order amounted to $2.2 million charged to Gulf, and was for capital equipment which should be offset with a reduction of direct bill materials from GPC. Gulf provided no documentation or other evidence that the savings that will offset these capital dollars have been reflected in the test year. In the absence of such a showing, $401,146 ($387,596 jurisdictional) should be removed from the test year.

ARGUMENT

According to Gulf's response to OPC interrogatory 229, the "dollars in this Work Order are for capital equipment required for such projects as Converge Networks." (TR 1632; EX 117, Interrogatory 229) OPC witness Dismukes testified that Gulf provided no documentation or other evidence that the savings that would arise from Work Order 46C805 for Wireless Systems have been reflected in the test year. (TR 1632) In rebuttal, Gulf witness McMillan did not respond to witness Dismukes' testimony about the Company's failure to include the associated savings in the test year. Instead, he merely related that Work Order 46C805 "covers wireless system materials costs that are capitalized as part of wireless system upgrade and replacement projects." (TR 2349) He further claimed that "[t]he increase from 2010 to 2012 in the amount charged to Gulf through this work order is solely the result of a change in billing procedures." (TR 2349) This Work Order amounted to $2.2

million charged to Gulf, and was for capital equipment which should be offset with a reduction of direct bill materials from Georgia Power. In the absence of such a showing that savings have been recognized, $401,146 ($387,596 jurisdictional) should be removed from the test year. (TR 1632)

Issue 17: **Should the SouthernLINC Charges that are the subjects of SCS work orders be included in rate base?**

No. Southern Company charges all affiliates for the total SouthernLINC Wireless charges that are not able to be recovered through commercial revenues, and in 2012, the charges to Gulf Power are projected to increase because of the "larger than anticipated drop in commercial customer revenue." SouthernLINC is an unregulated affiliate, and its losses should not be subsidized by Gulf Power's ratepayers. The Commission should remove $79,141 from the test year capital additions related to the expense reduction recommended in Issue 52.

ARUGMENT

SouthernLINC Wireless (SouthernLINC) charges that are the subjects of SCS work orders should not be included in rate base. According to Southern Company's Form 10-K, "SouthernLINC Wireless provides digital wireless communications for use by Southern Company and its subsidiary companies and markets these services to the public and also provides wholesale fiber optic solutions to telecommunication providers in the Southeast." (TR 1630; EX 191, at I-1) According to Southern Company's Security Exchange Commission (SEC) filings, SouthernLINC is hemorrhaging money due to its inability to compete with wireless competitors and this anemic ability to compete is affecting Southern Company's non-electric operating revenues. (EX 191, at II-19) SouthernLINC suffered revenue decreases of $21 million in 2008 and $25 million in 2009 "related to lower average revenue per subscriber and fewer subscribers due to increased competition in the industry." EX 191, at II-19. That hemorrhaging continued in 2010 and continues in 2011.

In its 2010 Form 10-K, Southern Company stated that "Southern Company's non-electric operating revenues from [its non-electric affiliates] decreased $19 million in 2010 primarily as a result of a decrease in revenues at SouthernLINC Wireless related to lower average revenue per subscriber and fewer subscribers due to increased competition in the industry." EX 191, at II-19. The bleeding continues in 2011. According to Southern Company's Form 10-Q, year-to-date through third quarter 2011, non-electric operating revenues had decreased from $63 million to $53 million, a $10 million decrease year-to-date when comparing 2011 with 2010 and $4 million in the third quarter alone. EX 215, at 16. Southern Company once again attributed this revenue decrease to SouthernLINC. EX 215, at 16. ("The third quarter and year-to-date 2011 decreases were primarily the result of a decrease in revenues at SouthernLINC Wireless related to lower average revenue per subscriber and fewer subscribers due to continued competition in the industry.").

All Southern Company subsidiaries, including Gulf, are required to use SouthernLINC Wireless for their wireless communications. While its wireless services may be available to the general public, SouthernLINC is predominantly a wireless service provided for the benefit of Southern Company and its affiliates. Upon review of Southern Company's SEC filings, it is plain to see that SouthernLINC is failing to compete in the unregulated wireless market. In fact, it appears that SouthernLINC is losing a lot of business to competition, and is becoming dependent on subsidization by other Southern Company affiliates, such as Gulf and the regulated electric businesses, to compete in the wireless arena. Without the captive non-competitive regulated market of other Southern Company subsidiaries, it is likely that SouthernLINC Wireless would have gone the way of many small regional wireless carriers, which either have gone bankrupt or have been purchased by their competitors.

To stem the flow of these revenue decreases attributed to SouthernLINC, this money-losing subsidiary depends on subsidization by other Southern Company subsidiaries to compete. According to OPC witness Dismukes, "all affiliates are responsible for the total SouthernLINC charges that are not able to be recovered through commercial revenues." (TR 1631; EX 117, Rog 229, p. 13 of 23).

As such, due to SouthernLINC's continued revenue decreases, the charges allocated to Gulf are projected to increase in 2012. (TR 1631) Because SouthernLINC is an unregulated affiliate of Southern Company, its losses should no longer be subsidized by Gulf's ratepayers. Using regulated electric operations to subsidize non-regulated operations is contrary to standard ratemaking practices and should be disallowed. For these reasons, OPC recommends that the Commission should remove $79,141 from the test year capital additions related to the expense reduction recommended in Issue 52.

<u>Issue 18</u>: Is Gulf's requested level of Plant in Service in the amount of $2,612,073,000 ($2,668,525,000 system) for the 2012 projected test year appropriate? (Fallout Issue)

No. OPC's recommended plant in service includes adjustments related to transmission capital additions, the Crist turbine upgrade transfer to base rates, the incentive compensation capital additions and SCS work orders for Wireless Systems and LINC Charges. OPC's adjustment related to the Smart Grid Investment Grant Program Projects has not been included. The resulting balance in plant in service should be no more than $2,625,391,000. Plant in service should be increased by $13,318,000 on a jurisdictional basis.

<u>Issue 21</u>: Is Gulf's requested level of Accumulated Depreciation in the amount of $1,179,823,000 ($1,207,513,000 system) for the 2012 projected test year appropriate? (Fallout Issue)

No. OPC's recommended accumulated depreciation includes adjustments related to transmission capital additions, the Crist turbine upgrade transfer to base rates, and the incentive compensation capital additions. OPC's adjustment related to the Smart Grid Investment Grant Program Projects has not been included. The resulting balance in accumulated depreciation should be $1,180,779,000. Accumulated depreciation be increased by $956,000 on a jurisdictional basis.

<u>Issue 22</u>: Is Gulf's requested Construction Work in Progress in the amount of $60,912,000 ($62,617,000 system) for the 2012 projected test year appropriate?

No. By definition, the CWIP has not entered service and is not being used by customers. It is therefore no different in character than the $232,012,000 of CWIP that Gulf excluded from rate base. Gulf has made no showing that the CWIP is needed to maintain its financial integrity. The requested balance of CWIP should be removed completely from rate base.

ARGUMENT

"Construction Work In Progress," or CWIP, refers to investment in plant that has not been completed, and therefore has not been placed into service and is being used to provide service to customers. As a basic proposition, the costs of plant are not reflected in the rates customers pay until the plant is placed into service. This reflects the policy inherent in the "matching principle," pursuant to which the customers who benefit from plant should be the ones to pay for that plant. (TR 1459-1460) The accounting standards that the Commission employs provide the utility with the ability to calculate and apply an Allowance for Funds Used During Construction (AFUDC) to the balance of eligible CWIP, and capitalize the AFUDC amounts as part of the cost of the plant—to be recovered through depreciation expense once the plant enters service.

In Rule 25-6.0148, F.A.C., the Commission established the criteria that govern the applicability of AFUDC. Projects of a certain magnitude and that last over a year will accrue AFUDC. Shorter term projects are not eligible for AFUDC. (TR 1461)

In this case, Gulf included $60,617,000 of CWIP in rate base—based ostensibly on the proposition that, if short-term CWIP is ineligible for AFUDC, it follows that such CWIP should be included in rate base. (TR 1461)

Rule 25-6.0149, however, does not require this result. The fact that certain projects are short-term, and therefore do not qualify for AFUDC, does not alter the fundamental basis for excluding any CWIP from rate base. Like the $232,012,000 of CWIP which the utility removed from rate base, the short-term projects are incomplete, and thus do not fall within the category of "plant in service" on which the utility is entitled to earn a return from the customers who are using the utility's services.

Originally, the Commission allowed a portion of CWIP in rate base when an unusually large construction program challenged its financial integrity, and the utility needed to show additional cash earnings to support its ability to borrow funds for the construction program. Gulf has made no such claim in this case. (TR 1460-61) That the policy limiting the circumstances under which the Commission will allow a utility to place CWIP in rate base may have eroded over time does not mean the Commission should not revisit the subject. Absent the showing that CWIP in rate base is required to maintain the utility's financial integrity, OPC submits the better policy is to remove all CWIP -- including short-term projects-- from rate base.

Issue 24: **Should the North Escambia Nuclear County (sic) plant site and associated costs identified by Gulf be included in Plant Held for Future Use? If not, should Gulf be permitted to continue to accrue AFUDC on the site?**

* The Commission should deny Gulf's request to place the property in rate base, because neither Gulf's premature effort to portray the North Escambia property as a potential nuclear site nor (given the availability of Crist, Smith, Scholz, Mossy Head, and Caryville for the purpose) the potential use of the property for conventional generation provides adequate justification to do so in this proceeding. Carrying costs are specific to and unique to the extraordinary advance collection mechanism of Rule 25-6.0423, F.A.C.; therefore, Gulf must be prepared to absorb any and all carrying costs that the Commission permits Gulf to accrue unless and until the Commission awards a determination of need for a nuclear unit on the site.*

ARGUMENT

In the order in which it approved the inclusion of Gulf's Caryville site in "property held for future use," the Commission articulated a two-pronged standard: (1) prudence of the acquisition, and (2) a plan to use the property in the reasonably foreseeable future. See Order No. 5471, issued in Docket No. 71342-EU on June 30, 1972. In the current proceeding, Gulf sought to support its request to place its investment in the 4,000 acre North Escambia property in rate base on the grounds the property will preserve a "nuclear option" for Gulf. However, it is clear from the record that Gulf Power has no plans to employ the property for that purpose in the foreseeable future. In fact, Gulf has no plans to submit a petition for a determination of need for a nuclear unit. Even in a situation in which a utility has obtained an affirmative determination of need, the Commission requires the utility to demonstrate its intent to build a nuclear power plant before allowing the utility to continue to collect nuclear-related costs prior to the in-service date of the unit. See Order No. PSC-11-0095-FOF-EI, issued in Docket No. 100009-EI on February 2, 2011, at pages, 9, 10. As Gulf has not advanced even to the point of planning a petition to determine need, it cannot demonstrate the requisite intent. (TR

1536) Just as Gulf is premature in its request to declare "site selection costs" and require customers to pay them in this case (see OPC's position on Issue 1), so too is Gulf premature in its efforts to add a "nuclear site" to rate base.[1]

It is equally clear that, if Gulf were ever to undertake the development of a nuclear generating unit, it would not do so alone. For instance, Gulf's first interest was in participating with at least one other entity in a secretive project dubbed "Project Frank". (TR 2219) Also, because Gulf is part of the Southern Company system (TR 736-37), other utilities would participate in the use of (and therefore help justify the construction of) a nuclear plant built on the North Escambia site. In fact, Southern Company has created a subsidiary that operates its system's nuclear assets. (TR 1606)

While it is clear that any nuclear unit built on the North Escambia site would benefit entities other than Gulf, Gulf's proposal to place the site in rate base now would require Gulf's customers to bear 100% of the costs of the property over what will likely be a very long period before —if ever— Gulf (a) decides to use the property for a nuclear unit and (b) finds participants sufficient to make the proposed use feasible. This means that during that period, Gulf's customers would be called upon, not only to bear the risk that Gulf may never use the property for which they would be paying for a nuclear project, but also to subsidize the yet-to-be-identified entities whose participation will be necessary, and who will derive benefits from the project. The proposal, therefore, is as inequitable as it is premature.

Gulf tried to enhance its proposal to place the North Escambia site in rate base by asserting it is also available for the construction of conventional, fossil-fired generating units. This does not help Gulf's argument, because Gulf already possesses such sites in abundance. For instance, Gulf Power

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[1] Gulf divided its investment in the North Escambia property into "site acquisition costs" of approximately $18 million and those additional costs that Gulf incurred to evaluate the property for use as a site in which to construct a nuclear generating unit. OPC submits that no portion of the investment belongs in rate base; if the Commission were to allow a portion in rate base, the amount should be limited to site acquisition costs.

acquired the 2,200 acre Caryville site in 1964. Gulf's customers have been paying for the Caryville site since 1972. (Order No. 5471, above) The Caryville site is already certified by the Florida Electrical Power Plant Siting Board for up to 3,000 MW of conventional fossil fuel-fired generating capacity. (TR 776) Gulf also acquired the 250 acre Mossy Head site for additional combustion turbines. (TR 759) Significantly, in its 2011 Ten Year Site Plan, Gulf identified the sites at which Gulf likely will build additional capacity in the future: "Because the Company's next need for capacity does not begin to develop until 2022, Gulf will consider its existing Florida sites at Plant Crist in Escambia County, Plant Smith in Bay County, and Plant Scholz in Jackson County, as well as its Greenfield Florida site at Shoal River in Walton County[2] as potential sites for locating future generating unit(s) in Northwest Florida." (EX 190) Interestingly, Caryville (Holmes County), which has been in rate base and "on call" for such duty for nearly four *decades*, did not even make Gulf's current "top four" most likely choices! In this case, OPC has not advocated the removal of Caryville from rate base, but the availability of Caryville -- plus Smith, Scholtz, Crist, and Mossy Head -- means that Gulf has not justified adding the North Escambia site to rate base.

Issue 24 also asks whether Gulf should be permitted to continue to accrue AFUDC on its investment in the North Escambia site (OPC assumes this means a carrying charge, as there is no construction of a nuclear unit). In response to Issue 1, OPC demonstrated that Gulf is attempting improperly to merge two mutually exclusive mechanisms (advance recovery following receipt of a determination of need under Rule 25-6.0423, which contemplates the possibility of carrying charges on a nuclear site, and general ratemaking authority, which does *not*) to build certain site selection costs into base rates far earlier than even the extraordinary recovery-in-advance mechanism authorized by the Legislature would permit. In this case, Gulf Power uses the concept of carrying charges chiefly as a rationale for including the North Escambia site in rate base: that is, Gulf contends that including the

[2] This is referred to as the Mossy Head site in Gulf's testimony. (TR 759)

property in rate base now would avoid an accumulation of carrying charges over time. (TR 1080; 237) However, Gulf would not be able to collect any such carrying charges unless and until the Commission awards a determination of need for a nuclear unit. To allow such dubious and contingent costs to affect the question of whether to include the North Escambia site in rate base would be akin to allowing the tail to wag the dog—except that, in this case, the dog has yet to germinate a tail. As to whether, after the Commission has denied the request to place North Escambia in rate base, Gulf Power should continue to accrue the carrying charge, OPC submits that, in order to qualify for such an accrual, a utility would need to demonstrate a certain maturity of project to warrant the accrual. Otherwise, any utility would be able to acquire a piece of property, declare it to be a potential nuclear site, and begin recording carrying charges. If the Commission permits Gulf Power to continue to accrue carrying charges, it should state clearly that in electing to do so Gulf must accept the risk of non-recovery, as such carrying charges do not represent a future asset or an obligation of customers to bear those costs. In other words, such an accrual should not give Gulf a "leg up" on supporting a future petition to determine need. Inasmuch as this rate case proceeding was not a proper forum for making such a "pre-approval" determination, no point of entry or due process will have been afforded the substantially affected customers in the event the Commission would give such an indication.

<u>Issue 25</u>: **Is Gulf's requested level of Property Held for Future Use in the amount of $32,233,000 ($33,352,000 system) for the 2012 projected test year appropriate? (Fallout Issue)**

No. PHFU should be reduced by $26,751,000 to reflect a jurisdictional balance of $5,482,000.

<u>Issue 27</u>: **Should any adjustment be made to Gulf's requested storm damage reserve, annual accrual of $6,539,091 ($6,800,000 system), and target level range of $52,000,000 to $98,000,000?**

*Yes. Gulf's requested increase in the annual accrual is excessive and unjustified based on the historical charges to the reserve, the storm standards established for Florida electric utilities, and the storm hardening measures implemented after 2005. Gulf's unreliable storm study included extraordinary storm repair costs which historically have been recovered by surcharge mechanisms.

The annual storm accrual should be reduced to $600,000, which reflects a decrease to O&M expense of $6.2 million ($5,962,113 jurisdictional). Because the storm reserve has almost reached the specific target range that was previously determined by the Commission, it currently is sufficiently funded to cover ordinary storm costs that are likely to occur based on recent history, excluding the extraordinary storm costs incurred in 2004-2005.*

ARGUMENT

While the annual storm damage reserve accrual funds the property damage reserve account, for the purposes of consistency with the issue description, OPC will refer to the annual property damage accrual as the storm damage reserve annual accrual; the property damage reserve as the storm damage reserve; and target amount as the storm damage target amount.

Purpose of the storm reserve and the storm surcharge

It has long been Commission practice to allow utilities to have a storm damage reserve. In Gulf's 1972 rate case, the Commission stated:

> "We have always adhered to the theory that the establishment of a storm or property damage reserve is sound and reasonable. Such charges in anticipation of future casualty losses resulting from tropical disturbances or hurricanes are legitimate operating expenses *so long as the reserve does not become so large that it exceeds the reasonable needs of the utility.*"

Order No. 5471, issued June 30, 1972, in Docket No. 71342-EU (Gulf's 1972 rate case) at 14 (emphasis added).[3] While the storm reserve in theory is sound and reasonable, the Commission noted the need to limit the reserve amount to a reasonable level. In Gulf's 1975 rate case order, the Commission stated:

> This reserve represents the total net accrual for self-insurance for damages to the Company's system that may be sustained through tropical hurricanes, tornadoes, hail, and other action of the elements as well as large deductibles related to coverage for equipment failures.

[3] Order No. 5471, issued June 30, 1972, in Docket No. 71342-EU (Gulf's 1972 rate case) available at 72 FPSC 425, 1972 WL 236569 (Fla.P.S.C.)

Order No. 6650, issued May 7, 1975, in Docket No. 74437-EU (Gulf's 1975 rate case) at 4.[4] These two Gulf orders help summarize the original purpose of the storm damage reserve. At the time the purpose of the storm reserve was established, Gulf's service territory had not been struck by extraordinarily severe hurricanes like the ones which occurred during the 2004-2005 hurricane seasons.

Hurricanes Erin and Opal in 1995

In 1995, Hurricanes Erin and Opal struck Gulf's service territory, causing approximately $11 million and $9 million in costs chargeable to the storm reserve. Order No. PSC-96-0023-FOF-EI at 2.[5] The cost of the damage caused by these two storms was unprecedented at the time and fully depleted Gulf's storm reserve; however, as will be discussed later, the costs of the damage was not catastrophic or extraordinary when compared with the 2004-2005 hurricane seasons. At the time, Gulf's storm reserve of $12 million was sufficient to cover the damage caused by Erin, but not Opal. Order No. PSC-96-0023-FOF-EI at 2. In November 1995, Gulf petitioned the Commission for "relief for the 1995 hurricane-related expenses of approximately $9 million in excess of the accumulated provision account balance to avoid the effect on earnings that would otherwise result [and] increasing the annual accrual to the Accumulated Provision for Property Insurance account from $1.2 million to $3.5 million." Order No. PSC-96-0023-FOF-EI at 2. The Commission's decision on Gulf's request authorized the following: A provisional increase in the annual accrual to $3.5 million pending a review of a storm study which Gulf was ordered to file within six-months; special accounting treatment, allowing the expensing of the approximately $9 million in damages attributable to

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[4] Order No. 6650, issued May 7, 1975, in Docket No. 74437-EU (Gulf's 1975 rate case) available at 75 FPSC 488, 1975 WL 349917 (FLA.P.S.C.)

[5] Order No. PSC-96-0023-FOF-EI, issued January 8, 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 at 2.

Hurricane Opal against the storm reserve; and authority to apply any earnings for calendar year 1995 above Gulf's authorized ROE to replenish the storm reserve. Order No. PSC-96-0023-FOF-EI at 4.

In compliance with the Commission's order, Gulf filed its 1996 T&D storm study. The following is a discussion of the 1996 storm study and a comparison of that document with Gulf's current, flawed storm study.

Gulf's 1996 storm study compared with its current storm study

The purpose of Gulf's 1996 T&D storm study was to address the impact of random storm events and to evaluate the potential effects on the storm reserve balance caused by storms of varying intensities and paths. Order No. PSC-96-1334-FOF-EI, issued November 5, 1996, in Docket No. 951433-EI, at 2.[6] Gulf's 1996 storm study estimated "that Gulf can expect $25.1 million in T&D damages due to a recurrence of the strongest storm on record and $106.9 million due to a worst case scenario." Order No. PSC-96-1334-FOF-EI, at 2. Gulf's current study does not specifically refer to the strongest storm on record or a "worst case scenario." (EX 19, Sch. 5)

Gulf's 1996 storm study evaluated "[k]ey criteria such as location of facilities, current replacement costs, design standards, storm paths, and a 120-year history of tropical storms were incorporated into the probabilistic model." Order No. PSC-96-1334-FOF-EI, at 2. While the Commission did not necessarily agree with all the 1996 storm study assumptions, the Commission did not find any of the key assumptions to be unreasonable. Order No. PSC-96-1334-FOF-EI, at 2. The key assumptions evaluated by Gulf's 1996 study appear to be similar to Gulf's current, flawed storm study with one notable difference – the current study uses thousands of random, variable, synthetically created storms combined with historical storms which caused ordinary and extraordinary damage, whereas the 1996 storm study appears to have relied only on historical storms. The basis for this

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[6] While the order was titled: "NOTICE OF PROPOSED AGENCY ACTION ORDER APPROVING ACCOUNTING TREATMENT OF STORM RELATED DAMAGE," this order memorized the Commission's review of Gulf's 1996 storm study and established the currently approved $3.5 million annual accrual and reserve target amounts.

assertion is that there is no indication that the 1996 storm study relied upon thousands of random variable storms. (Order No. PSC-96-1334-FOF-EI; TR 1550; EX 19, Sch. 5) OPC asserts that the use of ordinary historic storms that have actually struck the Gulf service territory in estimating annual storm damage amounts may be reasonable, but the use of thousands of random variable synthetic storms striking within and without Gulf's service territory is not reasonable. (TR 1550) The use of random variable storms has the singular effect of increasing the number and probability of storms making landfall in Gulf's service territory, thereby inflating annual storm damage estimates for Gulf. (TR 1549-53) This one key assumption significantly inflated Gulf's requested annual storm damage accrual amount. Moreover, increasing the annual damage estimates also inflates the target levels for the storm reserve.

According to the Commission's review of Gulf's 1996 storm study, the Commission was primarily concerned that the "accrual amount be sufficient to cover annual damages and promote growth in the Accumulated Provision for Property Insurance account balance." Order No. PSC-96-1334-FOF-EI, at 2. At the time, Gulf estimated the long-term average annual T&D damage losses to be $1.3 million, yet Gulf's current study estimates expected annual damage (EAD) to be $8.3 million, and Gulf seeks to increase its accrual to $6.8 million. (Order No. PSC-96-1334-FOF-EI, at 2; TR 1548)

While T&D replacement costs have certainly increased in the last 15 years, there is no testimony that those costs have increased more than fivefold in that period. Further, if the extraordinary damage caused by the 2004-2005 storm season is excluded, as OPC witness Schultz contends the study should have done, Gulf's average actual storm damage costs charged to the reserve since 2001 have averaged less than $600,000, which is less than the long-term average annual amount of $1.3 million projected by Gulf in 1996. (TR 1551)

It should be noted that the 1996 and current T&D storm studies are limited in scope and did not take into account other events which could potentially damage Gulf's plant in service which may be charged against the storm (property) damage reserve, such as generation plant fires or severe thunder storms.

Inherent Problems with Gulf's Current Storm Study

Issues with Gulf's current study are not limited to the use of thousands of random variable hurricanes. OPC witness Schultz observed that no alternative assumptions were used as inputs. (TR 1549) By keeping all assumption inputs the same, the only way one could adjust the accrual was to increase it. (TR 1549) Further, the study failed to perform an alternative analysis without the impact of the damage caused by Hurricanes Ivan and Dennis. (TR 1550) This is a problem, because these storms were extraordinary, and severely skewed the historical storm damage average. (TR 1550-52) The storm study also failed to include the storm hardening activities of Gulf since the 2004-2005 storm seasons. (TR 1554) Finally, since Gulf's 2006 storm study in Docket No. 060154-EI, referenced in Witness Schultz's testimony, Gulf has not experienced an increase in severe storm activity; instead, the last severe storm to make landfall was Hurricane Dennis in 2005. (TR 1555) After 2005, Gulf has only charged approximately $2.1 million against the storm reserve. (EX 37, Sch. C-1)

Inflated Storm Study Damage Estimates

Two things may account for the current storm study's inflated expected annual damage amount. First, the storm study annual expected damage estimates were based in part on thousands of random variable storms whose skewing effect on estimate annual damage was discussed above. Second, the storm study includes the extraordinary costs associated with the catastrophic damage caused during the 2004 and 2005 hurricane seasons. Both of these serve to inflate the expected annual damage estimate.

Extraordinary Storm Damage Skews Estimates

The storm reserve was established to help provide self-insurance against ordinary expected storm damage caused by tropical storms and hurricanes. It is common knowledge that when extraordinary storms struck the service territories of Florida Power & Light, Progress Energy Florida, and Gulf, wiping-out their storm damage reserves, the Commission authorized storm surcharges to help replenish the storm reserves. OPC witness Schultz asserted that if a storm or series of storms is severe enough to require the utility to request a storm damage surcharge to replenish the storm reserve, then the damage costs from those storms should not be considered in the utility's storm study. (TR 1551-52) Ordinary historical storm damage costs are ripe for consideration by the storm study, but not extraordinary storm damage costs that cause the utility to resort to a storm surcharge mechanism. (TR 1551-52)

As the record well establishes, in 2004 and 2005 Gulf's service territory was impacted by three severe storms – Hurricanes Ivan, Dennis, and Katrina – which caused extraordinary storm damage to Gulf's T&D systems. While at least two Gulf witnesses responsible for various operations of Gulf testified that the damage caused by the 2004-2005 storms was severe to catastrophic (TR 457-58; 466-68; 582; 598-99), the Gulf witness responsible for supporting the storm accrual testified that Hurricanes Ivan, Dennis, and Katrina were not extraordinary – even though 91 percent of Gulf's ratepayers lost power as a result of Hurricane Ivan and over 60 percent as a result of Hurricane Dennis! TR 2317-19; 2322. Notwithstanding the credibility-stretching testimony of the storm accrual witness, these three storms were extraordinary, unprecedented, and beyond anything Gulf or its ratepayers had previously experienced. The combined total damage incurred in 2004-2005 was over $145 million (EX 37, Sch. C-1), dwarfing the $20 million in damage caused by Hurricanes Erin and Opal in 1995.[7] The combined damage of the 2004-2005 storms was well beyond Gulf's 1996 worst case scenario of $106.9 million. OPC asserts that

[7] Incidentally, Gulf witness Erickson called Hurricanes Erin and Opal "significant," but was unwilling to call Hurricanes Ivan, Dennis, and Katrina extraordinary even though these storms caused sevenfold more storm damage than Erin and Opal. (TR 1029; 2317-19; 2322)

the storm damage reserve was not designed to self-insure against catastrophic damage caused by extraordinary storms; therefore, the damage associated with these three severe to catastrophic storms should not be included in Gulf's storm study when trying to estimate the annual storm accrual amount needed to fund the storm reserve balance or set target reserve amounts.

Requested Accrual Amount and Storm Reserve Target Range should be Rejected

Gulf's requested storm reserve accrual amount of $6.8 million should be rejected because it exceeds actual historical storm damage levels. According to OPC witness Schultz, if the 2004-2005 storm season damage is excluded, since 2001 Gulf's average actual *storm damage* charged to the reserve is $575,566. EX 37, Sch. C-1. Additionally, the amount of actual storm damage is significantly less than the $1.3 million Gulf projected in 1996 and tenfold less than what Gulf is now proposing to accrue annually.

Gulf's currently authorized storm reserve target range is $25.1 million to $36 million. The storm reserve 2011 ending balance is projected to be approximately $31 million, which is the mid-point of authorized range. (TR 1548; EX 37, Sch. C-1; Order No. PSC-96-1334-FOF-EI) Gulf's requested storm reserve target range in the amount of $52 million to $98 million is based in part on damage that would be associated with extraordinary storms. The reserve target should be based on ordinary expected damage amounts but not damage caused by extraordinary storms, as Gulf appears to be suggesting. Moreover, Gulf's own storm study, as questionable as it is, indicates that there is less than a five percent (5%) chance of storms causing $52 million of damage in a year and less than a two percent (2%) chance of storms causing $98 million of damage in a year. (EX 19, Sch. 5, at 20) According to Gulf's own study, it is *statistically improbable* that Gulf's service territory will experience damage in the range Gulf is requesting in a single year. As noted in the introduction to this issue, the Commission historically has been concerned that the storm "reserve does not become so large that it exceeds the reasonable needs of the utility." Gulf's 1972 rate case Order No. 5471 at 14. Based on Gulf's actual storm damage history for ordinary storms, Gulf's storm accrual request and requested storm reserve target is unreasonable and facially excessive, and thus should be rejected.

Storm Study Disclaimer Renders the Storm Study Meaningless

The final reason the storm study should not be considered by this Commission for purposes of establishing the storm accrual and reserve target amounts is the fact that the storm study includes an unusual disclaimer. (EX 19, Sch. 5, at 4) While much of the language in the disclaimer appears to be standard legalese to protect EQECAT from future liability stemming from its T&D storm analysis, there is also language which essentially renders the storm study meaningless. The following excerpt is illustrative of the inherent problems with the study:

> . . . the data and methodology described herein, and the analyses and services provided herein, are provided "as is" without any warranty or guaranty of any kind. Neither EQECAT nor its officers . . . Guarantees or warrants the correctness, completeness, currentness, merchantability or fitness for a particular purpose of the analysis provided hereunder. . . .
>
> A significant amount of uncertainty exists in key analysis parameters that can only be estimated. . . .
> EX 19, Sch. 5, at 4.

It is plain to see that EQECAT is unwilling to stand behind its storm study and is flatly telling Gulf that the study is unreliable for the "correctness, completeness, currentness, merchantability or fitness for a particular purposes of the analysis provided hereunder. . . ." Id.[8] Yet, Gulf is boldly asking this Commission to rely upon this unreliable storm study as the sole basis for increasing the accrual amount and storm reserve target range by millions of dollars which its ratepayers would be required to pay. If EQECAT is unwilling to stand behind the "correctness, completeness, currentness, merchantability or

[8] It is troubling that Gulf testified that it routinely relies upon studies like this in the normal course of business. (TR 986) It begs the question whether those other studies contain similar disclaimers and how much Gulf's reliance on those studies costs the ratepayer.

fitness" of the storm study, then neither should the Commission. OPC asks the Commission to reject the storm study.

Current Reserve Accrual Amount should be Reduced

OPC witness Schultz testified that because the storm reserve is projected to be approximately $31 million by the end of 2011, the current reserve accrual amount of $3.5 million should be reduced until the storm reserve is fully funded. (TR 1556-57) To accomplish this, the reserve annual accrual should be reduced to $600,000 which approximates the actual average ordinary storm damage charged to the reserve by Gulf over the last 10 years. (TR 1556) OPC witness Schultz testified that the current reserve level is sufficient to cover ordinary storm costs that are likely to occur based on recent history. (TR 1556) The level of the recommended accrual is supported by the fact that Gulf witness Erickson testified that Gulf incurred $600,000 in storm damage in 2011 following Tropical Storm Lee. (TR 988)

Conclusion

Gulf's requested increase in the annual accrual is excessive and unjustified based on a consideration of the historical charges to the storm reserve, the storm standards established for Florida electric utilities, the storm hardening measures implemented after 2005, and the deficiencies in Gulf's storm study document. For these reasons, the annual storm accrual should be reduced to $600,000, which reflects a decrease to O&M expense of $6.2 million ($5,962,113 jurisdictional). This $600,000 accrual amount approximates the ten-year historical average annual storm costs that have been historically charged to the reserve. The ten-year historical average excludes the 2004-2005 extraordinary storm costs which were recovered through a surcharge. Moreover, the storm reserve target range does not need to be increased. The reserve has almost reached the specific target range that was previously determined by the Commission. The storm reserve currently is sufficiently funded to cover storm costs that are likely to occur based on recent history excluding the extraordinary storm costs incurred in 2004-2005.

Issue 28: **Should unamortized rate case expense be included in Working Capital?**

No. The Commission has consistently disallowed the inclusion of unamortized rate case expense in working capital. This long standing Commission policy was recently reaffirmed in Commission Order No. PSC-10-0131-FOF-EI, involving Progress Energy Florida. Working capital should be reduced by $2,450,000.

ARGUMENT

OPC witness Ramas testified that Gulf should not be permitted to increase working capital by $2,450,000 for Gulf's projected unamortized rate case expense associated with this case. The Commission has consistently disallowed the inclusion of unamortized rate case expense in working capital. This long standing Commission policy was recently reaffirmed in Commission Order No. PSC-10-0131-FOF-EI involving Progress Energy Florida. At pages 71 to 72 of the order in that case, the Commission stated as follows with regard to unamortized rate case expense:

> We have a long-standing policy in electric and gas rate cases of excluding unamortized rate expense from working capital, as demonstrated in a number of prior cases. The rationale for this position was that ratepayers and shareholders should share the cost of a rate case: i.e., the cost of the rate case would be included in the O&M expenses, but the unamortized portion would be removed from working capital. It espouses the belief that customers should not be required to pay a return on funds expended to increase their rates.
>
> While this is the approach that has been used in electric and gas cases, water and wastewater cases have included unamortized rate case expense in working capital. The difference stems from a statutory requirement that water and wastewater rates be reduced at the end of the amortization period (Section 367.0816, F.S.). While unamortized rate case expense is not allowed to earn a return in working capital for electric and gas companies, it is offset by the fact that rates are not reduced after the amortization period ends.
>
> We agree with the long-standing policy that the cost of the rate case should be shared, and therefore find that the unamortized rate case expense amount of $2,787,000 shall be removed from working capital.

Other cases espousing this policy in electric and gas cases include rate cases for Gulf Power,[9] Tampa Electric[10] and Florida Public Utilities.[11] The Commission should continue its long-standing policy in electric cases of not allowing the utility to include the unamortized rate case expense in rate base. Consistent with the Commission's finding in the Progress Energy Florida case, it would be unfair to customers to pay a return on the costs accrued by the Company in this case that were used by Gulf to increase those rates charged to customers. Rate base should be reduced by $2,450,000 to reflect the full removal of the unamortized balance of rate case expense from working capital. (TR 1489-1490)

Issue 30: **Is Gulf's requested level of Working Capital in the amount of $150,609,000 ($155,044,000 system) for the 2012 projected test year appropriate? (Fallout Issue)**

No. Working capital should be reduced by $2,788,000 to reflect a balance of $147,821,000. This includes adjustments to remove unamortized rate case expense and the stipulated corrections to fuel inventories.

Issue 31: **Is Gulf's requested rate base in the amount of $1,676,004,000 ($1,712,025,000 system) for the 2012 projected test year appropriate? (Fallout Issue)**

No. The appropriate rate base should be decreased by $78,089,000 to reflect a balance of $1,597,915,000 on a jurisdictional basis.

Cost of Capital

Issue 32: **What is the appropriate amount of accumulated deferred taxes to include in the capital structure?**

The appropriate amount of accumulated deferred income taxes is $245,119,000, which reflects a pro rata reduction to Gulf's requested balance of $257,098,000. Also, if the Commission grants Gulf's request to annualize the impacts of the Crist Units 6 and 7 turbine upgrades in rate base, which OPC recommends against, the Commission should either increase the amount of deferred income taxes in the capital structure or lower rate base by $9,16,000 for the resulting impact of those projects on deferred income taxes.

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[9] Order No. 23573, issued October 3, 1990, in Docket No. 891345-EI, In re: Application of Gulf Power Company for a rate increase;

[10] Order No. PSC- 09-0283-FOF-EI, issued April 30, 2009; in Docket No. 08317-EI, In re: Petition for rate increase by Tampa Electric Company;

[11] Order No. PSC-09-0375-PAA-GU, issued May 27, 2009, in Docket No. PSC-09-0375-PAAGU, In re: Petition for rate increase by Florida Public Utilities Company.

ARGUMENT

OPC witness Ramas testified that Gulf's proposed annualized treatment of the two turbine upgrades projected to be placed into service in 2012 should be denied and that recovery should be based on the traditional average test year approach. If the Commission instead agrees with one of Gulf's proposed methods that allows for recovery of the annualized investment level, one of two additional adjustments are appropriate to annualize the impacts on accumulated deferred income taxes. The first method would annualize the amount included in the deferred tax component of the capital structure associated with the tax timing differences for the two 2012 projects, thereby reducing the overall rate of return to be applied in this case. The second, simpler approach would be to reduce rate base by the difference between the annualized amount of accumulated deferred income taxes caused by the 2012 upgrade projects placed in service and the average balance already incorporated in the filing. (TR 1503) The appropriate adjustment for either method was calculated by Ms. Ramas in a late-filed exhibit to her deposition. (EX 204)

<u>Issue 33</u>: **What is the appropriate amount and cost rate of the unamortized investment tax credits to include in the capital structure?**

Gulf's requested balance of ITCs should be reduced by $136,000 related to OPC's recommended adjustments to rate base to reflect a reconciled balance of $2,793,000. Consistent with Commission practice, the appropriate ITC cost rate should be 7.10%, calculated as a fall out by taking the weighted average cost of long-term debt, preferred stock and common equity as approved by the Commission.

ARGUMENT

The Company's balance of ITCs of $2,929,000 ($2,993,000 system) should be adjusted for the pro-rata portion of the rate base adjustments identified in Issue 31. Consistent with Commission practice,[12] the cost rate for unamortized investment tax credits will be calculated as a fallout by taking

[12] See Order No. PSC-09-0283-FOF-EI, p. 135, issued on April 30, 2009, in Docket No. 080317-EI, In re: Petition for rate increase by Tampa Electric Company; and Order No. PSC-94-0983-FOF-EI, issued August 12, 1994, in Docket No. 930720-EI, In re: Modified Minimum Filing Requirements Report in compliance with S3ection 366.06(3), Florida Statutes for Fernandina Beach by Florida Public Utilities Company.

the weighted average cost of short-term debt, long-term debt, preferred stock and common equity as approved by the Commission.

<u>Issue 37</u>: What is the appropriate return on equity (ROE) to use in establishing Gulf's revenue requirement?

When developing his recommendation of 11.7% ROE, Gulf witness Dr. Vander Weide gave new meaning to the expression, "Aim high." To narrowly selected, upwardly biased assumptions and sources of data he added an unwarranted, after-the-fact, apples-to-oranges, 90 basis point upward "leverage adjustment." (The Missouri PSC rejected his "leverage adjustment" rationale and methodology so emphatically that one of his Missouri clients directed him not to incorporate it again.) By contrast, OPC's Dr. Woolridge drew on a robust variety of sources, which he evaluated in light of the advantages and drawbacks of each to more properly assess the conditions of capital markets and the return that is appropriate for Gulf. The Commission should adopt his recommendation of 9.25% ROE.

ARGUMENT

Because Gulf Power is a subsidiary of Southern Company, which owns 100% of Gulf's stock, the appropriate return that should be authorized for Southern's equity investment in Gulf cannot be derived directly from market transactions. Instead, it is necessary to review market information related to proxies for Gulf, and adjust the results of that analysis to Gulf's specific circumstances. (TR 1659)

In this brief, OPC will compare the analysis and recommendation of its expert witness, Dr. Randall Woolridge, with that of Gulf Power witness Dr. James H. Vander Weide. Both witnesses employed well recognized models in their analyses. However, while Dr. Woolridge performed a *thorough* analysis, Dr. Vander Weide's was *thoroughly skewed* to the upside.

<u>The witnesses' DCF analyses</u>

An appraisal of the witnesses' respective treatments of the discounted case flow model (DCF) proves this point. The DCF model holds that the current price of a share of stock is explained by a mathematical calculation that quantifies the stream of present and future dividends and discounts that stream to its present value. The discount factor that converts the anticipated stream of payments to the present stock price is the investor's required rate of return. (TR 1666) Since that present value (price of the stock) is known, and the current and future dividends can be estimated, the analyst can solve an algebraic equation to determine the discount factor/required rate of return:

$$K = \frac{D + g}{P}$$

Which, converted to English words, means:

$$\text{Required Return} = \frac{\text{Dividend + Divided Growth Rate}}{\text{Price}}$$

The differences in the manner in which Dr. Woolridge and Dr. Vander Weide populated the DCF formula with values are revealing. To quantify the dividend, Dr. Woolridge recognized that companies often change the amount of a dividend during the course of an annual period. He therefore increased the dividend by half the growth rate he assigned to future growth in dividends. (TR 1671) This is the same methodology that the Federal Energy Regulatory Commission ("FERC") employs. (TR 357) Dr. Vander Weide assumed dividends would be paid quarterly, *and* that each quarterly dividend payment would continue to earn a return equal to the dividend growth rate through the remainder of the year. (TR 1697) Dr. Vander Weide's method introduces an unwarranted and fallacious compounding effect that overstates the dividend input to the DCF equation. (TR 1697)

The reason why the compounding of quarterly dividend payments overstates the dividend value can be explained simply. Once an investor receives a dividend payout, that money has left the corporation. The corporation has neither the responsibility nor the ability to add to, or subtract from, the amount paid to the investor. On the other hand, the investor has the ability to either invest the dividend anew (whether in the same or different investment vehicle) or spend it. Whether the payment is placed in a mutual fund or a dividend-paying stock, used to defray country club dues, or paid to a charity, the decision to seek an additional return, or put it under a pillow, or extract another form of value is in the hands of the investor.

Dr. Vander Weide's method, therefore, is flawed in two respects. First, it assumes a continuing control over the paid dividend that does not exist. More importantly, it overstates the dividend by attributing a multiplier effect to the dividend to which the investor is not entitled, that the investor neither expects nor requires, and that the investor does not receive in the real world. A dividend payment that an investor receives on March 31 and promptly places in a bond mutual fund does not thereafter earn both the return generated by the bond mutual fund *and* an increase equal to the dividend growth rate through December 31 of the year. Similarly, a dividend that an investor receives on March 31 and promptly uses to pay down a credit card balance does not both reduce the amount owed to the credit card company by the full amount of the dividend *and* receive additional returns from the company through the end of the calendar year. Likewise, a dividend payment that the investor uses to pay estimated income taxes does not reduce tax liability by the full amount of the dividend *and* continue to earn the dividend growth rate thereafter. (TR 354)

Their respective approaches to quantifying the dividend growth rate of the DCF equation also display the extent to which Dr. Woolridge consulted a wide variety of sources, while Dr. Vander Weide focused, laser-like, on a single source that is notorious for its bias toward overstated estimates of required returns. In his analysis, Dr. Woolridge employed historical *and* projected information, and in doing so made conscious judgments as to the advantages and disadvantages of each.[13] (TR 1671, 1673)

[13] In his rebuttal testimony, Dr. Vander Weide erroneously stated that Dr. Woolridge did not use analysts' projections. (TR 1835) Dr. Woolridge used them, but also consulted other sources. (TR 1676-78, TR 1671) Further, when using them he was conscious of analysts' well documented, chronic tendency to be overly optimistic in their projections.

Further, Dr. Woolridge used—not only market information regarding dividends—but also historical and projected values of earnings per share, GDP, and internal growth (from retained earnings) to fully inform himself about the various factors that bear on the dividend growth rate.

In sharp contrast to the robust, multi-sourced analysis that Dr. Woolridge performed, Dr. Vander Weide relied solely and exclusively on Wall Street analysts' projections of the long term (three to five years) growth rate of earnings per share to derive the dividend growth rate that he plugged into the DCF formula. Untempered by other sources, an exclusive reliance on Wall Street analysts' long term projections of earnings per share overstates the required return, because those long term projections are famously and demonstrably biased to the high side.

Dr. Vander Weide denied that Wall Street analysts' long term estimates of earnings per share are upwardly biased. Dr. Vander Weide included in his rebuttal testimony a list of nine articles (Table 3) that, he claimed, supported his position. (TR 1840) During cross-examination, OPC introduced each of the nine articles. (Ex 210) Dr. Vander Weide acknowledged that *none* of the nine articles involved a study of long term (three to five years) projections of earnings per share. Rather, each involved a review of *quarterly* or *annual* projections. (TR 1970-73) Borrowing from sports parlance, in his Table 3, Dr. Vander Weide was 0 for 9.

On redirect, Dr. Vander Weide professed to be nonplused. While the articles admittedly are limited to short-term projections, he said, they nonetheless demonstrate that Wall Street analysts' projections are unbiased. (TR 1976) In other words, said the witness, a projection is a projection, and any will do to support my hypothesis! Here, Dr. Vander Weide displayed tenacity, but not credibility.

Dr. Vander Weide's effort to claim no distinction exists between projections of short term quarterly results and projections of three to five years is lame on its face. To place the differences in perspective: a quarter consists of three months; Dr. Vander Weide's definition of "long term projection" contains *thirty-six to sixty* months. Just as a torpedo that is off course by only inches after launch when measured at ten yards will exhibit the full magnitude of its error hundreds of yards later, a projection of a firm's earnings per share has relatively little opportunity to manifest the extent of its bias in only three months, or even a year.

This is particularly true, given the extensive amount of information that corporations provide to the analysts that cover them on a quarterly and annual basis. Quarterly reports, conference calls, and formal earnings "guidance" issued by corporations enable analysts to develop projections that are based on information that is generated almost in real time. Some observers even see a symbiotic relationship in which the firms provide analysts the information with which to produce short-term estimates, and the analysts' estimates give the firms the opportunity to report earnings that exceed those estimates by the end of the projection period. (TR 1699-1700) Small wonder, then, that Squawk Box may announce that "Corporation X Beats the Street by Two Cents Per Share," or that "Firm X Matches Analysts' Consensus Earnings For Third Quarter." The analysts and the corporations they follow are in virtual lockstep during the short term.

The second reason why the Commission should reject Dr. Vander Weide's effort to equate short-term and long-term projections is that, unlike the studies of short-term projections in his Table 3, studies of long-term projections of earnings per share demonstrate that Wall Street analysts' projections chronically are overly optimistic. Dr. Woolridge demonstrated this vividly by contrasting real examples of analysts' long term predictions with the significantly lower actual results for those same periods. (TR 1698-1706) One study by McKinsey Company in 2010 led it to conclude:

> Alas, a recently completed update of our work only reinforces this view (that analysts are overly optimistic)—despite a series of rules and regulations, dating to the last decade, that were intended to improve the quality of the analysts' long-term earnings forecasts, restore investor confidence in them, and prevent conflicts of interest.
> (TR 1705)

It is for good reason, then, differences in short-term projections of earnings and actual results are measured in precise dollars and cents, whereas differences in forecasts of long-term projections and actual earnings per share are expressed in percentages. (TR 1675)

The witnesses' risk premium analyses

The same contrasting attributes of robust thoroughness vs. selective bias are evident in the witnesses' respective risk premium analyses, of which Dr. Woolridge's capital asset pricing model, or CAPM, is an example. The premise of the CAPM model is that the return required for a utility can be quantified by identifying the cost of a risk-free source of capital and adding to it the increment of return that investors require to compensate them for accepting the risk of a particular security. The CAPM quantifies this increment by subtracting the risk-free rate from the overall market return, and applying to the difference a measure (Beta) that describes the risk of the firm being evaluated relative to that of the overall market. (TR 1680-81) For example, if one assumes (for purposes of illustration only) that the risk-free rate is 3.5%, the overall market return is 8.5%, and the Beta of the company under consideration is 0.8, the CAPM would quantify the return required by investors as follows:

Required Return = Risk free rate of 3.5% + 0.8 (8.5% - 3.5%)

Required Return = 3.5% + 0.8 (5.0%)

Required Return = 3.5% + 4% = 7.5%

In the course of developing the risk premium that he used in his CAPM exercise, Dr. Woolridge used, among other things, the "building block" approach. The premise underlying the "building block" approach is that past market returns can be "deconstructed" into those portions attributable to inflation, stock valuations (P/E ratios), dividend yields, and real earnings growth. (TR 1687) Once those components of past returns have been isolated, the analyst can "build" an ex ante (forward looking) return by estimating the contribution of each of these components to forecasted scenarios based on the current economic environment. Using this methodology, Dr. Woolridge constructed an ex ante return from building blocks consisting of a dividend yield of 2.4%, real earnings growth of 2.75%, and an inflation rate of 2.8%. (Dr. Woolridge assumed there will be no material change in the market's stock valuations as measured by P/E ratios.) His building blocks indicate a total market return of 7.95%, which is consistent with forecasts by the Federal Reserve Bank of Philadelphia and a survey of corporate CFOs, among others. (TR 1698)

However, in quantifying the risk premium that he employed in his CAPM analysis, Dr. Woolridge did not use only the risk premium that he calculated using the market return from his "building blocks" approach. In fact, he incorporated the results of some thirty other studies. (TR 1690; EX 61, p. 5) These studies "cover the waterfront" of historical information, projections, surveys, and the "building block" exercises of other analysts. From this variety of sources Dr. Woolridge distilled an equity risk premium of 5.10%. This value is consistent with, among other things, a survey of 6,000 financial analysts and companies and a recent study of McKinsey & Co. (TR 1692) Using a risk-free rate of 4%, a Beta of 0.70, and the risk premium of 5.10%, Dr. Woolridge estimated a CAPM-based ROE of 7.6%. However, giving greater weight to the results of his DCF study, he recommended an ROE of 9.25% for Gulf Power.

Dr. Vander Weide discarded his CAPM results, so they will not be assessed in this brief.

In addition to his DCF analysis, Dr. Vander Weide performed both an "ex post" (based on historical data) and an "ex ante" (based on projections) risk premium analysis. In each, he chose inputs that imparted an upward bias to his results.

For instance, Dr. Vander Weide used the projected yield on an 'A' rated utility bond as his base yield. The particular value of 6.15% that he chose for his exercise is *significantly higher than* current market rates. Further, his choice of a corporate bond as the base interest rate injected a risk of default that is not inherent in Treasuries. (TR 1710) When calculating the risk premium, Dr. Vander Weide again turned to Wall Street analysts' predictions exclusively, thereby recreating and reintroducing the upward bias that characterized his DCF analysis. (TR 1712) Using the trajectory established by analysts' rosy view, Dr. Vander Weide assumed, for purposes of his risk analysis, that the stock market will provide an overall return of 13.3% consistently during future periods—an assumption that Dr. Woolridge demonstrated to be unrealistic.[14] (TR 1720)

Dr. Vander Weide's next step was to average the results of his DCF and risk premium analyses to arrive at 10.8%. However, he did not stop there. Dr. Vander Weide reasoned that, because the 10.8% had been calculated with the use of his proxy companies' market-value-based capital structure and was being applied to Gulf's book value-based data, it was necessary to increase the 10.8% ROE he derived through his DCF and risk premium analyses by an additional 90 basis points to arrive at his recommended 11.7% ROE. There is no basis for this adjustment, other than to add a thick layer of excess return on top of an already overstated result. As Dr. Woolridge noted, investors are aware of both book value-based and market value-based capital structures and the different uses made of them. Book value-based capital structures appear in corporations' financial statements and in the reports they file with regulatory agencies. (TR 1728) There is no change in leverage or in risk of a utility before or after the DCF and risk premium analyses. (TR 1728) Investors assess all risks associated with a security—including financial risks associated with debt, however it is measured—and those perceptions are reflected in the price they are willing to pay for the stock.

There is little wonder, then, that Dr. Vander Weide has gained so little traction with his leverage adjustment elsewhere. Dr. Vander Weide referred to the Federal Communications Commission's decision in an arbitration proceeding involving the choice of a ROE that should be used

[14] Dr. Vander Weide supported his use of analysts' projections partly with the argument that investors' pay attention to them. To the extent they do, informed investors will take into account analysts' propensity to be overly optimistic (TR 1673) and discount obviously unreasonable assumptions.

in pricing a local exchange company's unbundled network elements (UNEs) to be leased to competitive local exchange companies. The order does not support the use of his adjustment in this case. In the order, the FCC recited that it was prohibited by the Federal Telecommunications Act of 1996 from employing traditional rate base/ rate of return regulatory measures when pricing UNEs. As Dr. Vander Weide acknowledged, this Commission must employ the very regulatory framework that the FCC said it is prohibited from using. The use of book value-based capital structures is part and parcel of the traditional rate base/rate of return regulatory framework. The FCC also noted that, in pricing UNEs, it is directed to employ information that is well suited to an environment of intense competition. Such an environment of intense competition does not exist for a regulated utility that possesses a monopoly on retail service within its service area. Finally, the FCC order (like the orders of tax authorities and the agency that oversees the rates charged by railroads, also cited by Dr. Vander Weide) does not present an example of an instance in which an agency accepted his "leverage adjustment." In all of these instances, the agency simply worked directly with market-value-based data to quantify the required return. As explained above, knowledgeable investors are familiar with both types of capital structures, and can assess the risk of a security whichever is used. (EX 178; TR 366-370)

During the discovery phase of this proceeding, the Commission Staff asked Gulf Power to provide examples of instances in which a regulatory body adopted Dr. Vander Weide's leverage adjustment. Gulf provided an order of the Missouri Public Service Commission involving a petition by Empire Electric District. Gulf did not disclose what happened to Dr. Vander Weide's recommended leverage adjustment in Missouri subsequently. In 2008, in a case involving the same utility, the Missouri agency declined to adopt Dr. Vander Weide's proposed leverage adjustment. (Ex. 181) In 2007, in a case involving a different utility (Union Electric subsidiary Ameren UE, for whom

Dr. Vander Weide also testified), the Missouri Public Service Commission emphatically rejected the methodology. The agency disparaged the proposed adjustment as an effort to inflate the ROE value artificially, and questioned the credibility of the witnesses who sponsored it. (TR 375; EX 182) In the next Empire Electric District case before the Missouri Agency, *Dr. Vander Weide* omitted the adjustment—at his client's direction! (TR 377-78) The ROE that he recommended as appropriate in that case was based on the average of his three separate analyses, without the artificial augmentation of his "leverage adjustment." (EX 183)

During redirect, counsel for Gulf read this sentence from the Missouri Ameren UE case cited above:

> Q. Vander Weide acknowledged at the hearing that—I'm not even going to try to pronounce it—Ameren—Ameren UE's risk as about average for the electric utility industry. Do you see that?
> A. Yes, I do.
>
> Q Is it your---in this case what is your testimony about Gulf's financial risk compared to the average for your proxy group of companies?
> A. Gulf's financial risk is greater than that of the proxy group that's reflected in the cost of equity.
> Q. And as a result of having that greater financial risk, what adjustment is appropriate?
> A. An adjustment to the cost of equity from the –that's the—that's calculated from the proxy companies in order to reflect the greater financial risk of Ameren—of Gulf Power's ratemaking capital structure compared to the average capital structure of the proxy companies. (TR 439-440)

The Commissioners should see this exchange for what it is: a bit of misdirection in an effort to avoid or downplay the impact of the Missouri agency's caustic rejection of the methodology on which Gulf's request for an outsized ROE so critically depends.[15] Just as Dr. Vander Weide's leverage adjustment results from a mixing of apples and oranges, so does the exchange on redirect attempt to mix apples and oranges.

[15] So critical is this layer of additional return to Gulf's aspirations for an extreme high ROE that Gulf engaged another consultant, Michael J. Vilbert, whose sole function was to endorse Dr. Vander Weide's methodology.

The "apple" is the manner in which the Missouri agency characterized the applicant as having risk similar to the industry average—a proposition to which, according to the order, Dr. Vander Weide agreed. Note that in the case, Dr. Vander Weide sponsored his favored leverage adjustment on the basis of the difference in "financial risk" that he attributed to the use of book value and market value capital structures, but also agreed, during the hearing, that the utility that was the subject of his adjustment had "about industry average" risk. In its order, when using the term "average risk," the Missouri agency clearly was piercing Dr. Vander Weide's attempted construct, and referring to overall investment risk of the applicant and other firms when measured on a consistent basis.

The "orange" is the effort by Gulf's witness and counsel to evade the impact of the equivalency in risk between the witness' client and the utility industry to which the Missouri agency referred, and to which (according to the order) he agreed during the Missouri hearing on the rationale for his leverage adjustment, by reverting again to his proposition that Gulf's capital structure based on book value is more highly leveraged, and the firm therefore has greater financial risk than the market value-based capital structures of the firms in his proxy group. (This is the very proposition that the Missouri PSC rejected based on the witness' admission that his client displayed "about average" risk!) However, the record in this case won't permit the attempt at evasive action. Just as Dr. Vander Weide was forced in the Missouri case to acknowledge that his client's risk was "about average for the utility industry," Dr. Woolridge's testimony and exhibits demonstrate that Gulf Power's capital structure is similar to the 24 companies of his proxy group *when Gulf and the proxy companies are compared consistently on the basis of book value-derived capital structures.* Specifically, when measured on a book value basis, Gulf's equity ratio is 47.83%; the composite equity ratio of the 24 utilities in Dr. Woolridge's proxy group, measured on the same book value basis, is 45.4%. (TR 1657-58; TR 1735; EX 55-56)

Gulf, therefore, has "about average risk" as that term was used by the Missouri PSC in the Ameren UE case. Just as in the Missouri Ameren UE case, only by artificially comparing a book value-based equity ratio to an equity ratio based on market value does Dr. Vander Weide contrive a discrepancy with which to fuel his claim of a difference in "financial risk." The Commission should reject his rationale and the adjustment that accompanies it.

A few words about Gulf's references to rating agencies.

During the case, and principally through the testimony and exhibits of Gulf witness Teel, Gulf attempted to infuse the process with the notion that Wall Street regards the Commission as having stumbled from its previously "constructive" and "supportive" past. These were not-so-veiled references to the most recent decisions in the proceedings on base rate requests by Florida Power & Light Company ("FPL") and Progress Energy of Florida ("PEF"). For example, one of Mr. Teel's exhibits is a report by the Fitch rating agency. The author of the Fitch report complained that the Commission granted increases that were far less than those sought by the utilities and had given less-than-average ROEs in response to "populist" pressures. The author expressed his view that the departure was temporary, and predicted that the Commission will right itself from its fallen ways. (EX 10)

Rating agencies view regulatory proceedings from the investors' viewpoint, so their partisan comments come as no surprise. Still, the Fitch document is unusually lacking in even a façade of analytical structure: Does the author really regard a comparison of amount awarded with amount requested as a meaningful yardstick? It should go without saying, but since Gulf sponsored the Fitch report in support of its request: If the Commission finds that a utility has overreached in its request, it should protect customers with disallowances based on its view of the merits of specific proposals, rather than try to please Wall Street analysts who employ such simplistic and meaningless metrics to criticize decisions that fall short of utilities' requests. Wall Street has no legitimate expectation that the Commission will do anything else.

More importantly, time has disproved—make that *obliterated*—the Fitch author's premise. For instance, during the hearing OPC introduced evidence demonstrating that FPL has earned at the top of its authorized range (11% ROE) consistently since the rates set in its case took effect. FPL encountered no difficulty in issuing bonds on reasonable terms. (TR 236-237; EX 173)

In most circles, one would expect the author of such criticism to be discredited when facts have proven him wrong. Not in this arena, however. Indeed, Gulf tried to perpetuate the message that "Wall Street is not pleased, and expects you to change your behavior." In the face of the evidence that the Commission's decisions in the FPL and PEF cases were well reasoned, disallowances justified, and results not harmful to the utilities, Gulf's witnesses attempted to attribute the other utilities' ability to operate successfully to the provisions of post-decision settlements that enabled the utilities to consume depreciation reserve surplus to keep earnings at a satisfactory level. (TR 276) This assertion constitutes outright distortion; it also smacks of desperation.

As recent surveillance reports disclose, FPL has used the mechanism of its Commission-approved settlement most frequently to *increase* depreciation expense above the level set in its rate case so as to enable FPL to *reduce* its net operating income to the level that equates to its maximum authorized rate of return. Said differently, FPL has been using the provisions of its settlement agreement to *hold down* its earned ROE. (EX 213) Just as the Commission should view in proper perspective the rating agencies' congratulatory and flattering terms of "constructive" and "supportive," it should refuse to be influenced by ongoing efforts to propagate a false narrative about the claimed inadequacy of past decisions by those who urge the Commission to "prove itself" to Wall Street. Instead, it should confine itself to analyzing the relative merits of competing presentations and applying the pertinent provisions of law to the facts of this case. With respect to the ROE it should authorize for Gulf, this means that it should reject the recommendation of Gulf's witness and authorize a return of 9.25% ROE.

<u>Issue 38</u>: What is the appropriate weighted average cost of capital including the proper components, amounts and cost rates associated with the capital structure?

Using Gulf's proposed capital structure ratios, and after adjustments for the rates for the stipulated rates for short-term debt, long-term debt, and preferred stock, and OPC witness Woolridge's recommended ROE and ITC amortization rates, the appropriate weighted average cost of capital is 6.00%.

ARGUMENT

All parties have agreed to use Gulf's proposed capital structure ratios and have stipulated the cost rates for short-term debt, long-term debt, and preferred stock. The only outstanding issues relate to the appropriate return on equity and the ITC amortization rate. Using Dr. Woolridge's recommended ROE of 9.25% (Issue 37) and the fallout calculation of the weighted cost of investor sources of capital for the amortization rate for ITCs (Issue 33), the appropriate weighted average cost of capital is 6.00%.

<u>Net Operating Income</u>

<u>Issue 39</u>: Is Gulf compensated adequately by the non-regulated affiliates for the benefits they derive from their association with Gulf Power? If not, what measures should the Commission implement?

No. The non-regulated companies receive significant intangible benefits that the regulated electric companies developed over the years and have provided to the non-regulated companies at no cost simply by their close affiliation and association. An adjustment should be made to compensate the regulated electric companies as discussed in Issue 40.

ARGUMENT

Southern Company has a number of non-regulated subsidiaries which are affiliates of Gulf Power – Southern Nuclear, Southern Communications Services (d.b.a. – SouthernLINC Wireless), Southern Telecom, Southern Power, and Southern Renewable Energy, the newest affiliate of Gulf established in 2010. (TR 1612; 1614; EX 191, Form 10-K, I-1) The non-regulated companies receive significant benefits from being related to Southern Company's regulated electric companies – Alabama Power, Georgia Power, Gulf Power, and Mississippi Power. (TR 1612-13) The benefits include but are not limited to, the regulated electric companies' reputation, goodwill, corporate image, and financial wellbeing. (TR 1613) Fitch Ratings recognized that the financial benefits the regulated electric companies provide Southern Company "in the form of dividends for the payment of corporate expenses, debt-service, and for other business matters and relatively modest parent debt leverage" and predictable cash flows. (TR 1613)

If Southern Company as the parent company benefits from the four regulated electric companies, then those financial benefits also flow through to the non-regulated affiliates. Southern Company can use dividend payments and cash flow from the regulated electrics to directly fund the activities of non-regulated affiliates. Southern Renewables, as a relatively new affiliate, will plainly need infusions of cash and equity from Southern Company to fund start-up costs. Southern Company also can require that the regulated electrics use the services of the non-regulated affiliates. For instance, as noted for SouthernLINC in Issues 17 and 52, all the regulated electric companies use SouthernLINC Wireless for their wireless communications – this captive group of guaranteed customers provides significant benefits to SouthernLINC's financial bottom line. (TR 1630-31) Similarly, as there is a close relationships between Southern Power (which manages Southern's wholesale business) and the regulated electrics, there will also be close relationships with the recently created Southern Renewable Energy and the regulated electric companies. Finally, if Gulf's nuclear ambitions ever leave the hypothetical drawing board, then Gulf will likely develop close relationships with Southern Nuclear, which operates and provides services to Alabama Power's and Georgia

Power's nuclear plants. (EX 191, Form 10-K, I-1) The activities and interests of the regulated electric companies and non-regulated companies are intertwined.

Gulf's non-regulated affiliates clearly and significantly benefit financially, operationally, and otherwise from being associated with the regulated electric companies. Consequently, these non-regulated affiliates should compensate the regulated electric companies for those benefits. Gulf's non-regulated affiliates receive significant intangible and tangible benefits that were developed by the regulated electric companies and funded by ratepayers. These benefits were bestowed upon the non-regulated companies at no cost simply by their close affiliation and association. Therefore, to ensure that the regulated companies and their captive ratepayers are fairly compensated for the substantial benefits provided to the non-regulated affiliates the Commission should impute a compensation payment as discussed in Issue 40.

__Issue 40__: Should an adjustment be made to increase operating revenues by $1,500,000 for a 2 percent compensation payment from non-regulated companies?

Yes. The Commission should assume a two percent compensation payment on the revenue earned by the non-regulated companies, which should be allocated to the regulated companies on the basis of the amount of revenues earned by the non-regulated companies. A two percent compensation payment applied to the non-regulated revenue of several affiliates would result in an increase to Gulf's test year revenue of $1.5 million.

ARGUMENT

OPC witness Dismukes testified that a two percent compensation payment from the non-regulated affiliates' revenues to the regulated electric company should be imputed, resulting in an increase to Gulf's test year revenue of $1.5 million. (TR 1618-20; 1622) The foundation for OPC's recommendation is the Commission's decision in the United Telephone Company of Florida (United Telephone) case which was subsequently appealed and upheld in *United Telephone Long Distance, Inc. v Katie Nichols et al.*, 546 So. 2d 717,719 (Fla. 1989); (Order No. 18939 in Docket No. 870385-TI; TR 1619-20) In its decision, the Commission imposed the payment on the long distance subsidiary of United Telephone in order to ensure that customers were compensated for the intangible benefits the wholly owned subsidiary received for use of the regulated parent company's name, logo, and reputation. (TR 1620) The Florida Supreme Court upheld the compensation payment imposed by the Commission, finding that it was supported by competent substantial evidence; authorized by statute; and constitutionally permissible. 546 So. 2d at 720.

Gulf witness Deason suggested that ratepayers did not risk their capital, yet would still receive the two percent compensation payment or imputed revenues from the non-regulated affiliates even if those businesses fail. (TR 2112) However, this is not wholly correct. First, he ignored the source of Southern Company capital to invest in those non-regulated affiliates – the ratepayers of the regulated electric companies. Second, it is highly unlikely that all of the non-regulated businesses will fail and if they do, there is no guarantee that the financial consequences will not be felt by the regulated electric companies. Third, while Mr. Deason suggests failure, he provided no proof of such failure has occurred since Southern Company formed its first non-regulated subsidiary. Finally, if those non-regulated businesses fail and the two percent compensation payment assumption becomes no longer viable, Gulf can file for a rate case and request appropriate adjustments.

Gulf witness Deason correctly stated that the cost allocation and affiliate transactions rule sets forth the Commission's policy on cost allocations and affiliate transactions. (TR 2113; Rule 25-6.1351, F.A.C.) However, he incorrectly attempted to apply the rule to the factual issues raised by OPC witness Dismukes. (TR 2113) The purpose of Rule 25-6.135(1), "is to establish cost allocation requirements to ensure proper accounting for affiliate transactions and utility non-regulated activities so that these transactions and activities are not subsidized by utility ratepayers. . . ." Under this issue of intangible benefits derived from regulated electric companies, OPC witness Dismukes is not disputing "cost allocation" as it relates to "affiliate transactions" or "non-regulated activities" (cost allocation and affiliate transactions are raised elsewhere). The issue raised by OPC witness Dismukes is not whether costs are allocated appropriately, but rather whether Gulf is adequately *compensated* by the non-regulated affiliates for the intangible benefits derived from their association with Gulf Power and the other regulated electric companies. (TR 1612-14; 1618-20; 1622) This issue is directly addressed in the Commission's United Telephone orders.

Gulf witness Deason also correctly stated that Commission Order No. 19734, issued July 27, 1988, modified Order No. 18939, and deleted the "fourth paragraph on page ten." (TR 2113) Gulf witness Deason however mischaracterized or perhaps misapprehended OPC witness Dismukes' testimony, asserting she misquoted Order No. 18939. This is simply inaccurate. First, OPC witness Dismukes was quoting the order of the Florida Supreme Court that decided United's appeal of the Commission's order. (It should be noted that the Supreme Court rendered its decision on July 6, 1989, *after* the Commission deleted the fourth paragraph). Second, OPC witness Dismukes acknowledged the modification of Order No. 18939, amended her pre-filed testimony when she took the stand, and deleted the fourth paragraph from her official hearing testimony. (EX 207, deleting lines 9-15, except footnote on TR 1621)

However, the deletion of the fourth paragraph in subsequent Order No. 19734 does not abrogate the Supreme Court's decision that the Commission has the statutory and constitutional authority to impose a compensation payment where warranted and supported by the fact. Indeed, by attempting to distinguish the United Telephone orders, witness Deason tacitly acknowledged that the Commission presently has the authority to impose a compensation requirement should the Commission desire to exercise its authority.

OPC asserts that imposing a compensation requirement is a policy decision that is within the power of the Commission, and one that should be exercised. Since the non-regulated affiliates of regulated electrics benefit from their close association, then Gulf should be adequately compensated by the non-regulated affiliates. A two percent compensation level is OPC's recommendation, but clearly under the *United Telephone* case, the Commission has the authority to impose a different percentage amount.

For the reasons stated above, the Commission should exercise its authority and assume a two percent compensation payment applied to the revenue earned by the non-regulated companies. This amount should be allocated to the regulated companies on the basis of revenues earned by the non-regulated companies. A two percent compensation payment applied to the non-regulated revenue of several affiliates would result in an increase to Gulf's test year revenue of $1.5 million.

__Issue 41__: Should an adjustment be made to increase test year revenue for Gulf's non-utility activities?

Yes. Gulf is able to earn an excessive rate of return from three non-regulated products and services which stem from the regulated electric operations. These non-utility operations could not be offered without the close association with and good will of Gulf's regulated electric utility. Revenues of $572,000 should be moved above-the-line because Gulf has failed to demonstrate that Gulf has been compensated for the use of its reputation, goodwill, and logo. Alternatively, the Commission could require that the non-regulated operations provide Gulf a compensation payment of at least two percent of annual revenue. OPC also recommends that Gulf should be ordered to conduct a thorough examination of these operations and develop appropriate cost allocation procedures for non-regulated operations.

ARGUMENT

Gulf offers three products and services through its non-regulated operations – Premium Surge, Commercial Surge, and AllConnect. (TR 1624; 2267) Any and all profits from these non-regulated operations are credited to the shareholders and not the ratepayers. (TR 2267) Unlike in Issue 42 as it relates to compensation payments, the Commission's cost allocation and affiliate transaction rule should provide guidance for evaluating Gulf's non-regulated activities and help ensure that regulated operations do not subsidize the non-regulated operations. (TR 1623) This is because Gulf's own cost accountability and control manual is silent on how to treat these non-regulated products and services for ratemaking or accounting purposes. (TR 1623) OPC witness Dismukes describes each of the three services in her testimony. (TR 1624-25) She stresses that Premium Surge, Commercial Surge, and AllConnect that are offered by Gulf receive substantial benefits from being associated with the regulated operation of Gulf without compensation to Gulf. (TR 1625)

The intangible benefits received include, but are not limited to, using Gulf Power's name, logo, reputation, goodwill, corporate image, Gulf's website, and referrals from Gulf's customer call center. (TR 1625) By being made available on Gulf's website, Premium Surge and Commercial Surge directly benefit from Gulf's logo, reputation, goodwill, and corporate image. (TR 1625) AllConnect is a service designed for new ratepayers when they initiate utility service with Gulf. (TR 2267-69) Every new Gulf Power customer is offered this service at the end of their initial call. Undoubtedly, AllConnect benefits significantly from these referrals from Gulf's call center. (TR 2267-69) All of these products and services are available exclusively to Gulf customers and no one else. (TR 2267) The fact that these services and products are not offered to non-Gulf customers should clearly inform the Commission, that but for the regulated captive customers of Gulf Power, this revenue would not be earned. These non-utility operations would not be offered without the close association with, and goodwill of, Gulf's regulated electric operations.

Because of the association with Gulf Power's captive ratepayers, Gulf is able to earn an excessive rate of return from these non-regulated products and services. Any earnings in excess of the regulated rate of return should be moved above-the-line for ratemaking purposes. This will ensure that ratepayers receive compensation for the benefits associated with these non-regulated products and services' exclusive use of Gulf's logo, reputation, goodwill, and corporate image—all of which were paid for by ratepayers. Revenues of $572,000 should be moved above the line because Gulf has failed to demonstrate that it has been compensated for the use of its reputation, goodwill, and logo. (TR

1628) Alternatively, the Commission could require, for ratemaking purposes, that the non-regulated operations provide Gulf a compensation payment of at least two percent of their annual revenue. (TR 1629) OPC also recommends that the Commission order Gulf to conduct a thorough examination of these operations and develop appropriate cost allocation procedures for non-regulated operations, which can then be examined/audited by the Commission in Gulf's next rate proceeding.

Issue 42: **Is Gulf's projected level of Total Operating Revenues in the amount of $481,909,000 ($499,311,000 system) for the 2012 projected test year appropriate? (Fallout Issue)**

No. The appropriate amount of operating revenues is $484,019,000 (jurisdictional). This reflects an increase to test year revenues of $2,110,000 for the 2% compensation payment on the revenue earned by the non-regulated companies and the imputed revenue for non-regulated services and products.

Issue 47: **Has Gulf made the appropriate adjustments to remove all non-utility activities from net operating income?**

No. See OPC's positions on Issues 39-41 and 48-68.

Issue 48: **Should adjustments be made to the expenses allocated or charged to Gulf as a result of transactions with affiliates?**

Yes. See OPC's positions on Issues 49-68.

Issue 49: **Should adjustments be made to expenses to allocate SCS costs to Southern Renewable Energy?**

Yes. Because Southern Renewable Energy was formed in 2010 and the allocations provided by Gulf date from 2009, neither Southern Company Services overhead nor costs allocated on the basis of megawatts have been allocated to Southern Renewable Energy. The omission means costs allocated to Gulf Power are overstated and it should be assessed a two percent compensation payment analogous to that described in Issue 41.

ARGUMENT

As described in the testimony of OPC witness Dismukes, Southern Company Services (SCS) allocates costs to the affiliates through three methods: direct assignment, direct accumulative distribution, and fixed percentage distribution. (TR 1608-09) Deficiencies in Gulf's allocation factors are discussed under Issue 51. As discussed under Issue 51, Southern Renewable Energy was not allocated any costs from SCS, even though this new affiliate was formed in 2010. As a result, test year costs from SCS to Gulf are overstated. This is clearly inappropriate; ratepayers should not be forced to subsidize the non-regulated Southern Renewable Energy.

To cure this omission, OPC recommends that the Commission assess a two percent compensation payment on Southern Renewable Energy revenues based upon the Commission's inherent authority described in Issue 41. Charging this affiliate a two percent compensation payment would ensure that GPC's regulated customers do not subsidize this non-regulated affiliate. No Gulf witness challenged OPC witness Dismukes' recommended adjustment.

Issue 51: **Should adjustments be made to the allocation factors used to allocate SCS costs to Gulf?**

Yes. Allocation factors should be based upon cost-causative relationships to the extent possible and also recognize the benefits received from the service provided. Gulf used a "financial" factor to allocate many affiliate administrative and general expenses, which overstates allocations to regulated companies and understates allocations to non-regulated companies. On the expense side, the factor apparently includes fuel and purchased power expenses, which over allocates costs to the regulated operating companies. OPC recommends that the financial factor be adjusted to remove the revenue component in the factor and the fuel and purchased power from the expense component of the factor. The impact is to reduce expenses by $832,284.

ARGUMENT

Gulf Power had nearly $81 million dollars in transactions with its affiliates during the test year. The majority of Gulf Power's affiliate transactions are with Southern Company Services. They totaled $56 million dollars during the test year. (TR 1639)

Gulf used several different allocation factors to allocate expenses from SCS to Gulf Power. These factors are deficient in several respects. First, they failed to incorporate the significant benefits the nonregulated companies receive from their association with the regulated operating companies. Second, they used stale data for the allocation factors and failed to allocate costs to newly formed companies. Third, the financial factor contains inappropriate components. (TR 1610)

The first deficiency, the failure to consider the significant benefits the nonregulated subsidiaries of Southern Company receive from their associated with the regulated operations, is a serious omission. These benefits include the operating companies' reputation, goodwill, and corporate image; being associated with large, financially strong, well-entrenched electric companies; and using the personnel of the service company. (TR 1612-13) Recently Fitch Ratings affirmed the high credit rating for all of the subsidiaries of Southern Company, indicating that it was due in no small part to the benefits the "solid" regulated operating companies provide to Southern Company in the "form of dividends for the payment of corporate expenses, debt-service, and for other business matters." (TR 1613) The nonregulated affiliates obtain these substantial intangible benefits at no cost—which would clearly not be the case in an unregulated competitive market.

The second problem, Gulf Power's use of allocation factors based upon 2009 data to allocate projected 2012 expenses, is a mismatch between the test year data and the allocation of costs. The data upon which the allocation factors are based are three years behind the dollar values being allocated. Gulf's use of outdated allocation factors is unacceptable. Given the magnitude of the dollars that are being allocated, a minor change in the allocation factors can have a meaningful impact. For example, if the financial allocator, which is used to allocate a number of common administrative and general expenses, was modified for Gulf Power by one percent, this would translate into a reduction in test year expenses of $1 million. (TR 1614)

Gulf's use of the 2009 allocation factors did not consider that Southern Renewable Energy was formed in 2010 to construct, acquire, own and manage renewable generation. Not only are the SCS overhead costs not allocated to Southern Renewable Energy, but other costs allocated on the basis of MWs were not assigned to this company for the projected test year. Both of these factors overstate the costs included in the Company's projected 2012 test year expenses because the Company used 2009 data to allocate projected 2012 test year expenses.

The Company stated the information was not available to update the allocation factors for 2010 prior to filing its rate case. (EX 113, Interrogatory 43) The Commission should reject this claim, as this information would have been available on or before April 2011—three to five months before the Company filed its rate case in July 2011. (TR 1644-1645) In rebuttal, the Company stated that updating the fixed allocation factors for 2010 would increase Gulf Power's share of SCS billings by $1.26 million. (TR 2348) The Commission should also reject this claim, as this complex information should have been submitted at the time the Company filed its rate case so that it could have been thoroughly evaluated. The allocation factors used by the Company are numerous and complex. There is simply no way this last minute information can be subjected to the appropriate scrutiny it would have received had it been provided at the outset of the rate case. The Commission must reject the Company's last ditch effort to resolve a problem that should have been presented in its direct case. The parties' due process rights would be violated if the Commission were to accept the Company's eleventh hour calculations. Over $41 million dollars were allocated using these allegedly "updated" allocation factors (EX 47), thus to deny OPC and the other parties the ability to thoroughly examine this data prior to adoption by the Commission would be unfair and unreasonable.

The third problem with the Company's allocations relates to the financial factor. Gulf Power uses the financial factor to allocate many administrative and general expenses. This factor consists of the average of net fixed assets, operating expenses, and operating revenue. Including revenue in the allocation factor presents many problems, the first of which is overstating the allocations to regulated companies and understating the allocations to nonregulated companies. Also, a revenue allocation factor tends to under allocate costs to new nonregulated companies, which generally produce little revenue relative to the level of effort and management activities focused on these new ventures. Similarly, a revenue allocator tends to over allocate costs to companies that are more capital intensive because they need to generate more revenue to produce the same return on investment as a less capital intensive company. In addition, the revenue factor is biased in favor of the nonregulated companies. One example of this bias compares the revenues per kWh for Gulf compared to those of Southern Power, which sells its power at the lower wholesale level and may not be indicative of the benefits or the level of service provided by SCS to Southern Power. Additionally, including a revenue allocation factor tends to under allocate costs to new non-regulated companies. New start-up companies produce little revenue relative to the level of effort and management activities focused on these new ventures, while revenue allocators tend to over allocate costs to capital-intensive companies because they need to generate more revenue to produce the same return on investment than less capital-intensive companies. Moreover, using a revenue allocator will automatically increase the allocation of SCS expenses to Gulf Power (and its sister operating companies) with the implementation of a rate increase, despite the fact that there has been no change in Gulf Power's operations or the effort required by SCS to provide services to Gulf Power. There is no logic to this result, and it obviously demonstrates that the use of a revenue component in the allocation factor is improper. Allocation factors should be based upon cost-causative relationships to the extent possible and also recognize the benefits received from the service provided. (TR 1613-1614)

In addition, the expense portion of the financial factor incorrectly includes fuel and purchased power expenses. Inclusion of fuel and purchased power is obviously inappropriate as these costs have no relationship to the Administrative and General functions performed by SCS and allocated with the financial factor. Including these expenses over allocates costs to the regulated operating companies and under allocates the costs to the nonregulated companies because the nonregulated companies do not incur expenses for fuel and purchased power.

The Commission should adopt OPC's recommendations to correct the effect of inherent biases present in Gulf Power's allocation factors. This recommendation would reduce test year expenses by $832,284.

Issue 52: **Should the Commission remove costs from the 2012 test year for costs associated with SouthernLINC?**

Yes. Southern charges all affiliates for the total SouthernLINC charges that are not able to be recovered through commercial revenues. In 2012, the charges to Gulf Power are projected to increase because of the "larger than anticipated drop in commercial customer revenue." SouthernLINC is an unregulated affiliate. Its losses should not be subsidized by Gulf Power's ratepayers. The Commission should remove $294,765 from the test year expenses. See OPC's position on the capital component in Issue 17.

ARGUMENT

Yes. The Commission should remove $294,765 from the test year expenses for the reasons set forth in OPC's position on the capital component in Issue 17.

Issue 55: **Did Gulf adequately document and justify the costs associated with Work Orders 46EZBL, 46IDMU, 46LRBL, 47VSES, 47VSTB, 47VSTH, 47VSZ1, and 47VSZ5? If not, should the costs related to these work orders be removed from operating expenses?**

No. Because Gulf Power did not justify including the costs of these work orders, the Commission should reduce test year costs by $186,780. Gulf was unable to provide several of the requested Work Orders, which show the purpose of the work order, the method used to allocate costs, and the client company.

ARGUMENT

OPC requested that Gulf provide additional supporting documentation for selected work orders included in the test year. Gulf was unable to provide several work orders showing the purpose, the method used to allocate costs, and the client company. OPC witness Dismukes recommended that the Commission disallow all of the expenses associated with the above work orders totaling $190,945 since Gulf did not meet its burden. Without supporting the need of these services, test year expenses should be reduced by $186,780. (TR 1632-1633) Gulf witness McMillan stated that while Gulf could not provide the actual work orders, company descriptions and spreadsheet explanations should be sufficient. (TR 2348-2349) Clearly, support documentation is necessary to satisfy Gulf's burden of proof; therefore, Ms. Dismukes' adjustments should be made.

<u>Issue 56</u>: **Should the costs related to Work Order 471701, associated with a Securities and Exchange Commission inquiry, be removed from operating expenses?**

Yes. Looking at this accounting-comptroller work order, it is not clear what service is being provided to Gulf and its customers or if the description remains valid today. In the absence of supporting documentation showing that the costs booked benefit Gulf and its customers, test year expenses should be reduced by $116,841.

ARGUMENT

According to the description, this work order relates to costs associated with a SEC inquiry of the Southern Electric System initiated in 1989. OPC witness Dismukes testified that it is not clear from the work order what service is being provided to Gulf and its customers or if the description remains valid. In the absence of supporting documentation showing that the costs booked benefit Gulf and its customers, test year expenses should be reduced by $116,841. (TR 1633) Gulf witness McMillan's rebuttal regarding this item was vague and insufficient. (TR 2349) Reading his explanation of how Gulf used an outdated form for various special projects, including Enterprise Solutions transition and implementation, leads one to need further information in order to understand the type of costs being charged and, more importantly, how ratepayers benefited from these costs.

<u>Issue 57</u>: **Should the Commission adjust operating expenses for the costs related to Work Order 473401, related to a benefit's review that does not appear to occur annually?**

Yes. This 2011 work order relates to consulting funds for an outside benefits review which apparently was increased because it did not occur annually. Because the review will not reoccur annually, the cost should be amortized over two years. The corresponding adjustment is a reduction of $18,067 to test year expenses.

ARGUMENT

The description for the increase in this 2011 Work Order 473401 relative to Southern Company Human Resources Management indicates that it relates to consulting funds for an outside benefits review. OPC witness Dismukes testified that Gulf's reason for the budget increase relative to 2011 suggests that this benefits review does not occur on an annual basis. This expense should be amortized over two years and $18,067 should be removed from the test year. (TR 1634-1634) Gulf witness McMillan admitted that this benefits review takes place every other year, but he added that other reviews are conducted on a recurring basis or an as-needed basis through the years. (TR 2350) Missing from his analysis is an identification of the costs that are included in the test year for benefits reviews. For this reason, his argument fails.

<u>Issue 59</u>: **Should the costs related to Work Order 4Q51RC and a formerly CWIP classified Work Order 4QPA01, be removed from operating expenses?**

Yes. There is no evidence that these items should be expensed rather than capitalized, and also no evidence they are recurring in nature. Test year expenses should be reduced by $20,102 and $102,411, respectively.

ARGUMENT

Gulf's explanation for these work orders stated that the expense increase from the 2011 to 2012 budgets was due to moving a formerly capitalized item for Work Order 4Q51RC and a formerly CWIP classified Work Order 4QPA01 to expense. Ms. Dismukes testified that Gulf failed to demonstrate these costs should be expensed as opposed to capitalized, and did not provide any evidence that the costs are recurring in nature and properly included in test year expenses. She recommended that the Commission reject these proposed reclassifications and reduce test year expenses by $20,102 and $102,411, respectively for these two items. (TR 1634-1635) Gulf witness

McMillan addresses both of these work orders in his rebuttal; however, he failed to provide any documentation to address the concerns addressed by Ms. Dismukes. (TR 2352) Ms. Dismukes' adjustments should be approved in light of Gulf's lack of supporting documentation.

Issue 60: **Should operating expenses be adjusted to remove public relations expenses charged by SCS?**

Yes. The Commission typically disallows expenses that are public relations oriented and image-enhancing, finding that they benefit stockholders, not customers. Gulf Power failed to demonstrate that such expenses benefit customers. Based on past Commission precedent, test year expenses should be reduced by $17,482.

ARGUMENT

When considering utilities' requests to include membership dues, image building advertising, legislative or lobbying expenses, and contributions in a utility's test year expenses that are public relations-oriented, the Commission typically determines these types of expenses should be disallowed.[16] These costs serve to improve the image of the company, resulting in a direct benefit to the utility's shareholders, not to the customers. The Commission also ordered that image-enhancing advertising expenses be removed in Gulf Power's last rate case.[17] OPC witness Dismukes testified that based upon past precedent, the Commission should continue its policy and remove these expenses from the test year. (TR 1635-1636) Gulf witness McMillan testified that these public relations costs were not image building; however, he provided no documentation to this effect to support his testimony. (TR 2351) It is the company's burden to justify that its costs are reasonable and are not image-enhancing. Ms. Dismukes' adjustment should be approved.

[16] See Order No. PSC-97-0618-FOF-WS, issued May 30, 1997, in Docket No. 960451-WS, for United Water Florida Inc.; Order No. PSC-93-0301-FOF-WS at 19- 20; Order No. PSC 96-1320-FOF-WS at 151-153; and Order No. PSC-96-1320-FOF-WS, issued October 30, 1996, in Docket No. 950495-WS for Southern States Utilities, Inc.
[17] Order No. PSC-02-0787-A FOF-EI, issued June 10, 2002, in Docket No. 010949-EI for Gulf Power Company.

<u>Issue 61</u>: Should operating expenses be adjusted to remove legal expenses in Work Orders 473ECO and 473ECS charged by SCS?

Yes. These work orders relate to Chief Operating Officer legal expenses and External Affairs legal matters. Gulf has not demonstrated that the costs charged to these two accounts benefit ratepayers. Test year expenses should be reduced by $33,690.

ARGUMENT

OPC witness Dismukes testified that these work orders related to the Chief Operating Officer legal expenses and External Affairs legal matters, and that they do not benefit ratepayers. She recommended that, unless the Company could demonstrate how these expenses benefit ratepayers, they should be excluded from test year expenses. As shown on Schedule KHD-12 they amount to $33,690. (TR 1637; EX 50) Gulf witness McMillan testified that these functions provide services and are budgeted to Gulf, and included only a vague description of how these functions benefit ratepayers. (TR 2350) With this explanation, Gulf has not met its burden to demonstrate the prudence of these costs and how ratepayers benefit.

<u>Issue 62</u>: Should operating expenses be adjusted to remove aircraft expenses in Work Order 486030 charged by SCS?

This issue is subject to a stipulation and agreement to be considered by the Commission on January 10, 2012.

<u>Issue 63</u>: Should any adjustments be made to expenses related to use of corporate leased aircraft?

This issue is subject to a stipulation and agreement to be considered by the Commission on January 10, 2012.

<u>Issue 64</u>: Should operating expenses be adjusted to remove investor relations expenses related to Work Order 471501 charged by SCS?

Yes. Consistent with prior Commission practice, test year operating expenses should be reduced by $96,851 to remove the costs of shareholder services, which benefit stockholders, not ratepayers.

ARGUMENT

Consistent with prior Commission practice, the costs of shareholder services should be moved below-the-line for ratemaking purposes.[18] These services benefit stockholders, not ratepayers, and companies are compensated for these costs through the rate of return on equity. (TR 1637) The Commission should continue its practice and remove these expenses in the amount of $96,851 from the test year.

<u>Issue 66</u>: Should interest on deferred compensation be included in operating expenses?

No. Gulf has projected interest expense with an estimated 2012 prime rate of 6.78% on deferred compensation presumably for executives or senior level employees. Gulf has not documented or justified why interest is being paid, how the deferred compensation amounts resulted, or why such a high rate of interest should be passed on to Gulf's ratepayers. Test year expenses should be reduced by $362,309 ($355,059 jurisdictional).

ARGUMENT

Gulf's ratepayers should not pay for the interest cost of the deferred compensation program which benefits a limited number of upper management employees. Gulf has provided no compelling evidence explaining how deferring compensation for executives benefits the Florida ratepayers. (TR 2001-03; 2035-36) It is an executive perquisite and an unnecessary luxury in these trying economic times; if continued by Gulf, the interest on deferred compensation should be funded by the shareholders. Therefore, OPC recommends that test year expenses should be reduced by $362,309 ($355,059 jurisdictional). (TR 1481)

<u>Issue 67</u>: Should SCS Early Retirement Costs be included in operating expenses?

No. Gulf neither explained nor supported what the "SCS Early Retirement" accrual was for or why it should be passed on to Gulf's ratepayers. Test year expenses should be reduced by $50,340.

ARGUMENT

Gulf advocates that Gulf ratepayers should pay for costs associated with early retirement benefits provided to a group of Southern Company Services employees who have not worked for Southern Company Services since the 1980s and 1990s. (TR 2007; 2036-37) Gulf witness Kilcoyne

[18] See Order No. PSC-96-1320-FOF-WS, issued October 30,1996, in Docket No. 950495-WS for Southern States Utilities, Inc.

could provide no explanation of how current Gulf ratepayers benefit from these retired SCS employees. Instead, she said "this is just a cost of doing business. . . ." (TR 2037) Because it is doubtful that Gulf ratepayers received any benefit from these SCS employees who retired in the 1980s and 1990s, and the current ratepayers certainly receive no benefit, the Commission should disallow the costs associated with these retirement benefits and reduce test year expenses by $50,340. (TR 1481)

Issue 69: **Are Gulf's proposed increases to average salaries for Gulf appropriate?**

No. See OPC's position on Issue 70.

Issue 70: **Are Gulf's proposed increases in employee positions for Gulf appropriate?**

* No. Gulf projected 159 additional employees (a 12% increase) between year ended December 31, 2010 and beginning of the 2012 test year. Since its last rate case, Gulf's vacancy rate has consistently ranged from 5.08% to 6.10% below budget. For the 6-month period ended June 30, 2011, Gulf's average employee complement was 9.81% below budget. It is unrealistic and unreasonable to assume that Gulf will fill 100% of its budgeted employee positions by January 2012 or that Gulf will maintain a 0% vacancy factor throughout the entire test year. Using the employee count as of June 30, 2011, Gulf's total employee count should be limited to 1,398 employees in the test year. Gulf's expenses should be reduced by $3,195,627. *

ARGUMENT

Gulf projected 159 additional employees (a 12% increase) between year ended December 31, 2010 and the January 1, 2012 beginning of the test year. (TR 1464) This results in a projected 2012 base payroll costs increase of $4,387,786. (TR 1464-65) Overall O&M expenses, after removal of clauses, were increased by $6,120,261 related to the new employees once the related bonuses and employee benefits are also considered. (TR 1465) Gulf assumed a zero employee vacancy rate for the entire 2012 test year. (TR 1465) Since its last rate case, in the past nine years Gulf's vacancy rate has consistently been below budget and by a range of 5.08% to 6.10%. (TR 1466) For the 6-month period ended June 30, 2011, Gulf's average employee complement was 9.81% below budget. As of June 30, 2011, Gulf had increased its number of employees by 33, but was still 124 employees below budget. (TR 1466) It is unrealistic and unreasonable to assume that Gulf will fill 100% of its budgeted employee positions by January 2012 or that Gulf will maintain a 0% vacancy factor throughout the entire test year. (TR 1468) Using the historical average percentage by which Gulf's actual employee compliment has been below the budgeted level, Gulf's employee increase should be reduced by 91 positions, allowing 68 additional positions, or 42.8% of its request, which results in 1,398 employees in the test year. (TR 1468) This allows for more employees than actually were on-hand as of June 30, 2011, thereby allowing for additional employee growth above and beyond actual levels. (TR 1469)

In rebuttal, Gulf witnesses updated the number of employees hired since June 30, 2011. At the hearing, Gulf updated the numbers of full-time equivalents (FTEs) hired as of December 12, 2011 for Production, Transmission, and Distribution. EX 217. This exhibit shows the test year FTEs, revised 2012 FTE budget, actual FTE hires, and outstanding offers for employment. (TR 2435-37; EX 217) This exhibit, while partially incomplete, serves as a proxy for the entire Gulf employee complement. According to this exhibit, Gulf has not filled all the test year budgeted positions, clearly showing that a zero employee vacancy rate is unrealistic. In at least these three employee categories, Gulf's vacancy rate is 4.43% when comparing "to date" FTEs with the number budgeted for the test year. While Gulf has narrowed the vacancy gap between June 30, 2011 and December 12, 2011, Gulf's vacancy rate is indicative of Gulf habitually being under its budgeted FTE amounts. Further, it is reasonable to assume that the vacancy factor in these and other employee categories will fluctuate and potentially increase throughout the test year. Therefore, despite the apparent narrowing of the vacancy gap in Production, Transmission, and Distribution, OPC recommends that Gulf's expenses should be reduced by $3,195,627, which removes the base payroll, medical and other group insurance costs, and employee savings plan costs associated with the disallowed portion of the complement. (TR 1469)

OPC's recommendation provides for a significant increase above historical employee levels and a level higher than the current employee complement.[19]

Issue 71: **How much, if any, of Gulf's proposed Incentive Compensation expenses should be included in operating expenses?**

Test Year expenses include $12,623,632 for incentive compensation plans, all of which should be removed and funded by shareholders. The Stock Option Expense, Performance Share Program, and Performance Dividend Program focus on shareholder return goals and are provided to upper level employees only. The Performance Pay Program ("PPP") is weighted 2/3 on shareholder financial benefits and 1/3 on operational goals. The PPP target awards range from 5% to 60% of base pay, depending on the employee's pay grade. No PPP awards are given unless Southern's earnings per share ("EPS") exceed the prior year's dividends, clearly a shareholder only benefit. Test year costs should be reduced an additional $2,259,624 to remove the stock based compensation allocated to Gulf by SCS.

ARGUMENT

OPC supports an adjustment to remove all incentive compensation identified by OPC witness Ramas from rate base and operating expenses. The incentive compensation offered by Gulf is geared first and foremost to achieving shareholder financial goals, and should be borne by the shareholders. (TR 1508, 1520) Gulf asserts that the cost for all incentive compensation, which Gulf characterizes as "at-risk" compensation, should borne by the ratepayers. (TR 1983) Gulf attempts to argue that achieving shareholder goals for rate of return and earnings per share somehow benefits the ratepayer. (TR 1987) Because of the emphasis on shareholder goals and benefits, OPC witness Ramas testified that the projected test year incentive compensation should not be capitalized to rate base and should instead be funded by the shareholders. (TR 1469-81) Contrary to the mischaracterization of Gulf witness Kilcoyne, OPC witness Ramas is not arguing that incentive compensation should be eliminated. (TR 2013-14) As OPC witness Ramas indicates in her testimony, because the majority of

[19] Regarding the variance in FTEs for the Production 2012 test year and 2012 current budget shown on Exhibit 217, in rebuttal testimony witness Groves indicated that Gulf shifted 10 positions in the test year from being FTEs to contract labor. (TR 2457-58) Groves asserted that Gulf still plans to expend those dollars. (TR 2458) However, there is no guarantee that Gulf will continue funding the contract labor positions into the future, or that employing contract labor would cost as much as hiring internal employees and full benefits to those employees.

the goals for Gulf's incentive compensation programs align with and benefit the shareholders of the parent company, the shareholder, not the ratepayer, should absorb those costs. (TR 1469-81)

Incentive Compensation Programs

According to the record, Gulf offers five separate incentive compensation programs – Performance Pay Program, Stock Option Expense, Performance Share Program, Performance Dividend Program, and Cash/Spot Awards – which total $16,464,470. (TR 1470) The Cash/Spot Awards program is not at issue in this rate case. Instead, it is the remaining long-term and short-term incentive compensation programs which should be funded by the shareholder for the reasons described below.

Gulf's long-term incentive programs

Gulf has three long-term incentive compensation programs – Stock Option Expense, Performance Share Program, and Performance Dividend Program. (TR 1999) These programs are available only to management level employees in salary grades of seven and above. Non-exempt employees, exempt employees in salary grades six and below, and bargaining unit employees are not permitted to participate in these programs. (TR 1472-74; 1999) Of Gulf's 1,379 employees, only 119 (or less than 10 percent) are eligible to participate in these three long-term incentive compensation programs. (EX 160, Sch. 1) As described in OPC witness Ramas' testimony, Gulf's Stock Option Program focuses on increasing Southern Company's common stock price. (TR 1472-73) Gulf's Performance Share Program and Performance Dividend Program (which is being phased out in favor of the Performance Share Program) both focus on total shareholder returns for Southern Company as compared to industry peers. (TR 1472-74) These three programs focus on achieving long-term financial goals for Southern Company and are clearly aligned with, and designed to meet, Southern

Company shareholder goals and expectations. None of these programs set forth any long-term operational goals for Gulf, which could conceivably benefit Gulf's ratepayers.

Gulf witness Kilcoyne, responsible for rebutting OPC witness Ramas' recommendation to disallow incentive compensation programs, did not explain or describe how Gulf's long-term incentive programs benefit Gulf's customers or help achieve operational goals. Her testimony is silent on this subject. (TR 1979-2008) Even during cross examination, witness Kilcoyne did not explain how long-term incentive compensation programs benefit the ratepayer or achieve operational goals. (TR 2012-2058) Because Gulf failed to provide a nexus between long-term shareholder financial goals (increasing Southern Company stock price and shareholder returns) and ratepayer benefits (better customer service or achieving operational goals), Gulf's long-term incentive programs should be disallowed from the test year. These three long-term incentive programs should be funded by the shareholders, as they are clearly designed to serve shareholder goals without any consideration for ratepayer benefits.

These three programs are designed to encourage a very limited number of senior level employees to strive to increase the stock price of Southern Company over a long period of time. Since these goals align with that of the shareholder, they should be funded by the shareholder. OPC is not arguing that these programs be discontinued, only that the ratepayer should not pay for a program that is unaligned with the ratepayer's interests.

<u>Gulf's short-term incentive program</u>

The lion's share ($13.6 million of $16.5 million) of Gulf's incentive compensation is short-term and governed by Gulf's Performance Pay Program ("PPP"). (TR 1474, 1999) Nearly all Gulf employees participate in the PPP. (TR 1474) The amount of incentive pay (Target Award) an employee can earn depends upon his/her employee category. The Target Award for bargaining-unit (union) employees is five percent of base pay; that for non-exempt employees is ten percent of base pay; the corresponding amount for exempt employees salary grades 1 to 5 is ten percent of base pay; salary grade 6 employees may receive 12.5 percent of base pay; and for management employees, salary grades 7 to 15, the Target Award ranges from 25 to 60 percent of base pay. (TR 1475)

The PPP program focuses on achieving three equally weighted goals – Southern Company Earnings per Share (EPS), Gulf's Return on Equity (ROE), and Gulf Operational Goals. (TR 1475; 1999) The first two PPP goals are financial goals; the third goal is based on the employees' business units' operational goals. (TR 1475) Prior to consideration of these three goals, Southern Company's EPS must exceed the prior year's dividends. If this initial trigger is not met, there will be no payouts under the PPP program. (TR 1475, 1988) Notwithstanding that two-thirds of the PPP goals are directly tied to achieving financial goals (directly benefiting the Southern Company shareholder), and that Southern Company's earnings must achieve a certain level prior to any payouts being made, Gulf believes that the ratepayers should pay for 100 percent of the PPP incentive compensation.

The PPP program goals, being first triggered by a Southern Company EPS financial goal and then weighted two-thirds in favor of financial goals, fail to align Gulf management's financial interests with the ratepayer's interests. As noted in testimony, Gulf management level employees (grades 7 and above) have the most incentive pay at risk if the PPP goals are not achieved. The total compensation amount for management is more dependent than other employees on overall company performance. (TR 1475, 1983, 2038) OPC asserts that overall company performance is tied two-thirds to financial goals and one-third to operational goals. By designing the PPP program to emphasize company financial goals, Gulf has possibly created an incentive to management level employees to focus on achieving the financial goals of the company without sufficient incentives to maintain a proper focus upon achieving operational goals. (TR 1477) If PPP goals are weighted two-thirds towards achieving the financial goals, then naturally Gulf management employees, especially those in upper management, would focus most of their time and efforts achieving those financial goals. While lower level management may supervise the operational employees (employees grade 6 and below), much of the effort at achieving the PPP operational goals naturally falls to operational employees working below the level of management. It should be noted that the operational employees do not have nearly as much incentive compensation at risk as do the management level employees.[20] Whereas individual management decisions by Gulf upper management can affect the overall ROE of Gulf and possibly Southern Company EPS, the individual decisions of non-management operational employees do not have that great of an individual effect on achieving financial goals.

It is unquestioned that attaining the financial goals set forth by the PPP can directly lead to a stronger financial position for Gulf and Southern Company. This effort directly benefits the shareholder. The converse is not necessarily true for the ratepayer. Attaining financial goals, notwithstanding the testimony of Gulf witnesses Kilcoyne and Teel, may only indirectly benefit the ratepayer assuming Gulf can also obtain a lower cost of debt or capital based upon the company's strong financial position. (TR 1987) Achieving operational goals is not the main emphasis of the PPP program. (TR 1477)

Further, almost all of Gulf's incentive compensation program goals are designed to benefit shareholders notwithstanding the current state of the economy. For instance, if the Southern Company does not meet its financial performance trigger, i.e., earnings per share exceeds prior year dividends, the incentive compensation payments can be eliminated while the revenues paid by ratepayers for those incentive compensation programs are retained by Gulf and not returned to the ratepayers. (TR 2028, 2043) Similarly, if the shareholder-oriented financial targets of the PPP program (Southern Company's EPS target and Gulf's rate of return on equity target) are not met, then the incentive

[20] Operational employees have only five to ten percent of their pay at risk if the goals are not achieved.

compensation payments can be reduced while the revenue paid by ratepayers for those incentive compensation programs are retained and not returned to the ratepayers. (TR 2026-29; 2043) If Gulf exceeds its financial target goals, Southern Company shareholders will receive the financial benefits of exceeding financial targets, the Gulf employees will receive PPP payouts, but the ratepayers will not receive anything. In fact, in determining the amount of incentive compensation expense to include in the case for the PPP, Gulf assumed that Southern Company would achieve its EPS goal and Gulf would exceed its return on equity target in the test year. (TR 1478-79)

With the notable exception of 2009 when Southern Company EPS targets were not met due to the Great Recession, Gulf has consistently paid PPP compensation to its employees at or above 100% target pay. (TR 2043) By making the PPP targets too low and too easy to achieve, it appears that Gulf's short-term incentive compensation program may not actually "incent" the exceptional behavior Gulf is seeking to achieve. (TR 1479)

Who should pay for incentive compensation

While OPC is advocating that the Southern Company shareholders pay for the long-term incentive programs and the short-term PPP incentive compensation program, OPC is not advocating that incentive compensation be reduced or eliminated, as charged by Gulf. Gulf witness Kilcoyne spent numerous pages mischaracterizing the testimony of OPC witness Ramas, implying that OPC is advocating a pay reduction for hard working Gulf employees. (TR 1981-2001) This is simply not true. When Gulf witness Kilcoyne was asked to point out where in OPC witness Ramas' testimony Ramas advocated the reduction or elimination of incentive compensation, Kilcoyne admitted she could not. (TR 2013-14) Nowhere in the testimony of OPC witness Ramas did she advocate that Gulf should stop paying incentive compensation. When asked if Gulf or Southern Company would terminate the various incentive compensation programs should the Commission disallow them for ratemaking purposes, Gulf witness Kilcoyne avoided the question and testified that she did not know. (TR 2015-16) There is no testimony or record evidence that Gulf will eliminate its incentive compensation program should the Commission require those costs be properly borne by the shareholders.

Gulf witness Kilcoyne also stated Gulf would have difficulty attracting and retaining quality employees if incentive compensation was eliminated. (TR 1984) That might be true if Gulf eliminated incentive compensation; however, as previously stated there is no testimony or record evidence that Gulf will eliminate its incentive compensation program should the Commission require those costs be borne by the shareholder.

When asked how requiring the shareholders to pay for incentive compensation would impede Gulf's ability to attract and retain quality employees, witness Kilcoyne avoided the question. (TR 2018) When asked how requiring the shareholders to fund the incentive compensation programs would reduce the pay of these employees, witness Kilcoyne again avoided directly answering the question. (TR 2020) A number of witness Kilcoyne's responses were evasive and thus should be given no weight. Regardless, the fact remains, Gulf did not testify that it would affirmatively eliminate its incentive compensation programs should the burden of paying for them be shifted to the shareholders.

Moreover, achieving shareholder financial goals could provide the funding for incentive compensation. OPC witness Ramas testified that the PPP assumptions used to project the test year incentive compensation costs assumed that Gulf would achieve its financial goals by 125% of target level. (TR 1478-79) If Gulf achieves 125% of financial goals, then Gulf can fund its incentive compensation programs through its excellence in achieving its financial goals because shareholder earnings in excess of the target would provide additional earnings to shareholders that could be used for funding the programs.

Commission precedent regarding incentive compensation

In the last three electric investor-owned utility rate cases – Tampa Electric Company (TECO), Florida Power & Light (FPL), and Progress Energy Florida (PEF) – the Commission denied some or all of the incentive compensation requested by the companies. In each of the decisions, the Commission looked for a nexus between the incentive compensation goals and ratepayer benefits. In the TECO decision, the Commission partially disallowed incentive compensation finding "incentive compensation should be directly tied to the results of TECO and not to the diversified interest of its parent Company TECO Energy."[21]

In this case, all of the long-term incentive compensation programs are tied directly to the interests of the parent company; there is no hint of benefiting the ratepayers in these programs. Two-thirds of the short-term incentive compensation PPP goals are directly and indirectly tied to the interests of the parent company: the EPS component is expressly contingent on the earnings of Southern Company and the ROE component, while tied to Gulf, also indirectly advances the interest of the parent company. The operational goals component of the PPP program serves the interests of the shareholders and its ratepayers equally, in that both benefit when the employees achieve the operational goals. There is no testimony in the record that states the ratepayers benefit more than the shareholders regarding operational goals; however, a nexus between the operational goals and ratepayer benefits can be found.

In the PEF decision, the Commission held "that incentive compensation tied to EPS should not be passed on to ratepayers."[22] If this standard is applied to the Gulf case, it would require the EPS component of the PPP incentive compensation to be disallowed. The Commission further held "[t]he utility has the burden of proof to show that recovery for [its incentive compensation] plans is

[21] Order No. PSC-09-0283-FOF-EI, issued April 30, 2009, in Docket No. 080317-EI, at 58.
[22] Order No. PSC-10-0131-FOF-EI, issued March 5, 2010, in Docket No. 090079-EI, et al., at 114.

appropriate in this case."[23] The burden of proof appears to require a utility to show a nexus between the incentive compensation and it benefiting the ratepayers. In this case, Gulf has not demonstrated a nexus between the PPP plan's EPS goals or ROE goals and ratepayer benefits. With regards to operational goals, while Gulf presumes ratepayer benefits, it has not supplied any demonstrable evidence of such a nexus. Additionally, even if the operational goals are met, there will be zero payout under the plan if Southern Company's earnings per share do not first exceed the prior year's dividends to shareholders. (TR 2026)

In denying PEF's requested incentive compensation, the Commission determined that PEF's incentive compensation provided no benefit to the ratepayers (i.e., no nexus between the incentive compensation and ratepayer benefits).[24] Similarly, since Gulf has failed to affirmatively demonstrate a nexus between the PPP incentive plan and ratepayer benefits, the requested incentive compensation should be disallowed in its entirety. Alternatively, since one-half of the operational goals could benefit the ratepayer, then five-sixths of the PPP incentive compensation should be disallowed (that is one third EPS, one-third ROE, and one-half of the operational goals weighted at one-third (or one-sixth)).

In previous decisions, the Commission also considered the economic climate when it determined whether PEF should pay the entire cost of incentive compensation.[25] The economic climate of Florida does not appear to have improved measurably or returned to pre-Great Recession levels. Further compounding this situation is the ongoing economic impact of the 2010 BP Oil Spill in Gulf's service territory. (TR 1478) Therefore, when considering whether to allow incentive compensation, the Commission can and should consider the current economic climate. (TR 1478) (It

[23] Order No. PSC-10-0131-FOF-EI, issued March 5, 2010, in Docket No. 090079-EI, et al., at 115.
[24] Order No. PSC-10-0131-FOF-EI, issued March 5, 2010, in Docket No. 090079-EI, et al., at 115. The Commission staff recommended that PEF's proposed 2010 allowance for incentive compensation be reduced by $22,181,891 jurisdictional, but the Commission ultimately decided to reduce it by $32,854,378 jurisdictional.
[25] Order No. PSC-10-0131-FOF-EI, issued March 5, 2010, in Docket No. 090079-EI, et al., at 115.

is worth noting that during the Great Recession, Gulf's rate of return on equity, as measured under its PPP plan, was 12.66% in 2008, 12.18% in 2009 and 11.69% in 2010. The return on equity targets for each of those years under the PPP was 13.25%, 12.70%, and 11.90%, respectively.) (TR 1476)

In its FPL decision, the Commission found that FPL's executive incentive compensation was designed to benefit the value of shares and that incentive compensation payments effectively became base salary because FPL consistently achieved 30 to 40 percent above baseline year after year.[26] As a result, the Commission reduced the executive incentive compensation borne by customers.[27] In this case, Gulf's long-term incentive compensation programs are open only to management level employees and are designed to benefit the value of Southern Company shares. Therefore, to be consistent with the FPL decision, the cost of the long-term incentive compensation programs should be borne by the shareholders who directly benefit from increased stock price.

Consistent with its past decisions, the Commission should determine whether Gulf carried its burden to prove its request for ratepayer paid incentive compensation, whether there is a nexus between the goals of the incentive compensation program and ratepayer benefits, whether incentive compensation goals are set too low, and whether the ratepayer is still struggling with the effects of the Great Recession and the BP Oil Spill. Where those incentive compensation arrangements and ratepayer benefits clearly align, ratepayers should pay for that proportionate share of incentive compensation. However, where the goals of the incentive compensation clearly favor stock price, company earnings, and the shareholder over and above (and to the possible detriment of) the ratepayer, that proportional share of the incentive compensation should be disallowed for ratemaking purposes and all incentive compensation should be funded exclusively by the shareholders.

[26] Order No. PSC-10-0153-FOF-EI, issued March 17, 2010, in Docket No. 080677-EI, et. al., at 149-50.
[27] Order No. PSC-10-0153-FOF-EI, issued March 17, 2010, in Docket No. 080677-EI, et. al., at 149.

It is the position of OPC that both long-term and short-term incentive compensation programs should be disallowed for ratemaking purposes. The long-term incentive compensation programs should be disallowed in its entirety because the goals are designed solely to increase stock price. The short-term PPP incentive compensation program should be disallowed because the goals are consistently set too low and are predominantly focused on achieving shareholder financial goals. At a minimum, the shareholder financial goals, which constitute two-thirds of the short-term PPP incentive compensation program's focus, should be disallowed because those targets are completely aligned with achieving shareholder financial goals. As for operational goals, which constitute one-third of the PPP program, the ratepayer and shareholder have equal interest in achieving those operational goals because both benefit from a well run utility. However, due to the PPP plan's over-emphasis on achieving financial goals including the initial EPS trigger point, those persons with the most incentive compensation at risk (management and above) may tend to focus on the financial goals over and above and to the possible exclusion of the operational goals. For these reasons, the entire cost of the short-term PPP incentive compensation should be borne by the shareholder.

Allocated SCS Stock Based Compensation Should be Disallowed

In addition to disallowing all Gulf employee incentive compensation, the Commission should also disallow the costs allocated to Gulf from SCS for Stock Based Compensation. Gulf provided no evidence explaining how allocating SCS Stock Based Compensation benefits the Florida ratepayers. There is nothing in the record that indicates a nexus between this allocated incentive compensation and ratepayer benefits. Test year costs include $2,259,624 allocated to Gulf by SCS for this incentive compensation. (EX 119, Interrogatory 282) Because no nexus exists, these costs should be removed and funded by shareholders.

Issue 72: **What is the appropriate allowance for employee benefit expense?**

OPC's recommended adjustments to employee benefits have been incorporated into our positions on Issues 66, 67, 68, 70 and 71.

Issue 74: **What is the appropriate amount of Gulf's requested level of Salaries and Employee Benefits for the 2012 projected test year? (Fallout Issue)**

See OPC's positions on issues 68 through 73.

Issue 76: **What is the appropriate amount of the accrual for storm damage for the 2012 projected test year?**

Gulf's requested increase in the annual accrual is excessive and unjustified based on the historical charges to the reserve, the storm standards established for Florida electric utilities, and the storm hardening measures implemented after 2005. Gulf's unreliable storm study included extraordinary storm repair costs which historically have been recovered by surcharge mechanisms. The annual storm accrual should be reduced to $600,000, which reflects a decrease to O&M expense of $6.2 million ($5,962,113 jurisdictional). The storm reserve has almost reached the specific target range that was previously authorized by the Commission and is sufficiently funded to cover ordinary storm costs that are likely to occur based on recent history excluding the extraordinary storm costs incurred in 2004-2005.

ARGUMENT

The appropriate storm damage accrual is $600,000 for the reasons set forth in Issue 27.

Issue 77: **Should an adjustment be made to remove Gulf's requested Director's & Officer's Liability Insurance expense?**

Consistent with recent Commission decisions, Directors and Officers liability insurance should be reduced by $59,384 or 50% of the identified 2012 projected test year expense ($58,196 jurisdictional). This expense protects shareholders from the decisions they made when they hired the Company's Board of Directors and the Board of Directors in turn hired the officers of the Company. The question is whether this cost that the Company has elected to incur as a business expense is for the benefit of shareholders and/or ratepayers. The benefit of this insurance clearly inures primarily to shareholders.

ARGUMENT

OPC witness Schultz testified that Directors and Officers (D&O) liability insurance is an expense that protects the shareholders from their decisions to hire the Gulf's Board of Directors, who in turn hire the Gulf officers who manage the company. (TR 1566-68) D&O liability insurance is not a mandatory expense, but an optional business expense which solely benefits the shareholders, Directors, and Officers from executive mismanagement. (TR 1566-67) The Commission's decisions on whether these insurance costs should be borne exclusively by the ratepayer have varied. In some cases, the ratepayers have been required to bear the entire burden of D&O liability insurance. (TR 1567) In other cases, the Commission disallowed the cost in its entirety. Recently, in the 2010 PEF rate case decision, the Commission split the cost 50/50 between the ratepayers and shareholders. (TR 1567)

In ratemaking, the cost should follow the benefit. (TR 1567) OPC witness Shultz testified that the benefits of D&O liability insurance inures to the shareholders because shareholders – not ratepayers – are the ones who initiate litigation related to decisions made by Directors and Officers of the company. (TR 1567-68) In keeping with the Commission's PEF decision, OPC witness Schultz recommended a 50/50 split of the costs between ratepayers and shareholders. (TR 1568)

In rebuttal, Gulf witness Deason disagreed with OPC witness Schultz's 50/50 split for the D&O liability insurance costs. (TR 2107) He testified the insurance is necessary to attract and retain knowledgeable, experienced, and capable Directors and Officers, as without such insurance, the *personal assets* of these individuals would not be shielded from expenses, settlements, or judgments arising from shareholder lawsuits. (TR 2108) Of course, if the executives do not mismanage the company, they would not be liable to the shareholders; as these executives need D&O liability insurance to protect themselves from the consequences of their own mismanagement, the cost of the insurance should not be borne by customers.

Gulf witness Deason cited the 2009 Tampa Electric and People's Gas rate cases in support of his assertion that " 'D&O liability insurance has become a necessary part of conducting business.' " (TR 2109) (citations omitted) In those cases, the Commission allowed full recovery of D&O liability insurance from the ratepayer. (TR 2109-10) However, he failed to point out that the 2010 PEF decision on which OPC witness Schultz relies for the 50/50 split was decided *after* the 2009 Tampa Electric and People's Gas rate cases. Commission precedent and policy in electric and gas rate cases on D&O liability insurance have shifted in favor of sharing the costs.

In the 2010 PEF rate case decision, the Commission found that ratepayers and shareholders benefit from D&O liability insurance and thus required a sharing of these costs. Order No. PSC-10-0131-FOF-EI at 99.[28] Notwithstanding this clear precedent in favor of sharing these D&O liability insurance costs, Gulf is now arguing that ratepayers should shoulder the entire burden of an expense that predominantly and almost exclusively benefits the shareholders.

For the reasons stated above, OPC asserts that the benefits of D&O liability insurance protect the shareholders, Directors, and Officers from their mistakes. OPC recognizes there is some value in providing D&O liability insurance to attract and retain quality Directors and Officers and that ratepayers indirectly benefit from good management because the company may have easier access to capital. While it may have become a cost of doing business, D&O liability insurance remains an executive perquisite and luxury that benefits the shareholders and the insured Directors and Officers from their mistakes. In other words, like incentive compensation, it is a cost of doing business that should be borne by shareholders. Based on past Commission precedent, it is clear that the Commission has the authority to disallow all or part of the D&O liability insurance expense. Therefore, while OPC recommends a 50/50 split of the D&O liability insurance costs in light of recent precedent, OPC would not oppose a total disallowance of D&O liability insurance.

__Issue 79__: **What is the appropriate amount of Gulf's tree trimming expense for the 2012 projected test year?**

*Gulf's projected $4.918 million for distribution tree trimming in 2012 should be reduced by $386,834 (jurisdictional) to reflect a level of $4,531,320. Subsequent to Docket No. 060198-EI (the storm

[28] In the 2010 FPL rate case, it appears that D&O liability insurance was not an issue. That can be taken one of two ways – either the parties did not raise D&O liability insurance as a separate issue, or if D&O liability insurance provided to FPL executives, then FPL shareholders pay for the cost of that expense.

hardening docket), Gulf has averaged $4.3 million of tree trimming expense. Limiting maintenance in previous years, for whatever reason, is no justification for passing the catch up costs on to ratepayers on a continuing basis. Gulf's increase in projected spending increase for the rate case should not be approved. An adjustment is required to reflect the level of spending the Company is actually performing in its attempt to comply with the Storm Hardening Requirements approved by the Commission in Docket No. 060198-EI.*

ARGUMENT

Tree trimming is an integral part of the storm hardening of the Company. The Company has requested $4.918 million for distribution tree trimming in 2012. The approved annual spending resulting from Docket No. 010949-EI was $4.7 million and this amount was approved in the storm hardening Docket No. 060198-EI. (TR 1558-1559) Company witness Moore states that the requested $4.918 million is now required to maintain the cycle transition. (TR 2468-2469)

The Company was allowed $4.7 million annually beginning in 2007 for tree trimming. Since the approved increase was granted the Company has averaged $4,293,262. Limiting maintenance in previous years should not be justification for increasing the expense going forward. (TR 1559) Historically, tree trimming costs have been lower than what the Company has requested in its filing. The Company may budget at a higher amount, but historical actual spending is a better reflection of what the Company has determined to be reasonable and necessary. (TR 1571-1572) The adjustment to the Company's planned dollar of spending reflects the actual spending and the fact that the Company was not spending what they were previously allowed. (EX 154, Pages 17-18) The Company's request should be reduced by $386,834 based on the Company's actual performance. (TR 1558-1559)

Conclusion

While being allowed an annual spending of $4.7 million for the years 2007 through 2010, Gulf actual spending averaged approximately $4.3 million. Now, the Company claims a need for additional spending. OPC's witness Schultz recommended a moderate decrease to the previously approved amount of $4.7 million, but an increase over what the Company has actually spent on average over the years 2007-2010. Ratepayers previously provided funding for storm hardening that did not take place. Ratepayers should not be required to continue to pay for tree trimming at a level the Company indicates it plans to spend when history shows that on average it is spending less than what is currently allowed and/or planned. The $386,834 reduction recommended by OPC is reasonable.

<u>Issue 80</u>: What is the appropriate amount of Gulf's pole inspection expense for the 2012 projected test year?

This issue is subject to a stipulation to be considered by the Commission on January 10, 2012.

<u>Issue 84:</u> What is the appropriate amount of production plant O&M expense?

The appropriate amount of production plant O&M expense is $99,212,245, which is $11,675,270 less than the Company's requested $110,887,515. The appropriate jurisdictional adjustment is a reduction of $11,291,492. Gulf's projected 2012 expense is 19.38% higher than the 2010 expense and significantly higher than the historical 5-year average. Further, Gulf stated that it has not deferred any maintenance and the explanations to support the increase are inadequate.

ARGUMENT

The Company is requesting $110,887,515 for production O&M expense. In the 2010 test year, the Company expended $92,889,451. The 19.4% increase is excessive and not representative of actual going forward costs. Company witness Grove explains that the increase is justified due to the robust budgeting process employed by the Company and five factors that have caused the increase to occur. (TR 1561) The 2010 test year spending was unusually high compared to 2001-2009. After ten years of essentially level spending, the ratepayers should be protected from a sudden blank-check budget increase. (TR 1565-1566) Production O&M has historically been lower than what has been requested. OPC witness Schultz acknowledged the Company's budgeting process; however, he emphasized that the real factor in determining what is reasonable and necessary is what the Company has spent historically. (TR 1571-1572)

Company witness Grove acknowledged that the projected 2012 outage expense of $23 million was twice the actual 2010 amount and more than the 2006-2010 average spending of $11 million. (TR 906-908) Company witness Grove claimed that the Company spending for 2006-2010 is not representative of what is required going forward. (TR 922) He claimed that the Company did not forego maintenance; they simply extended cycles by doing things differently. For example, instead of replacing a whole section of a boiler they replaced parts and performed weld overlays. Company witness Grove claimed that the Company did what was necessary to operate reliably and efficiently from 2006-2010. (TR 925)

In discussing Company witness Grove's testimony, OPC witness Schultz acknowledged that the Company's reference to aging production plant may have some merit. However, he pointed out that to offset the aging infrastructure, the Company has included significant capital work that would mitigate the aging or perhaps even extend the units lives. (TR 1562) Witness Schultz also acknowledged that some costs for repairs may be increasing at a greater rate than inflation. However, he added that other costs may be lower and that he has not seen any study that would substantiate the Company's position that specific cost increases exceed inflation. (TR 1562)

The third reason that Gulf cited was that Smith Unit 3 was relatively new from 2006-2010. Witness Schultz disputed this claim by referring to the level of expense incurred in that period, and the fact that the decision in Docket No. 010949-EI specifically allowed for an increase in plant maintenance over the benchmark due to the addition of Smith Unit 3. (TR 1562-1563) Witness Schultz further took exception to the Company's fourth reason that increased maintenance would occur because the Perdido unit was going into service. Witness Schultz opined that a small unit like Perdido should not be a primary driver for a 19.4% increase in maintenance expense. Mr. Schultz noted that Gulf's fifth reason, that costs were controlled in 2009 and 2010, contradicts the Company's position that maintenance was not deferred. (TR 1563)

Conclusion

The Company's five purported reasons for increasing the production maintenance were not appropriate justification for such a significant increase as explained by OPC witness Schultz. The Company production maintenance has fluctuated from year-to-year. The fluctuation as described by the Company was due to doing things differently. The fact is the Company has provided safe and reliable service following its maintenance practice over the past years. The Company asserts maintenance was not forgone or deferred. The sudden increase is not justified based on the Company's accomplishments and/or spending in the past. An appropriate level of maintenance expense can be determined based on the historical performance and increased by an appropriate escalation as done by OPC witness Schultz, who employed an escalated five-year average. OPC's adjustment of $11,675,270 ($11,291,492 jurisdictional) to $99,212,245 is appropriate because it reflects an appropriate escalation of actual spending that was required to provide safe and reliable service.

Issue 86: What is the appropriate amount of Gulf's distribution O&M Expense?

See OPC's positions and arguments on Issues 79 and 80.

Issue 88: What is the appropriate amount of Rate Case Expense for the 2012 projected test year?

Gulf's rate case expense should be decreased at least by $482,273. Gulf overstated its estimates for meals and hotel expenses by $102,273. Adjustments are also appropriate to remove $321,000 in SCS charges for information technology, human resources, and accounting functions performed in-house at Gulf, and the cost of service study performed by SCS in addition to outside consultant charges. Gulf has not shown that the SCS costs are incremental to costs already projected to be allocated or charged to Gulf from SCS during the test year. Finally, $59,000 of projected overtime labor should be removed as labor costs should already be provided for in Gulf's 2012 budget incorporated in the filing.

ARGUMENT

Gulf requested $2,800,000 for rate case expense with a four-year amortization expense of $700,000. (TR 958, 1483) OPC witness Ramas testified that several adjustments were necessary to reflect a reasonable level of rate case expense. First, adjustments should be made to remove excessive amounts of hotel rooms, food, and transportation. (TR 1484) The Company estimated that 60 people will travel to and attend 10 days of hearings in this proceeding, equating to lodging expenses of $85,980 and estimated food expense totaling $39,000. Adjustments are appropriate to reflect a reasonable number of people attending hearings as well as an incorrect assumption regarding the number of hearing days. Ms. Ramas stated that for the 17 Gulf direct witnesses, the request to include 60 people as attending hearings on its behalf is excessive and should be adjusted. The Company's estimate that all 60 people would be attending ten days of hearings was unlikely and unreasonable. (TR 1485-1487)

Ms. Ramas assumed for the public hearings that six people would require one night of lodging and meals using three rented vehicles. (TR 1487) The Commission also set aside five days for the technical hearings in this case. Ms. Ramas testified that the hearing days should be reduced to 5 and the number of people attending should be reduced to 34 to reflect one member of support personnel for each of the Company's 17 direct witnesses. Ms. Ramas stated 34 people for 5 days may still be too high an estimate, but this recognized that legal counsel, some senior management, and a few witness would likely be needed to be present during all five hearing days. She concluded that it was unlikely that every witness would need to attend all five hearing days, and her adjustment also accounted for rental vehicles to correspond to the reduction in the number of people attending the hearings on Gulf's behalf. Ms. Ramas' adjustment reduced the estimated meals and travel expenses by $102,273. (TR 1486-1487 and EX 35 [DR-1, Sch. C-6, page 2, line 39]).

While Gulf used twenty-two witnesses in defending its case, four were stipulated and did not attend the hearing. Further, the hearing lasted only 3½ days, and many witnesses were excused after they testified. Gulf witness Erickson, in her deposition, stated that for the sixty persons estimated to attend the hearing, twenty-two were witnesses and the remainder were six attorneys, plus three regulatory, and six administrative and logistical personnel. This leaves twenty-three additional persons. Ms. Erickson also stated that some witnesses needed one additional support staff to assist with backup and others need more than one in addition to their assigned attorney. (EX149, pg. 33, 37, 38 and 41) OPC believes that this level of backup to support the utility's own rate case is excessive and should not be borne by the ratepayers.

Additionally, OPC questions why ratepayers should provide recovery of rate case expense associated with Gulf's decision to hire a second cost of capital witness (Vilbert), who endorsed the methodology of its primary cost of capital witness (Vander Weide). While Gulf is certainly entitled to defend its case on its own nickel, this piling on of witnesses and associated costs should not be paid for by the customers.

Ms. Ramas also testified that estimated expenses from Southern Company Services ("SCS") which totaled $321,000,[29] as well as $59,000 of overtime labor, should be removed from Gulf's projected rate case expense. First, the $99,000 for Information Technology, Human Resources and Accounting functions are already performed in-house at Gulf and there has been no justification that additional support from SCS specific to the rate case in these areas is needed. Additionally, Gulf's requested $222,000 from SCS for Cost of Service Study assistance, which is in addition to amounts from outside consultants for assistance in the rate case. Gulf has made no showing that the costs shown as coming from SCS are incremental to costs already projected to be allocated or charged to

[29] The response to Citizens' Interrogatory 172 breaks out this amount as follows: Cost of Service Study - $222,000; IT/Computers - $20,000; and Other Areas (HR, Accounting, etc.) - $79,000.

Gulf from SCS during the test year. Ms. Ramas recommended that $321,000 of projected SCS rate case expense should be removed. Finally, Ms. Ramas testified that Gulf's estimated overtime internal labor costs have already been included in Gulf's 2012 budget costs incorporated in the filing. To include these overtime labor costs in rate case expense would constitute double counting, so these amounts should be removed. Based on the above analysis, Gulf's rate case expense at a minimum should be reduced by $482,273, which decreases Gulf's projected rate case costs to $2,317,727. Test year amortization expense should be reduced by $120,568. (TR 1488-1489)

<u>Issue 89</u>: What is the appropriate amount of uncollectible expense for the 2012 projected test year?

The appropriate amount of uncollectible expense is $3,997,000. Gulf's projected 2012 projected bad debt factor of 0.3321% is not consistent with its historical bad debt rate, which averaged 0.3056% for 2007-2010. This 4-year average is higher than the 2010 rate realized by Gulf of 0.2937%, the year of the Gulf oil spill. Gulf has provided no information in its filing or testimony regarding how the factor was determined or the assumptions used. This unsupported projection should be replaced with a historical 4-year average of bad debt expense, resulting in a reduction of $346,000. The bad debt factor should also be adjusted to calculate the NOI multiplier.

ARGUMENT

OPC witness Ramas testified that Gulf included $4,137,000 of uncollectible expense in its 2012 test year. This was based on a projected bad debt factor of 0.3321%, resulting in uncollectible expense of $4,343,000. This was then reduced by $206,000 to reflect projected reductions resulting from Gulf's anticipated increase in collection efforts. The Company also included the projected 0.3321% bad debt factor in determining its net operating income multiplier. This bad debt factor is not consistent with Gulf's historical bad debt rates as reflected on Ms. Ramas' Schedule C-2. This schedule shows that the bad debt factors vary from year to year and range from a low of 0.2804% to a high of 0.3323% in 2009. For the most recent calendar year of 2010, the year of the BP Oil Spill, the bad debt factor was 0.2937%, which is lower than the 2009 rate.

Gulf provided no explanation of how the projections for 2011 and 2012 were calculated in its MFRs or testimony. Ms. Ramas recommended that Gulf's projected 2012 bad debt factor be replaced by the four-year average factor calculated using the years 2007 through 2010, resulting in a bad debt factor of 0.3056%. This is higher than the 2010 rate realized by Gulf of 0.2937%. As the level of bad debt expense to revenues varies from year to year, the use of an average rate is appropriate to reflect a normalized level in rates going forward. Replacing Gulf's proposed 0.3321% factor with OPC's recommended factor of 0.3056% results in projected net write-offs of $3,997,000 which is a $346,000 reduction to the amount included in the filing. See EX 35 [DR-1, Sch. C-2]. Gulf did not file rebuttal testimony on this issue and offered no argument against Ms. Ramas' recommended adjustment. As shown on Schedule A-1, Ms. Ramas' rate should be used for the bad debt factor for purposes of calculating the net operating income multiplier in Issue 98. (TR 1462-1464)

<u>Issue 90</u>: **Is Gulf's requested level of O&M Expense in the amount of $282,731,000 ($288,474,000 system) for the 2012 projected test year appropriate? (Fallout Issue)**

No. After OPC's recommended adjustments, the appropriate amount is $246,132,000.

<u>Issue 91</u>: **What is the appropriate amount of depreciation and fossil dismantlement expense for the 2012 projected test year?**

See Issue 92.

<u>Issue 92</u>: **Is Gulf's requested level of Depreciation and Amortization Expense in the amount of $87,804,000 ($89,613,000 system) for the 2012 projected test year appropriate? (Fallout Issue)**

*No. In its supplemental filing to include the Crist turbine upgrade projects, Gulf increased its depreciation expense request by $2,161,000 ($2,237,000 system). The appropriate amount is $95,694,000, which reflects a reduction to Gulf's updated requested balance of $1,647,000. On a jurisdictional basis, depreciation expense should be reduced by $378,000 for transmission and $42,967 for incentive compensation plant-related adjustments. The requested increase in depreciation expense for the Christ turbine upgrades should be reduced by $1,227,000 from $2,161,000 to $934,000. *

Issue 93: **What is the appropriate amount of Taxes Other Than Income Taxes for the 2012 projected test year? (Fallout Issue)**

The appropriate amount of taxes other than income should be $27,977,000. This reflects a reduction to Gulf's requested balance of $786,000 jurisdictional for OPC's recommended incentive compensation adjustment.

Issue 94: **Is it appropriate to make a parent debt adjustment per Rule 25-14.004, Florida Administrative Code?**

Yes. Gulf has not overcome the rebuttable presumption required by Commission rule and failed to show that the Southern's investment in Gulf is not made in the same ratios. The fact that no adjustment was made in the last rate case is not persuasive, especially since circumstances have changed. The argument that Gulf's dividends exceeded Southern's equity infusions fails because dollars cannot be traced. Southern's capital structure, after elimination of subsidiary debt, has outstanding debt and without an all equity parent capital structure, a PDA is appropriate for Gulf. Gulf's attempt to change the jurisdictional factor should be rejected. Income tax expenses should be reduced by $2,126,000 ($1,766,000 jurisdictional).

ARGUMENT

Rule 25-14.004, F.A.C., provides that "the income tax expense of a regulated company shall be adjusted to reflect the income tax expense of the parent debt that may be invested in the equity of the subsidiary where a parent-subsidiary relationship exists and the parties to the relationship join in the filing of a consolidated income tax return." Further, Rule 25-14.004(3), F.A.C., states that "it shall be a rebuttable presumption that a parent's investment in any subsidiary or in its own operations shall be considered to have been made in the same ratios as exist in the parent's overall capital structure." The parent debt adjustment impacts income tax expense and recognizes that the ratepayers should share in the benefits of a parent's debt invested in its subsidiary. If the Commission determines that an adjustment is appropriate, then any disallowance properly will decrease the above-the-line rate of return paid by ratepayers.

In several recent cases, the Commission has found that the companies have not effectively rebutted the presumption that the parent debt adjustment ("PDA") should be applied.[30] OPC witness Woolridge identified four proceedings (three since 2009) in which the Commission required a parent debt adjustment to be made. In each case, the Commission found that the companies had not overcome the rebuttable presumption of the Commission rule. In the most recent Progress Energy Florida rate case, the Commission found that PEF had not demonstrated that the investment made by Progress Energy in PEF could be attributed to any source other than the general funds of the parent. Further, PEF did not meet its burden of proof to demonstrate its claim that all contributions made and expected to be made by Progress Energy to PEF in 2009 and 2010 would be from funds generated from common equity issuances at Progress Energy. (TR 1729-1730)

Gulf witness Teel claimed that the PDA should not be made in this case because this adjustment was not an issue in the Company's last rate case; and since the last rate case, Gulf Power has paid more in dividends to Southern than Southern has invested in capital contributions to Gulf Power. Dr. Woolridge testified that the silence on the PDA issue in the last case provides no support for Gulf's position in this current case. The adjustment applies unless Gulf can overcome the rebuttable presumption that the rule creates. Mr. Teel's argument that Gulf sent more dividends to Southern Company over a period of years than the amount of equity that Southern invested in Gulf is faulty reasoning, because it is impossible to "trace dollars." Plus, Southern has debt remaining after elimination of subsidiary debt, and has debt outstanding on an ongoing basis. (EX 7: MFR Sch. D-2)

[30] See Order No. PSC-09-0411-FOF-GU, page 38, issued June 9, 2009, in Docket No. 080318-GU, In re: Petition for rate increase by Peoples Gas System; Order No. PSC-09-0283-FOF-EI, issued April 30, 2009 in Docket No. 0803 17-EI, In re: Petition for rate increase by Tampa Electric Company; See Order No. PSC-10-0131-FOF-EI, issued March 5, 2010, in Docket No. 090079-EI, In re: Petition for increase in rates by Progress Energy Florida, Inc.; See Order No. PSC-00-2054-PAA-WS, issued October 27, 2000, in Docket No. 990939-WS, In re: Application for rate increase in Martin County by Indiantown Company, Inc.

Dr. Woolridge opined that in the absence of an all equity capital structure at the parent level, a PDA is appropriate for Gulf Power. (TR 1730-1731)

The PDA requirement is a rule, and so is applicable if the Commission believes the utility has not met its burden. Gulf's witness Deason attempted to persuade the Commission that if this adjustment is made the Commission will be making a double leverage adjustment. (TR 2136-2137) This is clearly not the case. Moreover, his argument goes more to the appropriateness of the rule, which is not a matter for a revenue requirements docket. His discussion of the content of staff recommendations in the rule docket is similarly out of place.

Dividends in excess of equity infusions between Gulf and Southern for Gulf's chosen time frame do not rebut the presumption of the rule, especially since Mr. Teel reached back only as far as Gulf's last rate case. On cross examination, Mr. Teel stated that the reason Gulf chose the period since the last rate case to study the level of dividends exceeding equity infusions was because a PDA was not made in the last case and circumstances have not changed since then. Mr. Teel admitted that depending on the time frame that is chosen, the dividend-to-equity infusion analysis could look very different. (TR 239)

Additionally, under cross examination by staff, Mr. Deason acknowledged that Southern had only short-term commercial paper during the last rate case, and that made the PDA inapplicable. (EX 212) Thus, Mr. Teel's assertion that the status quo was maintained between the last rate case and the current rate case conflicts with the actual circumstances of the last case.

Witness McMillan attempted to persuade the Commission to change the dollar amount of the PDA by dramatically reducing the jurisdictional factor applied. OPC witness Ramas applied the income tax jurisdictional factor reported by Gulf in its MFR C-4. This is also the same factor that Gulf provided in response to OPC Interrogatory 153. (EX 114) In his rebuttal, Mr. McMillan changed the jurisdictional factor for only this one item to determine a much lower factor of 0.5003120 by excluding the Scherer Unit Power Sales from the denomination. (TR 2361) Examining MFR Schedule C-4, the calculation of the jurisdictional factor is consistent for each line; none of the calculated factors reflects such a low factor. (EX 7)

The new and novel method presented in McMillan's rebuttal position would artificially reduce, by a significant amount, the resulting parent debt adjustment, thereby removing a large portion of the benefit of that adjustment from ratepayers. It is not reasonable to assume that approximately 50% of the parent debt adjustment is related to non-regulated and non-jurisdictional areas. To demonstrate the unreasonableness of the proposed calculation, one need only observe how the parent debt adjustment is calculated. It is shown on Company MFR C-24 as the weighted cost of parent debt times the consolidated tax rate, times the equity of Gulf, excluding retained earnings. MFR Schedule D-1a shows total Gulf projected equity of $1,212.6 million, whereas MFR Schedule D-1b shows that the Unit Power Sales portion of that equity is $101.3 million, or less than 8.4% of the total. Mr. McMillan's proposed revision to the calculation of the jurisdictional portion of parent debt adjustment differs from that which was presented by the Company in its response to OPC discovery. Changing the factor from the correct amount of .8305076 to .5003120, is unreasonable and inaccurate.

<u>Issue 95</u>: **What is the appropriate amount of Income Tax expense for the 2012 projected test year? (Fallout Issue)**

Based on OPC's recommended adjustments, the appropriate amount of test year income tax expense before any revenue increase should be 29,877,000.

<u>Issue 96</u>: **Is Gulf's requested level of Total Operating Expenses in the amount of $420,954,000 ($432,449,000 system) for the 2012 projected test year appropriate?** (Fallout Issue)

No. Gulf's supplemental filing increases its requested operating expenses by $816,000 to $421,770,000, after OPC's recommended adjustments, the appropriate total operating expenses should be $398,726,000 (jurisdictional).

Issue 97: **Is Gulf's projected Net Operating Income in the amount of $60,955,000 ($66,862,000 system) for the 2012 projected test year appropriate? (Fallout Issue)**

No. Gulf's supplemental filing increases its projected Net Operating Income by $816,000 to $61,771,000. After OPC's recommended adjustments, the appropriate jurisdictional net operating income is $85,293,000.

Revenue Requirements

Issue 98: **What is the appropriate revenue expansion factor and the appropriate net operating income multiplier, including the appropriate elements and rates for Gulf?**

The appropriate net operating income multiplier should be 1.634173. This reflects the OPC's recommended adjustment to replace the Company's proposed bad debt rate of 0.3321% with a more appropriate rate of 0.3056%.

ARGUMENT

As discussed in Issue 89, OPC witness Ramas testified that the net operating income multiplier and revenue expansion factor should be adjusted to replace Gulf's overstated bad debt rate with the more appropriate rate of 0.3056% rate. This adjustment was unopposed by Gulf or any other parties. (TR 1464)

Issue 99: **Is Gulf's requested annual operating revenue increase of $93,504,000 for the 2012 projected test year appropriate? (Fallout Issue)**

No. Gulf's Supplemental filing increases the amount of annual operating revenue increase from $93,504,000 to $101,618,000. OPC's recommended adjustments, including OPC's recommended impacts associated with the Crist turbine upgrades, results in the appropriate revenue increase of $17,191,000.

Other Issues

Issue 117: **Should any of the $38,549,000 interim rate increase granted by Order No. PSC-11-0382-PCO-EI be refunded to the ratepayers?**

Yes. Gulf should be required to refund, with interest, the difference between the Commission approved $38.5 million interim increase and the $17.2 OPC recommended final increase.

CONCLUSION

For the reasons stated in this Brief, the Commission should approve and adopt OPC's positions on issues treated herein.

Respectfully submitted,

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CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true and foregoing **CITIZENS' POST-HEARING STATEMENT OF POSITIONS AND POST-HEARING BRIEF** has been furnished by electronic mail and U.S. Mail on this 9th day of January, 2011, to the following:

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