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GULF POWER
A SOUTHERN COMPANY

January 9, 2012

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Ms. Ann Cole, Commission Clerk
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, FL 32399-0850

VIA HAND DELIVERY

Re: Docket No. 110138-EI

Dear Ms. Cole:

Enclosed are an original and fifteen copies of the Post – Hearing Brief of Gulf Power Company to be filed in the above referenced docket. Also, enclosed is a CD containing the Post – Hearing Brief of Gulf Power in Microsoft Word as prepared on a Windows XP operating system.

Sincerely,

Susan D. Ritenour

nm

Enclosures

cc: Beggs & Lane
Jeffrey A. Stone, Esq.

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BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 110138-EI

POST-HEARING BRIEF
OF
GULF POWER COMPANY

GULF POWER
A SOUTHERN COMPANY

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

IN RE: Petition for increase in rates by Gulf Power Company.	Docket No. 110138-EI Date Filed: January 9, 2012

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

Gulf Power Company ("Gulf Power", "Gulf", or "the Company"), by and through its undersigned attorneys, files the following as its posthearing brief and posthearing Statement of Issues and Positions in this proceeding before the Florida Public Service Commission ("Commission") pursuant to Order No. PSC-11-0564-PHO-EI and Rule 28-106.215, Florida Administrative Code.

GENERAL DISCUSSION:

Gulf Power Company's current rates and charges will not provide Gulf a reasonable opportunity to earn a fair and reasonable rate of return for the period January through December 2012 (the "2012 test year") and beyond. Gulf filed this case seeking an annual increase in its rates and charges of approximately $93.5 million before adjustments necessary to implement the subsequent stipulation between the parties to move cost recovery of existing and proposed Crist turbine upgrades planned as part of the Crist Flue Gas Desulfurization project from the Environmental Cost Recovery Clause to Gulf's base rates. Now that the hearing has been completed, and various issues have been resolved by stipulations approved by the Commission, the adjusted amount of the requested increase in base rates is now $98,351,000, with a temporary offsetting credit through a reduction to environmental cost recovery rates of $3,485,000, to be applied through the remainder of 2012.

The requested base rate increase is the amount Gulf's witnesses have identified and supported through sworn testimony as being necessary in order for the Company to have the resources to continue providing the sufficient and reliable electric service that its customers are entitled to expect. This amount of increased revenues is the result of a thorough and careful budgeting process carried out by the men and women of Gulf Power whose experience and expertise in operating this utility is unchallenged and unmatched by any other witness in this case.

Gulf initiated this case on July 8, 2011 with the filing of the Company's petition, direct testimony and schedules containing the Commission's minimum filing requirements ("MFRs") for electric utility rate cases. Based on the data in Gulf's MFRs, the Company's adjusted 13-month average jurisdictional rate base for the 2012 test year was projected to be $1,676,004,000, and the jurisdictional net operating income was projected to be $60,955,000 using the rates in effect at the time of the petition. As shown in the petition, the resulting adjusted jurisdictional rate of return on average rate base for the 2012 test year was projected to be 3.64%, while the return on common equity was projected to be 2.83% for the same period. Such returns are so low that allowing present rates to remain in effect without change would severely jeopardize the Company's ability to finance future operations. The continued compulsory application of Gulf's present rates and charges will result in the unlawful taking of the Company's property without just compensation, resulting in confiscation of the Company's property in violation of the guarantees of the state and federal constitutions.

Gulf made every effort to defer filing this rate increase for as long as possible. In 2008 and 2009, Gulf took extraordinary steps to manage spending in a way that would not adversely impact service to its customers. These steps included extending maintenance cycles, adjusting outage schedules, restricting hiring, and foregoing merit increases in 2009. By 2010 and 2011, Gulf could no longer sustain these spending restrictions without putting its quality of service at risk. As Gulf has returned its spending to normal and necessary levels, its returns have suffered. By mid-2010, Gulf was earning below the bottom of its authorized range of return, and by the time of the hearing, Gulf's achieved return on equity was below 6 percent and still declining, even with the positive effect of the interim rate increase.

Despite the successful efforts on the part of Gulf's management and employees to control and reduce expenses, there are significant factors that have driven additional investment and increased Operations and Maintenance (O&M) expenses associated with continuing to provide reliable service to Gulf's customers that make the filing of this request for rate relief necessary. These significant factors include: the addition since 2002 of more than 850 miles of new power lines; replacing and repairing the electrical infrastructure necessary to meet the needs of existing customers as well as needs associated with customer growth; the impacts of repeated hurricanes; increased spending to harden the infrastructure to mitigate storm damage and facilitate restoration following storms; and a rise in material costs that has far exceeded the rate of inflation as measured by the Consumer Price Index. Stated simply, Gulf's base rate revenues have not kept pace with the increases in investment and O&M expenses.

Although the witnesses sponsored by the various intervenors have aggressively assailed various components of Gulf's test year levels of investment and expenses on which the Company has based its requested rate increase, none of these witnesses has any actual experience in utility operations. None of the intervenor witnesses actually reside in Northwest Florida and therefore none of these witnesses will actually face the consequences of their recommendations. It is the men and women of Gulf who actually provide service to Gulf's customers each and every day. It is these dedicated and highly skilled individuals who regularly survey Gulf's customers and take feedback regarding customer satisfaction, who use customer satisfaction surveys as a primary driver of business initiatives, and who have daily contact with Gulf's customers. Ultimately, it is the men and women of Gulf Power who must appropriately balance the needs of customers, employees and investors alike in order to continue to successfully operate the business of Gulf Power for the benefit of all.

Instead of acknowledging Gulf's efforts to defer its filing, the intervenors seek to punish Gulf by implying that if Gulf has been able to provide quality service while earning less than a 6 percent return on equity, the Company must not require the full relief it has requested in order to continue to provide such service in the future. Such an implication is either naïve or disingenuous. Gulf's returns have declined <u>because</u> Gulf has been willing to increase spending to needed levels despite the adverse impact on its investors. However, this combination of increased spending and reduced returns cannot continue. Now is the time for the Commission to set rates that will cover Gulf's reasonable and prudent operating expenses and provide Gulf the opportunity to earn a fair and reasonable rate of return on its investment.

In their efforts to trim the amount of Gulf's rate increase, the intervenors have taken a number of positions that, if adopted, would deny Gulf the opportunity to earn a fair rate of return on its investment. For example, the proposal to exclude non-interest-bearing construction work in progress (CWIP) from rate base would cut approximately $6 million of Gulf's revenues (effectively reducing the return on equity by over 50 basis points) while doing nothing to relieve Gulf of the obligation to invest those funds in needed construction projects. [Issue 22] Similarly, the proposal to deny the recovery of at-risk compensation would reduce Gulf's revenues by more than $12 million (over 100 basis points) and leave the company with the dilemma of reducing its employees' compensation to a level significantly below market or continuing to pay market-based compensation while ensuring it would be unable to actually earn its required return on equity. [Issue 71] The intervenors' proposal to exclude the North Escambia site from rate base would require Gulf either to suffer more than a $3 million reduction in revenues (over 25 basis points) or to consider selling the property and foregoing any future nuclear generation option for its customers. [Issue 24] Their proposal to impute fictional revenues for "intangible benefits" allegedly enjoyed by Gulf's non-regulated affiliates and unregulated operations through their mere association with Gulf would result in a revenue reduction of approximately $2 million. [Issues 39, 40, 41] And their proposal to limit Gulf's recovery of the Crist 6 & 7 turbine upgrade costs to only the 2012 investment even in 2013 and beyond would deny Gulf recovery of the full cost of projects that no one disputes will be providing significant net fuel cost savings to Gulf's customers.

Intervenors also proposed a number of adjustments to particular items of operating expense that ignored the detailed justifications provided by Gulf's managers who have the responsibility to operate and maintain Gulf's generation, transmission, and distribution systems. This includes a proposal to deny recovery of up to $5 million in payroll costs for additional employees who have been fully justified, and most of whom are already at work. [Issue 70] It also includes proposed reductions to production O&M and distribution O&M based on the use of historical averages which do not reflect the current and expected future level of required spending. [Issues 79, 80, 84, 86] Even the time periods used to develop intervenors' historical averages are not consistent, but appear to have been selected based on whatever period of years would produce the biggest adjustment. Mr. Schultz alone uses a 4-year average for tree trimming, a 1-year figure for pole inspection, a 5-year average for fossil plant maintenance, and a 10-year average for storm accrual (after assigning $0 to the years 2004 and 2005 in which Gulf suffered major storms). [McMillan, Tr. 2366]

As a provider of retail electric service to the people of Northwest Florida, Gulf is obligated by statute to provide such service in a reasonable, "sufficient, adequate, and efficient" manner. § 366.03, Fla. Stat. Gulf has a similar obligation to provide its investors with a reasonable and adequate return. Without the revenue increase requested, Gulf cannot meet its obligations either to customers or to investors in the long run. If Gulf is rendered unable to meet its obligations to the customers and investors due to inadequate rates, both customers and investors will suffer. Gulf's customers will suffer from less reliable service and eventually higher costs of electricity, while its investors will suffer from an inadequate and confiscatory return on their investment and will seek other places to invest their money. For these and other reasons detailed in the testimony and exhibits of Gulf's witnesses, Gulf is respectfully requesting an increase in rates and charges that will produce an increase in total base rate revenues of $98,351,000 after consideration of the adjustments for the stipulations approved at the beginning of the hearing in this case and other adjustments as detailed in the Company's positions on the issues remaining for consideration and decision by the Commission. In resolving these issues, Gulf urges the Commission to ignore the rhetoric and instead to focus on the evidence as outlined in the discussion of specific issues in this brief. By doing so, Gulf is confident that the Commission will reach a result that appropriately balances the interests of Gulf and its customers and provides Gulf an opportunity to cover its reasonable operating costs and earn a fair return on its investment.

DISCUSSION OF SPECIFIC ISSUES:[1]

ISSUE 1: Does Section 366.93, Florida Statutes, support Gulf's proposal to calculate a deferred carrying charge for the 4,000 acre Escambia Site and the costs of associated evaluations as nuclear site selection costs?

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[1] The listing of issues and position summaries that follow in this section is also intended to serve as Gulf Power's posthearing Statement of Issues and Positions required by Order No. PSC-11-0564-PHO-EI.

> *Yes. Under the rule promulgated by the Commission pursuant to Section 366.93, Gulf is authorized to accrue a carrying charge on the cost of acquiring the Escambia site and the cost of the associated evaluations prior to any need determination.*

Gulf proposes to include a total of $27,687,000 in rate base associated with the North Escambia site as discussed in Issue 24. Of this amount, $2,977,838 represents accrued carrying charges through December 31, 2011 on site acquisition and related site evaluation costs. [Ex. 90 at 000147] This issue relates only to the legal authority for Gulf to accrue these carrying charges. No party contests the Commission's authority to authorize rate base treatment for the land, the associated evaluations, and any carrying charges that Gulf had the right to accrue. [Prehearing Conference Tr. 15-16, 20-22]

Rule 25-6.0423 was adopted to implement the nuclear cost recovery provisions of Section 366.93. Subsection (3) of that rule specifically authorizes Gulf to accrue carrying charges on "site selection costs" related to a nuclear power plant:

> (3) Deferred Accounting Treatment. Site selection and pre-construction costs <u>shall be</u> afforded deferred accounting treatment and <u>shall ... accrue</u> a carrying charge equal to the utility's allowance for funds used during construction (AFUDC) rate until recovered in rates. (Emphasis added)

This is the rule that Gulf relied on in accruing carrying charges for its site selection costs. [McMillan, Tr. 1178]

The intervenors appear to claim that deferral of site selection costs is authorized only after the utility has filed for, and received, a determination of need for a nuclear power plant. This claim is contrary to the plain language of the rule. Under Rule 25-6.0423(2)(e), a site is deemed to be selected upon the filing of a need determination petition. Costs incurred <u>prior</u> to the filing of the need petition are "site selection costs" under subsection (2)(f), while costs incurred after the filing are "pre-construction costs" under subsection (2)(g). Importantly, the rule authorizes the accrual of deferred carrying charges for both site selection costs and pre-construction costs.

During the cross-examination of Mr. McMillan, OPC pointed to subsection (4) of the rule, which provides that after a need determination has been granted a utility "may file a petition for a separate proceeding" to recover its site selection costs. [McMillan, Tr. 1123-24] It appears from this cross-examination that the intervenors may attempt to claim that such a post-need proceeding is the exclusive method by which a utility can recover its site selection costs. That claim would be contrary to their position at the prehearing conference on the scope of this issue, which relates only to the authority to accrue and defer carrying charges, not to the Commission's authority to approve recovery in this proceeding of any authorized deferred charges. [Prehearing Conference Tr. 15-16, 20-22]

As Mr. McMillan made clear, Gulf is relying on the Commission's general ratemaking authority, not on subsection (4), as the basis for its request to discontinue accrual of carrying charges and to move its site acquisition and selection costs (including the carrying charges accrued through December 31, 2011) into base rates. [McMillan, Tr. 1178, 2359]

ISSUE 2: **Stipulated**

ISSUE 3: **Stipulated**

ISSUE 4: **Stipulated**

ISSUE 5: **Stipulated**

ISSUE 6: **Stipulated**

ISSUE 7: **Stipulated**

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

Except for the Crist turbine upgrades discussed in Issue 9, no other costs should be moved from the ECRC into rate base.

The parties have stipulated that recovery of the costs associated with the Crist 6 and 7 turbine upgrades through the Environmental Cost Recovery Clause ("ECRC") should be discontinued on a prospective basis beginning with the ECRC recovery factors to be applied during 2012, and recovery on a prospective basis should be provided though the base rates to be established in this docket. The Commission approved that stipulation by Order No. PSC-11-0553-FOF-EI issued in the ECRC docket. The Prehearing Officer subsequently issued Order No. PSC-11-0513-PCO-EI in this docket to adopt the schedule set forth in the stipulation for the filing of supplemental testimony related to the turbine upgrades.

This issue, which was raised by OPC, concerns whether any other capitalized items currently approved for recovery through the ECRC should be moved out of clause recovery and into recovery through base rates. Section 366.8255(5) "does not preclude" such a shift if inclusion in base rates "is necessary and appropriate." No party has provided testimony or evidence that such a shift is necessary and appropriate in this case. In fact, the only evidence on this issue is contained in the deposition of Ms. Ramas on behalf of OPC, where she stated that her recommendation on a base rate increase did not include shifting any projects from ECRC into base rates other than the Crist 6 and 7 turbine upgrades. [Ex. 153 at 67-70]

Absent any evidence that shifting capitalized items from ECRC into base rates is necessary and appropriate, the Commission should follow its decision in Gulf's last rate case and not increase Gulf's base rates by moving additional projects out of the ECRC. [Order No. PSC-02-0787-FOF-EI at 17-18]

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?

Pursuant to the approved stipulation, the Crist 6 and 7 turbine upgrades should be included in rate base. This transition from ECRC to base rates involves significant investment going into service at two different dates during the test year. To allow a smooth transition and full cost recovery for the turbine upgrades beginning in 2013 without the need for additional proceedings, $58,747,000 (plant in service of $61,753,000 less accumulated depreciation of $3,006,000) [$60,802,000 system] should be included in rate base and recovered in base rates. To avoid recovering more than the 13-month average balance through rates during 2012, this should be accompanied by a one-time credit to the ECRC in 2012 effective the same day as the new base rates.

By Order No. PSC-11-0553-FOF-EI issued in the ECRC docket (Docket No. 110007-EI), the Commission approved a stipulation to shift prospective recovery of the cost of the Crist 6 and 7 turbine upgrades from the ECRC into base rates. These three projects are designed to offset the internally consumed electricity associated with the installation of scrubbers at those units and to increase the overall efficiency of the scrubbed units. [McMillan, Tr. 1111] Customers are already receiving fuel cost and capacity cost savings from the first upgrade that was completed in January 2010. By 2013, they will be receiving the full savings from all three projects. [McMillan, Tr. 1117] The estimated savings in every year exceed the annual revenue requirements of the projects. [McMillan, Tr. 1117; Ex. 23, Sch. 2]

In order to provide fair ratemaking treatment to Gulf's customers and to the Company, Gulf has made two alternative proposals for recovering these costs in base rates. [McMillan, Tr. 1112, 2371-72; Ex. 23, Sch. 1] Gulf's primary proposal is to include all three turbine upgrade projects in rate base and NOI as if they had been in service for the entire year. [McMillan, Tr. 1113] This would set base rates for 2012 and later years at a level that includes the full cost of the projects of $58,747,000. [McMillan, Tr. 1113-14; Ex. 23, Sch. 1] This proposal would result in Gulf recovering incrementally more revenues (approximately $3.5 million) through base rates in 2012 than if the projects are included in rate base and NOI at their actual 2012 projected amounts. [*Id.*] To keep customers whole, Gulf proposes to credit the customers for the full amount of these incremental revenues by reducing the ECRC cost recovery factors for 2012 by a like dollar amount, to take effect on the same date that rates take effect in this docket. [*Id.*]

Gulf's alternative proposal is to set base rates for 2012 by including each of these projects in rate base at their 13-month average balance of $28,020,000, and including the actual 2012 projected level of expenses in the calculation of NOI. [McMillan, Tr. 1113] The Commission would then approve a step rate increase of approximately $4.3 million to Gulf's base rates beginning January 1, 2013, to reflect the full annual cost of these projects, which by then will be in service and providing electricity to Gulf's customers. [McMillan, Tr. 1113-14; Ex. 23, Sch. 1]

Each of these proposals results in customers paying total rates (base rates plus clauses) in 2012 as if the turbine upgrade projects had been included in rate base at their 13-month average balance, and expenses included in NOI at their actual 2012 amounts. [McMillan, Tr. 1115] Each proposal also results in Gulf receiving total rates beginning in 2013 that appropriately reflect the full cost of the projects. [*Id.*] As Mr. McMillan explained in response to a question by Commissioner Balbis, the proposals result in the same impact on ratepayers as if the projects continued to be recovered through the ECRC – the dollar amounts are the same and there is no double recovery. [McMillan, Tr. 1175]

In response to a question by Commissioner Edgar, Mr. McMillan acknowledged that Gulf's alternative proposal, which involves a step rate increase on January 1, 2013, is more consistent with prior Commission decisions, such as the decision in the last Tampa Electric

(TECO) rate case. [McMillan, Tr. 1170-71] However, Gulf's primary proposal – which produces the same end result – would minimize customer confusion by having only one base rate increase and making the necessary adjustments through the ECRC, which is adjusted on an annual basis in any event. [McMillan, Tr. 1115, 1171]

OPC contends that the Commission should include in base rates for 2012 and beyond only the 13-month test year average of the turbine upgrade costs. OPC claims that Gulf's proposals would result in a mismatch of test year investment, revenues and costs. [Ramas, Tr. 1499-1501, 1504] In fact, it is Ms. Ramas' proposed treatment that would result in a mismatch of investment, revenues and costs beginning in 2013, when revenues would not be provided to support the full amount of Gulf's investment in the turbine upgrades. [Deason, Tr. 2153-54] Unless this known and measurable change is taken into account in setting base rates for 2013 and beyond, Gulf's earnings will be depressed beginning in 2013, even before the new base rates have been in effect for a full year. [McMillan, Tr. 2371] Ms. Ramas' proposed treatment would also result in a mismatch of costs and benefits, since customers would be receiving the full benefits of the upgrades through lower fuel costs, but Gulf would be receiving a return on only a portion of the investment that generates those fuel savings. [McMillan, Tr. 2371; Deason, Tr. 2153-54] Such a mismatch would be inconsistent with the Commission's long history of encouraging investments which result in net savings to customers. [Deason, Tr. 2161]

To support her position that the turbine upgrades do not deserve any special ratemaking consideration, Ms. Ramas claims that the turbine upgrades are not part of the actual scrubber projects. [Ramas, Tr. 1497] This claim ignores the fact that the Crist 7 turbine upgrades completed in 2010 were previously approved for cost recovery through the ECRC as part of the scrubber project for that unit. [McMillan, Tr. 2370] The parties agreed to move these projects from the ECRC into base rates in order to be in compliance with an apparent change in Commission policy concerning the recovery of similar projects. [Deason, Tr. 2153] Her claim also ignores the fact that if these upgrades were performed independently of the scrubber project, they would have been required by environmental regulations to undergo a new source review analysis. [McMillan, Tr. 2370-71] Such review would likely have imposed additional costs and could have precluded Gulf from undertaking the turbine upgrades as stand-alone projects. [*Id.*]

Gulf's proposal to recover the full cost of these projects once they are in service is consistent with the Commission's policy of setting rates based on costs that are reasonably known to be incurred during the time rates are to be in effect. This policy is reflected in Section 366.076(2) and Rule 25-6.0435, which provide for "adjustments of rates based on revenues and costs during the period new rates are to be in effect and for incremental adjustments in rates for subsequent periods." [Deason, Tr. 2155] It is also consistent with recent precedent in the TECO rate case in which the Commission approved a step rate increase to reflect, in future years, the full cost of combustion turbine projects that were to be placed in service during the test year. [Deason, Tr. 2157-59; Order No. PSC-09-0283-FOF-EI at 4-6] In addition, Gulf's proposal better matches costs and benefits and is consistent with the Commission's long history of encouraging investments which generate fuel savings. [Deason, Tr. 2161] Unlike the TECO case, intervenors have no due process argument against a step rate increase in this proceeding, since the stipulation to which they were parties provides for full consideration of the Crist 6 and 7 turbine upgrades in this docket, including the right of all parties to file supplemental testimony related to the issue.

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

> *Yes. The Company has removed from rate base the investment, accumulated depreciation, and working capital amounts related to the Company's non-utility activities.*

Gulf believes that its adjustments to remove non-utility activities are not at issue. The intervenors' positions on this issue merely refer to their positions on Issues 16 and 17, neither of which relates to non-utility activities. Further, no intervenor has presented any testimony or evidence on this issue.

Nevertheless, as reflected on MFR B-1, column (4), and discussed in Gulf's response to Staff Interrogatory No. 172, Gulf made an adjustment to remove from rate base all non-utility activities in order to arrive at the total electric utility amount shown in MFR B-1, column (5). [Ex. 98 at 000323]

<u>ISSUE 11</u>: ***The deadline for briefing this issue was extended until January 11, 2012 in order to allow the Commission an opportunity to consider a Motion for Approval of Partial Settlement Agreements.***

<u>ISSUE 12</u>: How much, if any, of Gulf's Incentive Compensation expenses should be included as a capitalized item in rate base?

> *The entire $3,245,884 of Gulf's variable compensation capitalized in the 2012 test year should be included in rate base. Gulf's total compensation approach, including variable compensation, was approved in Gulf's last case and remains the same. Gulf's compensation program is appropriately targeted at the median of the market and has allowed Gulf to retain valuable and attract new employees necessary to serve customers. Gulf's use of variable compensation aligns the interests of employees with customers and shareholders, making employees accountable for their performance. The intervenors' proposed disallowance lacks any market analysis; is based on an erroneous premise that variable compensation does not serve customers; and completely fails to account for the adverse effects of such a disallowance on customers.*

Please see Issue 71 for a complete discussion of Gulf's at risk or variable compensation.

<u>ISSUE 13</u>: **Dropped**

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

For the period 2006 through projected year-end 2012, $69,056,000 ($71,335,000 system) will have been placed in Transmission Plant in service for Transmission Capital Infrastructure Replacement projects. These costs cover both the replacement of failed equipment and structures and the proactive replacement of equipment and structures which have reached the end of their useful life. This amount represents Gulf's actual cost of replacing this equipment and structures for the 2006 through 2010 period along with the projected cost for 2011 and 2012. These proactive transmission infrastructure replacements are developed and prioritized based on sound methodology and engineering analysis.

Gulf's transmission infrastructure replacement projects are reasonable and prudent expenditures necessary to provide reliable electric service to its customers. [Caldwell, Tr. 494] The transmission infrastructure replacement projects cover both the replacement of failed equipment and structures and the proactive replacement of equipment and structures which have reached the end of their useful life. [Caldwell, Tr. 497] The types of equipment and structures included in the infrastructure replacement projects are breakers, transformers, switches, regulators, relays, poles, arms and hardware on transmission lines. [*Id.*] A significant amount of Gulf's transmission assets were installed in the 1960 to 1980 time period and are now approaching or are at the end of their useful lives. [*Id.*] The proactive replacement of these facilities is necessary to avoid impacts to reliability and to allow for better, more cost-effective planning of Gulf's transmission system. [Caldwell, Tr. 497, 2462] Foregoing this investment would force Gulf to run the equipment to failure, impacting customers and causing an unpredictable and costly capital investment to replace the equipment under emergency conditions. [Caldwell, Tr. 2463] The budgeted amounts in 2011 and 2012 allow for the controlled replacement of aging facilities through well-planned projects. [*Id.*]

OPC suggests an inappropriate adjustment to Gulf's transmission infrastructure replacement projects for 2011 and 2012. The proposed adjustment is inappropriate for at least two reasons. First, the proposed adjustment by OPC witness Ramas is based on a simple historical average from 2003 to 2010 that ignores the fact that the 2011 and 2012 budget amounts are for specific projects developed to address assets that have reached the end of their useful lives. [Caldwell, Tr. 2461, 2463-64] The historical average for 2003 to 2010 is not representative of Gulf's needs in 2011 and 2012. [Caldwell, Tr. 2461-62] The specific transmission infrastructure replacement projects for 2011 and 2012 were developed through an inspection and evaluation of Gulf's transmission system using the transmission maintenance programs discussed in detail in Mr. Caldwell's testimony. [Caldwell, Tr. 503–08] Gulf develops the plans and budgets for these projects using a sound methodology and engineering analysis. [*Id.*] Gulf does not use historical averages, but instead budgets for real projects to address real issues. [Caldwell, Tr. 523] Ms. Ramas' proposed adjustment has the effect of allowing only $7.3 million per year for the transmission infrastructure replacement projects. In comparison to recent history, this amount is less than that expended by Gulf in 2009 and in 2010 by a significant amount. [Caldwell, Tr. 2463] The $7.3 million is not even half of the amount necessary to meet Gulf's transmission infrastructure replacement project needs for 2011. [Ex. 14, Sch. 5] In 2011, Gulf budgeted $15,948,000 for transmission infrastructure replacement projects. [*Id.*] Nearly half of this amount is for a single large project, the Sinai-Callaway 115kV line. [Caldwell, Tr. 2464] The implication of Ms. Ramas' approach is that for 2011 either Gulf will only have the Sinai-Callaway project and no other infrastructure replacement projects or that this project is not necessary. Nothing in the record supports either of these conclusions. Gulf projects to spend the entire Transmission Capital Budget for 2011 with much of the major material deliveries and workload coming in November and December of 2011 when the timing for outages is favorable. [Caldwell, Tr. 2465]

The second reason that Ms. Ramas' proposed adjustment is inappropriate is that in arriving at the adjustment she incorrectly assumes that the hurricanes of 2004 and 2005 resulted in higher levels of transmission infrastructure replacement projects during that time period and therefore Gulf should have fewer such projects in 2011 and 2012. [Caldwell, Tr. 2462] This assumption is without factual support. The hurricanes of 2004 and 2005 did not cause significant damage to Gulf's transmission system and did not affect the transmission infrastructure replacement projects. [*Id.*]

Gulf's requested funding level for transmission infrastructure replacement projects is reasonable and the projects included are necessary for Gulf to continue providing reliable transmission service. [Caldwell, Tr. 2462-63]

<u>ISSUE 15</u>: Stipulated

<u>ISSUE 16</u>: Should the wireless systems that are the subject of Southern Company Services (SCS) work orders be included in rate base?

Yes. These wireless infrastructure costs are an integral part of Gulf's communications system which is necessary and appropriate for inclusion in rate base.

This issue relates to Work Order 46C805 which covers wireless system materials costs that are capitalized as part of wireless system upgrade and replacement projects. These costs relate to the capital projects shown on Schedule 19 to Mr. McMillan's direct testimony as "Telecommunications Wireless and SCADA," "Voice and Data Converged Network," and "Telecommunication Transport and Facilities." As shown on that schedule, the amounts charged to these projects are consistent from year to year. [McMillan, Tr. 2350; Ex. 21, Sch. 19]

Ms. Dismukes proposes to disallow $387,596 ($401,146 system) of these costs. This represents the increase in the amount budgeted for Work Order 46C805 between the 2011 budget and the 2012 budget. [Dismukes, Tr. 1632] This proposal ignores the facts.

As described in both interrogatory responses and testimony, the increase in the amount to be billed through Work Order 46C805 is simply the result of a change in billing procedures. [McMillan, Tr. 2349] In the past, the cost for the portion of the wireless system materials stored in Georgia Power Company's Oakbrook Warehouse has been billed directly to Gulf by Georgia Power. [*Id.*] Thus, for 2011, this SCS work order did not include any amounts for such materials. [McMillan, Tr. 2349-50; Ex. 119 at 001087-88]

With the implementation of the Enterprise Solutions accounting software, SCS now has the ability to more efficiently track and bill the cost of these wireless materials. [McMillan, Tr. 2349-50; Ex. 119 at 001087] Costs that were previously billed to Gulf by Georgia Power will now be charged to this work order and billed to Gulf by SCS. [*Id.*] At the same time, the direct billing by Georgia Power will end. [*Id.*] Thus the increase in the budgeted amount from 2011 to 2012 does not reflect an increase in costs, but simply reflects the fact that these costs are first budgeted to be billed through this work order beginning in 2012. [McMillan, Tr. 2349-50; Ex. 21, Sch. 19; Ex. 119 at 001087-88]

ISSUE 17: Should the SouthernLINC charges that are the subjects of SCS work orders be included in rate base?

Yes. The portion of the SouthernLINC charges that are booked to capital accounts are appropriately included in rate base. SouthernLINC provides unique communication services to Gulf that have no commercial comparison in the marketplace. These communication services support service crew work management, interoperability between transmission and distribution automation systems, and voice/data communication. SouthernLINC's service characteristics are vital to Gulf's operations and its ability to provide reliable and efficient service to its customers.

The capitalized costs associated with SouthernLINC are reasonable and prudent and should be allowed in the test year. [Jacob, Tr. 2287] The SouthernLINC charges included in Gulf's 2012 test year are for communication services that are necessary for the continued reliable operation of Gulf's distribution and transmission system. [Jacob, Tr. 2283] A detailed discussion of the appropriateness of the SouthernLINC charges in the 2012 test year is found 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. The appropriate level of Plant in Service for the 2012 test year is $2,672,964,000 ($2,731,576,000 system). This amount includes adjustments to Gulf's original request to include the Crist 6 and 7 turbine upgrades (Issues 8 and 9) and to correct an ECCR adjustment error which includes the error in Distribution Plant in Service identified in the stipulation on Issue 15.

This is a fallout issue. The appropriate starting point is Gulf's requested jurisdictional Plant in Service of $2,612,073,000 as shown on MFR B-1. This amount should be increased by $61,753,000, representing the annualized jurisdictional Plant in Service associated with the Crist 6 and 7 turbine upgrades discussed in Issue 9. [Ex. 23, Sch.1 at 2] It should then be reduced by $862,000 for an ECCR adjustment error identified in Gulf's response to FEA's Interrogatory No. 46 and quantified in Gulf's response to Staff's Interrogatory Nos. 262 and 263. [Ex. 105 at 00535-37]

<u>ISSUE 19</u>: **Stipulated**

<u>ISSUE 20</u>: **Stipulated**

<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. The appropriate level of Accumulated Depreciation for the 2012 test year is $1,182,844,000 ($1,210,639,000 system). This amount includes adjustments to Gulf's original request to include the Crist 6 and 7 turbine upgrades (Issues 8 and 9), to correct an ECCR adjustment error, and to reflect the revised amortization period for non-AMI meters addressed in the stipulation on Issue 20.

This is a fallout issue. The appropriate starting point is Gulf's requested jurisdictional level of Accumulated Depreciation of $1,179,823,000 as shown on MFR B-1. This amount should be increased by $3,006,000 to reflect the Crist 6 and 7 turbine upgrades discussed in Issue 9. [Ex. 23, Sch. 1 at 2] It should also be increased by $458,000 for an ECCR adjustment error identified in Gulf's response to FEA's Interrogatory No. 46 and quantified in Gulf's response to Staff's Interrogatory Nos. 262 and 263. [Ex. 105 at 00535-37] Finally, it should be decreased by $443,000 to reflect a reduction in the accumulated depreciation balance for non-AMI meters contained in the approved stipulation on Issue 20.

<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?

Yes. Construction Work in Progress (CWIP) in the amount of $60,912,000 is needed to maintain reliability and meet customer demands. This amount is not eligible to accrue an Allowance for Funds Used During Construction (AFUDC) and should be allowed in rate base consistent with Commission policy.

There are two varieties of Construction Work in Progress for ratemaking purposes. In general, projects with an expected construction period of more than a year, and projects that involve plant additions of more than ½ of 1 percent of plant in service, are eligible to accrue an allowance for funds used during construction (AFUDC) and are not included in rate base until they are placed in service. [Rule 25-6.0141(1)(a)] Gulf made the appropriate adjustment to exclude from rate base the amount of this interest-bearing CWIP. [McMillan, Tr. 1080; Ex. 21, Sch. 2 at 2] No party has questioned the accuracy of this adjustment.

Conversely, projects with a construction period of less than one year, and projects involving plant additions of less than ½ of 1 percent of plant in service, are not eligible to accrue AFUDC. [Rule 25-6.0141(1)(b)] This non-interest-bearing CWIP is typically included in rate base unless the Commission (a) determines on a prospective basis that the impact on rates may require the exclusion from rate base of a portion of such CWIP <u>and</u> (b) allows the utility to accrue AFUDC on the excluded amount. [Rule 25-6.0141(1)(g)]

Notwithstanding the Commission's rule, OPC witness Ramas and FRF witness Chriss recommend that Gulf's $60.9 million of non-interest-bearing CWIP be excluded from rate base on the grounds that the related projects are not "used and useful." [Ramas, Tr. 1459-60; Chriss, Tr. 1309] Ms. Ramas also claims that since non-interest-bearing CWIP is "only 19%" of total CWIP, excluding the $60.9 million from rate base would have minimal financial impact on Gulf's financial integrity. [Ramas, Tr. 1459-61] These positions are contrary to Commission precedent, decisions by the Florida Supreme Court, and sound regulatory policy.

The Commission routinely recognizes that non-interest-bearing CWIP is appropriate for inclusion in rate base. In Gulf's last rate case, the Company's requested non-interest-bearing CWIP was included in rate base without discussion. [Order No. PSC-02-0787-FOF-EI at 21] Non-interest-bearing CWIP was also included in rate base in the most recent series of rate cases for Tampa Electric Company [Order No. PSC-09-0283-FOF-EI at 13-14], Progress Energy Florida [Order No. PSC-10-0131-FOF-EI at 67], and Florida Power & Light Company [Order No. PSC-10-0153-FOF-EI at 100]. No party in those cases attempted to claim that such CWIP should be excluded as not used and useful. Further, because of the short-term nature of the projects that make up non-interest-bearing CWIP, many of the projects will be placed in service during the test year. [McMillan, Tr. 1160]

Importantly, in two cases decided prior to the Commission's adoption of Rule 25-6.0141, the Florida Supreme Court held that the "used and useful" requirement of Section 366.06(1) does not preclude the inclusion of CWIP in rate base. *Citizens v. Public Service Commission,* 425 So.2d 534 (Fla. 1982); *Shevin v. Yarborough,* 274 So.2d 505 (Fla. 1973). Thus there is no legal basis for the intervenors' position.

Finally, the evidence in this case shows that the Commission's practice of allowing non-interest-bearing CWIP in rate base is sound regulatory policy. Customers expect and deserve to have facilities in place to serve them when needed and to modernize existing facilities when it is cost-effective and/or improves service. [Deason, Tr. 2128, 2130] This requires Gulf to continuously invest in new or upgraded facilities such as those shown on MFR B-13. Monies are spent to construct these projects, and investors are entitled to earn a return on that investment. [McMillan, Tr. 1159-61; Deason, Tr. 2128-30] For large or long-term projects, that return is provided through the accrual of AFUDC. [McMillan, Tr. 1159; Deason, Tr. 2129] For small or short-term projects, that return is provided by including CWIP in rate base. [*Id.*] It is unheard of, and inconsistent with sound regulatory policy, to expect investors to invest their money with no opportunity to earn a return. [McMillan, Tr. 1159] Yet, that is precisely what OPC and FRF urge. If these investments are not included in rate base, Gulf will be denied the opportunity to earn a return on the capital that it has deployed to adequately meet its customers' need for service. [McMillan, Tr. 1159-1161; Deason, Tr. 2128-2130]

Ms. Ramas' suggestion that a return should be denied because non-interest-bearing CWIP is "only 19%" of total CWIP is disingenuous. Not allowing a return on these short term investments would be analogous to a bank not paying interest on CDs of less than 12 months simply because the depositor invested "only 19%" of his funds in short-term CDs. Obviously, investors expect a return on 100% of their capital for the entire time that it is invested, not just for a portion of their capital or when the investment exceeds 12 months. [Deason, Tr. 2130, 2135]

Gulf's proposed level of CWIP in rate base represents investments that are required to continue to provide safe and efficient service to its customers. The inclusion of that amount is consistent with the Commission's AFUDC rule, prior Commission policy, judicial precedent, and sound regulatory policy. No adjustment should be made to Gulf's proposed level of CWIP in rate base.

ISSUE 23: Should an adjustment be made to Plant Held for Future Use for the Caryville plant site?

No. The Caryville site has been included in Gulf's rate base as Plant Held for Future Use through prior Commission decisions in previous Gulf rate cases and should continue to be included in rate base. The site's acquired cost is small relative to the cost of acquiring a new plant site. The site is already certified under the Power Plant Siting Act for coal capacity, but the site cannot be used for a nuclear plant. Inclusion of the Caryville site in rate base as Plant Held for Future Use is still a prudent decision. No witness has testified that the Caryville site should not be included in rate base.

FIPUG and FRF have taken the position that the Caryville site should not be included in Plant Held for Future Use. This is curious as neither of their witnesses, Mr. Pollock for FIPUG nor Mr. Chriss for the FRF, advocate that this property should be excluded from rate base. Even Mr. Schultz, OPC's witness who discussed the Caryville site in his testimony, did not advocate that the site be excluded from rate base. [Schultz, Tr. 1540-43] In fact, no witness provided any evidence to provide any basis to exclude the Caryville site. In contrast, Gulf's witness Mr. Burroughs testified that the Caryville site should be included in rate base for a variety of reasons. [Burroughs, Tr. 759-60, 767, 772; Ex. 147 at 31-38, 67-69] So, the only evidence before the

Commission regarding whether the Caryville site should be included in rate base is that it should be included.

A brief catalog of the evidence supporting the inclusion of the Caryville site in rate base is instructive. The site is approximately 2,200 acres in Holmes County, Florida, near the eastern end of Gulf's service area, and its book value is $1,356,000. [Burroughs, Tr. 759; Ex. 147 at 35] That translates into a cost of some $616 per acre. The site has been included in PHFU in Gulf's last six rate cases. [Burroughs, Tr. 759-60] The Caryville site is certified under the Power Plant Siting Act for two 500 MW coal units. [Ex. 147 at 31] It remains one of the few suitable sites in Northwest Florida for a steam electric generating unit, and Gulf's customers benefit by having a certified site ready for use. [Burroughs, Tr. 759] It was evaluated for nuclear and determined unsuitable. [*Id.*] However, it is suitable for combined cycle, coal and combustion turbines. [Ex. 147 at 37] It is close to a customer load center at the eastern end of Gulf's service area, and it strategically preserves a generation option for the system in that area. [Ex. 147 at 34-38] As explained by Mr. Burroughs, "it's imperative that we have both sites [Caryville and North Escambia] available." [Ex. 147 at 37]

<u>ISSUE 24</u>: Should the North Escambia Nuclear County 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?

$27,687,000 of North Escambia site costs should be included in rate base. Gulf was prudent: in 2007 investigating nuclear generation as an option; in considering nuclear to meet potential resource needs; in finding nuclear to be cost-effective; in performing site investigations; and in beginning permitting and licensing of a nuclear site. When Gulf learned that the North Escambia site was the only potential nuclear site in Northwest Florida, Gulf was prudent in preserving the nuclear option for its customers by acquiring the land. When circumstances changed, Gulf was prudent to defer its permitting efforts. By placing these costs in rate base, the Company can cease accruing carrying charges on the deferred nuclear site costs, which will save customers money.

Both Mr. Burroughs and Mr. McMillan addressed in Gulf's direct case why the North Escambia site should be included in Plant Held for Future Use. Prudence dictates that Gulf consider all viable generating technologies that have potential to be cost-effective to customers, and such an evaluation has implications in land held for future use. [Burroughs, Tr. 755] There is no value to customers in considering an option if there is no site potentially available for a technology. [*Id.*] So, after technical assessments of potential need and cost-effectiveness and learning there was only one site in Northwest Florida suitable for a nuclear plant, Gulf invested in the North Escambia site. [Burroughs, Tr. 755-59; Alexander, Tr. 2210-21] The site also can be used for other types of generation in addition to nuclear generation. [Burroughs Tr. 758; McMillan, Tr. 1079] The decision was reasonable, prudent and necessary to provide cost-effective generating resources for customers in the future. [Burroughs, Tr. 759; McMillan, Tr. 1080]

Three different intervenor witnesses testified that the North Escambia site should not be included in rate base. Both Mr. Chriss, FRF's witness, and Mr. Meyer, FEA's witness, argued that the North Escambia site should not be included because (a) Gulf did not have a determination of need for the site under Section 366.93, and (b) Gulf has no need for generation until at least 2022. [Chriss, Tr. at 1306-09; Meyer, Tr. at 1763-64] Mr. Schultz, OPC's witness, raised the same arguments as witnesses Chriss and Meyer as well as other arguments, including his unsupported claim that Gulf spent funds before undertaking analyses. [Schultz, Tr. 1533-47]

Gulf responded to the intervenor arguments with extensive testimony from Ms. Alexander, in which she rebutted every argument advanced by the intervenor witnesses. [Alexander, Tr. 2206-37, 2239-42] The intervenors moved to strike almost half of Ms. Alexander's rebuttal testimony, inaccurately arguing that it was supplemental direct rather than rebuttal. First the Prehearing Officer, and then the entire Commission, rejected this intervenor argument.

Ms. Alexander's rebuttal testimony places this issue in its proper perspective. The revenue requirements associated with the North Escambia site are approximately $3.1 million, less than 1% of Gulf's total base rate revenues. "The cost of including the North Escambia site in rate base would be roughly 26¢ on a 1,000 kWh residential bill." [Alexander, Tr. 2209] So, for essentially a quarter a month, Gulf has preserved a nuclear generation option that could save its customers hundreds of millions if not billions of dollars <u>if that option proves appropriate</u>.

Options have their greatest value at times of uncertainty. [Burroughs, Tr. 765] The North Escambia site is an extraordinarily valuable option that Gulf has preserved for its customers at a time of great uncertainty. There are a number of potential environmental requirements that could cause Gulf to face retirement of a significant part of its coal fleet: mercury, SO_2, NO_x, 316(b), water, and coal ash regulation. [Alexander, Tr. 2221] One of the greatest threats is prospective greenhouse gas emission controls. As Ms. Alexander pointed out, even under current forecasts, nuclear continues to be more cost-effective than gas in virtually any carbon control scenario. [Alexander, Tr. 2244]

Ms. Alexander's rebuttal also refuted each of the misstatements and mischaracterizations made by Mr. Schultz. Some of the major points of Ms. Alexander's testimony are addressed in the following paragraphs.

In his testimony, Mr. Schultz suggested that there was a question as to whether costs for which Gulf sought recovery were actually incurred. [Schultz, Tr. 1533] In response, Ms. Alexander provided a thirteen page discussion thoroughly explaining what costs had been incurred, what costs were forecasted to be incurred through the 2012 test period, and why the costs had been or should be incurred. [Alexander, Tr. 2209-21]

In response to Mr. Schultz's suggestion that nuclear did not make sense for Gulf "from an operational perspective," Ms. Alexander explained that Mr. Schultz's self-proclaimed "common sense" observations did not withstand critical scrutiny. [Alexander, Tr. 2223-24] The threshold technical issue to be addressed was whether Gulf had sufficient minimum load to justify the construction of a nuclear unit. Gulf performed the appropriate analyses and found that its minimum load was sufficient to justify such a unit. [*Id.*]

Ms. Alexander pointedly rejected Mr. Schultz's misleading suggestion that Gulf was considering building a 1,200 MW nuclear unit to meet only 30 MW of need in 2022. When Gulf first began considering the nuclear generation option to meet future needs, the Company faced a forecasted need of more than 1,000 MW, without consideration of coal retirements for environmental reasons. [Alexander, Tr. 2223; Ex. 163, Sch. 4] Even under its current forecast, when one looks beyond Gulf's forecasted need of 30 MW in 2022 (Mr. Schultz's data point) and considers the expiration of the 875 MW Central Alabama contract in May 2023, Gulf has a projected need of almost another 1,000 MW. Once again, this is without consideration of potential coal retirements due to environmental regulations. [Alexander, Tr. 2233]

Ms. Alexander also rebutted Mr. Schultz's mischaracterization of Mr. Burroughs' direct testimony that Gulf invested $27.7 million in the North Escambia site without technical analysis. She provided a number of analyses that showed Gulf thoroughly investigated the nuclear generation option and the North Escambia site before making its purchase decision. [Ex. 163, Sch. 3-11] Ms. Alexander then concluded:

> Gulf's purchase of the North Escambia site did not precede technical analysis. The purchase was the fruit of the technical analysis. Gulf needed to act to

> preserve the valuable nuclear option for its customers. The potential value of the nuclear option was supported by multiple years of site investigation, need assessments, cost-effectiveness analyses and other technical assessments.

[Alexander, Tr. 2233]

Ms. Alexander also refuted Mr. Schultz's claim that the purchase of the North Escambia site was inconsistent with preserving planning flexibility. She explained how the purchase preserved planning flexibility by keeping the nuclear option open without committing Gulf to any particular technology. [Alexander, Tr. 2234-35] The purchase of the North Escambia property preserves the only potential site in Northwest Florida where a nuclear unit could be built for Gulf's customers, and the newly purchased site can also be used for conventional generation technologies. [*Id.*]

The heart of Ms. Alexander's rebuttal was her total refutation of Mr. Schultz's undocumented assertion that the purchase of the North Escambia site was not reasonable and prudent. Ms. Alexander said it best:

> In the face of government policy that discouraged carbon emissions, forecasted capacity needs on Gulf's system, high forecasted gas prices, and state legislation designed to encourage nuclear unit development, Gulf was prudent in investigating the nuclear option. When nuclear appeared to hold promise to meet known and potential environmental induced need, Gulf was prudent to begin extensive site investigation and prepare for permitting and licensing. When Gulf learned there was only one nuclear site available in Northwest Florida, Gulf was prudent in beginning to purchase the site. When factors changed that made the need for capacity less imminent, Gulf was prudent again in deferring its licensing and permitting activities. And as Mr. McMillan points out in his direct testimony, ceasing to accrue carrying charges on the deferred nuclear site costs and asking for base rate recovery of those costs is also in the interest of Gulf's customers. The North Escambia site should be included in rate base.

[Alexander, Tr. 2236-37]

<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)**

Yes. The 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 is appropriate for purposes of computing base rate revenue requirements.

The only Property Held for Future Use contested in this case is the North Escambia Site in Issue 24. The Caryville site addressed in Issue 23 is uncontested. Both properties preserve valuable options for Gulf's customers and should be included in rate base. [Ex. 147 at 35]

ISSUE 26: **Stipulated**

ISSUE 27: 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?

No. Gulf's request for working capital related to the reserve and an increased accrual related to property damage is prudent and in the best interest of Gulf's customers. If the property damage accrual is changed from the amount proposed by Gulf, the working capital related to the reserve must also be adjusted. Since Gulf's target reserve level has not been adjusted since 1996, the reserve target should be increased to the range of $52 million to $98 million to reflect Gulf's actual experience. Issue 76 also discusses the appropriateness of the storm damage accrual.

No adjustments should be made to Gulf's requested (a) storm damage reserve, (b) annual accrual or (c) target reserve level. Despite the broad wording of this issue, this issue is a rate base issue associated with the working capital impact of Gulf's property damage accrual. If adjustments were made to Gulf's requested annual property damage accrual of $6,539,091 (jurisdictional), then corresponding adjustments should also be made to working capital as Mr. McMillan did in his direct testimony. [McMillan, Tr. 1080]

In the discussion of this issue, Gulf addresses the appropriate target range for the property damage reserve, which the Company has requested be increased from the current target range of $25.1 to $36 million to a new target range of $52 to $98 million. The amount of the annual accrual to the property damage reserve is addressed in Issue 76 and will not be repeated here.

Any changes to the property damage accrual made in response to Issue 76 will impact working capital as discussed in Mr. McMillan's testimony.

As noted above, Gulf has requested that its target property damage reserve range be raised to a new target range of $52 million to $98 million. [Erickson, Tr. 962-66] The existing $25.1to $36 million target range for the property damage reserve was established in a 1995 docket by Order No. PSC-96-1334-FOF-EI. [Erickson, Tr. 965] If the target range was merely adjusted for inflation and customer growth occurring since the current target range was established, the resulting range would be $48 million to $69 million in 2012 dollars. [Erickson, Tr. 2305] However, the Company has instead proposed a new target range based on Gulf's actual experience with the amounts charged to the property damage reserve in 2004 for Hurricane Ivan ($98 million) and in 2005 for Hurricane Dennis ($52 million). [Erickson, Tr. 965]

After fifteen years and the impact of customer growth and inflation, a new reserve target range is appropriate. No intervenor witness took issue with Gulf's proposed increase to the target range for the property damage reserve; the intervenor witnesses only addressed the annual accrual in opposition to the increase requested by Gulf. As noted earlier, that is the topic of Issue 76. Gulf's proposed target range for the property damage reserve of $52 - $98 million is essentially unchallenged, is based on the Company's actual property damage experience and should be adopted. [Erickson, Tr. 962-66]

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

Yes. Rate case expenses are prudently incurred business expenses. The Company should be allowed to fully recover these costs, including a return on the unamortized investment. This unamortized balance should be included in working capital, consistent with the Commission's treatment of these expenses in Gulf's previous rate case.

Ms. Ramas' recommendation to exclude unamortized rate case expense from working capital should be rejected. Rate case expenses are prudently incurred business expenses. [McMillan, Tr. 2365-66] The Company should be allowed to fully recover these costs, including a return on the unamortized investment. [*Id.*] This unamortized balance should be included in working capital, consistent with the Commission's treatment of these expenses in Gulf's previous rate case. [*Id.*]

ISSUE 29: **Dropped**

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. The appropriate level of Working Capital for the 2012 test year is $149,828,000 ($154,235,000 system). This amount includes an adjustment to Gulf's original request to reflect the effect of the stipulation on Issue 26 relating to fuel inventories.

This is a fallout issue. The appropriate starting point is Gulf's requested jurisdictional Working Capital of $150,609,000 as shown on MFR B-1. This amount should be reduced by $781,000 to reflect the effect of the stipulation on Issue 26 that removes $338,000 of Plant Scherer in-transit fuel and reduces the test year gas storage inventory by $443,000.

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 level of rate base for the 2012 test year is $1,733,093,000 ($1,771,141,000 system). This amount includes adjustments to Gulf's original request to include the Crist 6 and 7 turbine upgrades (Issues 8 and 9), to reflect the stipulated adjustment to accumulated depreciation for non-AMI meters (Issue 20), to correct an ECCR adjustment error, and to reflect the stipulated adjustment to fuel inventories (Issue 26).*

This is a fallout issue. The appropriate starting point is Gulf's requested jurisdictional rate base of $1,676,004,000 as shown on MFR B-1. This amount should be increased by $58,747,000, representing the annualized jurisdictional rate base (plant in service less accumulated depreciation) associated with the Crist 6 and 7 turbine upgrades discussed in Issue 9. [Ex. 23, Sch.1 at 1] It should also be increased by $443,000 to reflect a reduction in the accumulated depreciation balance for non-AMI meters contained in the approved stipulation on Issue 20. It should then be reduced by $1,320,000 for an ECCR adjustment error identified in Gulf's response to FEA's Interrogatory No. 46 and quantified in Gulf's response to Staff's Interrogatory No. 262 and 263. [Ex. 105 at 00535-37] Finally, it should be reduced by $781,000 for the reduction in fuel inventory made by the approved stipulation to Issue 26.

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

* The appropriate amount of accumulated deferred taxes to include in capital structure is $265,856,000. This amount includes adjustments to Gulf's original request to reflect the pro-rata portion of the rate base adjustments identified in Issue 31.*

The appropriate amount of jurisdictional deferred taxes to include in Gulf's capital structure should be determined by beginning with the requested level of $257,098,000 shown on MFR D-1a. This amount should be adjusted for the pro-rata portion of the rate base adjustments identified in Issue 31. In particular, it should be increased by $9,012,000 to reflect the inclusion of the Crist 6 and 7 turbine upgrades in rate base, and reduced by $254,000 for the effect of the stipulated rate base adjustments. No other adjustments are necessary or appropriate.

FEA's witness Mr. Gorman initially proposed an adjustment to the amount of deferred taxes included in Gulf's proposed capital structure. [Gorman, Tr. 1372] After reviewing Mr. McMillan's rebuttal testimony, which explained that the deferred tax balance included in Gulf's capital structure includes the net amount of regulatory assets and liabilities related to FAS 109, Mr. Gorman testified at hearing that he would "withdraw the proposed adjustments and no longer take issue with the company's proposed capital structure." [McMillan, Tr. 2361-62; Gorman, Tr. 1429]

OPC's witness Ms. Ramas asserts that if the Commission approves Gulf's proposal to include the full cost of the Crist 6 and 7 turbine upgrades in rate base beginning in 2013, the Commission should also adjust the amount of deferred taxes included in Gulf's capital structure. [Ramas, Tr. 1503] Such an adjustment is unnecessary and inappropriate. When these projects were expected to be recovered through the ECRC, their costs were removed from capital structure on a pro rata basis. [McMillan, Tr. 2372] Now that the parties have stipulated to their transfer from ECRC to base rates, their costs should be added back to capital structure on the same pro rata basis. [*Id.*] Ms. Ramas' suggestion to adjust only one source of capital without reflecting other changes in capital structure and cost of capital is not appropriate. [*Id.*]

Finally, OPC took the position that if Congress acted before the conclusion of the hearings in this case to increase the bonus depreciation rate for 2012, that change should be reflected in this case. Congress did not act and therefore no related adjustment is necessary.

ISSUE 33: What is the appropriate amount and cost rate of the unamortized investment tax credits to include in the capital structure?

* The appropriate amount of unamortized investment tax credits to include in capital structure is $3,026,000. This amount includes adjustments to Gulf's original request to reflect the pro-rata portion of the rate base adjustments identified in Issue 31. The appropriate cost rate is 8.34% for purposes of calculating the weighted average cost of capital. This rate includes adjustments to Gulf's original request to reflect changes in the rates of long-term debt and preference stock as stipulated in Issues 34 and 36.*

The appropriate jurisdictional amount of unamortized investment tax credits ("ITCs") to include in Gulf's capital structure should be determined by beginning with the requested level of $2,929,000 shown on MFR D-1a. This amount should be adjusted for the pro-rata portion of the rate base adjustments identified in Issue 31. In particular, it should be increased by $100,000 to reflect the inclusion of the Crist 6 and 7 turbine upgrades in rate base, and reduced by $3,000 for the effect of the stipulated rate base adjustments. No other adjustments are necessary or appropriate.

The appropriate cost rate for the ITCs is 8.34%. This is the weighted average rate of the three primary sources of investor capital – common equity, long-term debt, and preference stock. This weighted average rate is based on Gulf's requested cost of equity of 11.7% and the actual cost rates for long-term debt (5.26%) and preference stock (6.39%) contained in the approved stipulations on Issues 34 and 36.

This calculation method, which excludes short-term debt, is the method used in calculating the ITC cost rate on MFR D-1a. It is the method used by the Commission to establish Gulf's ITC cost rate in the Company's last rate case. No party to this proceeding presented testimony or evidence to challenge or question the Company's methodology. It is therefore the appropriate method to be used for setting rates in this docket.

ISSUE 34: **Stipulated**

ISSUE 35: **Stipulated**

ISSUE 36: **Stipulated**

ISSUE 37: What is the appropriate return on equity (ROE) to use in establishing Gulf's revenue requirement?

Evaluating both the operational and financial risks facing Gulf Power indicates that the market would expect a company with Gulf Power's profile to earn a return of 11.7% commensurate with the risk to investors' equity capital.

As a regulated utility, Gulf's investors must be given the opportunity to earn a return on their investment that is commensurate with the returns being earned on other investments of comparable risk. *See, Bluefield Water Works and Improvement Co. v. Public Service Comm'n.*, 262 U.S. 679, 692 (1923); *Federal Power Comm'n., v Hope Natural Gas Co.,* 320 U.S. 561, 603 (1944). [Vander Weide, Tr. 300-301, 304, 308-310] The testimony of Dr. Vander Weide establishes that an 11.7 percent return on equity is required to give Gulf's investors that opportunity to earn a return commensurate with investments in other utilities having similar business and financial risk. [Vander Weide, Tr. 301, 304, 345-346]

Dr. Vander Weide estimates Gulf's cost of equity by applying several standard cost of equity methods to market data for a large group of utility companies ("proxy companies") of comparable business risk. [Vander Weide, Tr. 300] As discussed in more detail below, these studies show that the cost of equity for the proxy companies is 10.8 percent. [Vander Weide, Tr. 301] Gulf's ratemaking capital structure involves more financial leverage, and hence greater financial risk, than the average market-value capital structure of the group of proxy companies. [Vander Weide, Tr. 301-03] A financial leverage adjustment is required to reflect this greater degree of financial risk. [*Id.*] Making this adjustment produces a cost of equity of 11.7 percent. [Vander Weide, Tr. 301; Ex. 11, Sch. 10; Ex. 145 at 55-56]

Dr. Vander Weide uses several generally accepted methods for estimating Gulf's cost of equity. These are the Discounted Cash Flow (DCF), the ex ante risk premium, the ex post risk premium, and the capital asset pricing model (CAPM). [Vander Weide, Tr. 316] Some variation of two or more of these models is employed by the other cost of capital witnesses in this proceeding, Dr. Woolridge on behalf of OPC and Mr. Gorman on behalf of FEA. The dispute among the parties is not about the basic models themselves, but rather the details of the way in which the models are applied.

Dr. Vander Weide's Analysis

DCF Model

Dr. Vander Weide's analysis begins with the DCF model. The DCF model is based on the assumption that investors value an asset based on the future cash flows they expect to receive from owning the asset and that investors value a dollar received in the future less than a dollar received today. [Vander Weide, Tr. 317-18] The DCF model therefore assumes that a company's stock price is equal to the present discounted value of all expected future dividends. [Vander Weide, Tr. 319] In performing his study, Dr. Vander Weide uses a quarterly DCF model rather than an annual DCF model. [Vander Weide, Tr. 319-20] This is necessary because the annual DCF model is a correct expression of the present value of future dividends only if dividends are paid annually at the end of each year. [*Id.*] Because all companies in the proxy group pay dividends quarterly, a quarterly DCF model should be used to estimate their cost of equity. [*Id.*; Ex. 12, App. 2] In fact, the Commission uses a quarterly DCF model in establishing the annual leverage graph that is used to estimate the cost of equity for water and wastewater utilities. [Vander Weide, Tr. 1825; Order No. PSC-11-0287-PAA-WS]

The quarterly DCF model requires an estimate of the dividends that investors expect to receive over the next four quarters. [Vander Weide, Tr. 320] Dr. Vander Weide estimates these amounts by multiplying the previous four quarterly dividends by the factor, (1 + the growth rate). [*Id.*] To estimate dividend growth, he uses analysts' estimates of earnings per share growth as reported by I/B/E/S Thomson Reuters. [Vander Weide, Tr. 321] Dr. Vander Weide uses analysts' projections because the DCF model requires the growth expectations of investors. [Vander Weide, Tr. 322] There is considerable empirical evidence that analysts' forecasts are the best estimate of those investor expectations, including a study performed by Dr. Vander Weide and Professor Carleton and later updated by State Street Financial Advisors. [Vander Weide, Tr. 322-323; Ex. 108 at 000603-608] Dr. Woolridge criticizes Dr. Vander Weide's reliance on analysts' growth rate projections, claiming that such projections are "overly optimistic and upwardly biased." [Woolridge, Tr. 1698] As demonstrated in Dr. Vander Weide's rebuttal testimony, the available research shows that analysts' growth forecasts are <u>not</u> optimistic. [Vander Weide, Tr. 1840, 1855] In fact, the most important contribution of more recent research is to identify substantial problems in earlier studies that caused some of them to accept the hypothesis of optimism when no optimism was present. [Vander Weide, Tr. 1840-42, 1855-1859]

Dr. Vander Weide also included a five percent (or 26 basis point) allowance for flotation costs in his analysis. [Vander Weide, Tr. 324, 335] This is a conservative estimate that is intended to reflect the combined effect of issuance costs and market pressure, which total anywhere from five to eight percent of the proceeds of an equity issue. [Vander Weide, Tr. 325] Such an adjustment is appropriate regardless of whether a company issues stock during the year, just as an adjustment is made to the cost of debt to reflect previously incurred debt issuance costs regardless of whether any debt is issued during the year. [Vander Weide, Tr. 324-325; Ex. 12, App. 3] Although Dr. Woolridge criticizes the inclusion of a flotation cost adjustment, the Commission stated in the 2009 TECO rate order that such an adjustment is typically appropriate:

> We have traditionally recognized a reasonable adjustment for flotation costs in the determination of the investor-required ROE. ...[S]uch adjustments have typically been on the order of 25 to 50 basis points. [Order No. PSC-09-0283-FOF-EI at 44]

In addition, the Commission typically uses a flotation cost allowance of four percent in both the DCF and CAPM models when establishing the annual leverage graph that is used to estimate the cost of equity for water and wastewater utilities. [Vander Weide, Tr. 1831; Order No. PSC-11-0287-PAA-WS]

Dr. Vander Weide applied his DCF model to a proxy group of 24 companies having comparable business risk to Gulf. This proxy group consists of all the companies in Value Line's groups of electric companies that met the five selection criteria described in his testimony. [Vander Weide, Tr. 325-327] The results of this study produced a market-weighted average DCF result of 10.7 percent as an estimate of the cost of equity. [Vander Weide, Tr. 327; Ex. 11, Sch. 1]

<u>Risk Premium Methods</u>

The risk premium method of estimating Gulf's cost of equity is based on the principle that investors expect a return on an equity investment in Gulf that reflects a premium over the return they expect on an investment in a portfolio of bonds. [Vander Weide, Tr. 327] Dr. Vander Weide used two methods to estimate the required risk premium on an equity investment in Gulf – the ex ante risk premium method and the ex post risk premium method. [Vander Weide, Tr. 327-29]

For his ex ante risk premium study, Dr. Vander Weide first compared the DCF expected return for Moody's group of 24 electric companies to the interest rate on Moody's A-rated utility bonds for the 136-month period from September 1999 to December 2010. [Vander Weide, Tr. 329-330; Ex. 11, Sch. 2; Ex. 12, App. 4] A regression analysis performed on the results revealed a relationship between the calculated risk premium and interest rates. [Vander Weide, Tr. 329] Dr. Vander Weide used the results of the regression analysis to estimate the investors' required risk premium (4.90 percent) which he then added to the forecasted yield to maturity on A-rated utility bonds (6.15 percent) to obtain a cost of equity estimate of 11.0 percent. [Vander Weide, Tr. 329-330]

For his ex post risk premium study, Dr. Vander Weide first compared the annual average historical returns, since 1937, for a portfolio consisting of Moody's A-rated utility bonds versus two stock portfolios, the S&P 500 and the S&P Utilities stocks. [Vander Weide, Tr. 330-31] He made two comparisons because electric utility companies today face risks that are somewhere between the average risk of the S&P Utilities and the S&P 500 companies over the period 1937 to 2010. [Vander Weide, Tr. 331-32] His study showed that the annual average return on the S&P 500 stock portfolio has been 11.06 percent, or a 4.64 percent risk premium above the 6.42 percent return on the Moody's A-rated utility bond portfolio. [Vander Weide, Tr. 331] Similarly, the annual average return on the S&P Utilities stock portfolio has been 10.5 percent, or a 4.1 percent risk premium above the 6.42 percent return on the Moody's A-rated utility bond portfolio. [*Id.*] Dr. Vander Weide then performed a regression analysis which determined that there is no statistically significant trend over time in the risk premium data. [Vander Weide, Tr. 333-334] Adding the historical risk premiums of 4.1 to 4.6 percent to the forecasted yield to maturity on A-rated utility bonds (6.15 percent) results in an expected return on equity in the range of 10.2 to 10.8 percent, with a mid-point of 10.5 percent. [Vander Weide, Tr. 335] Adding a 26 basis point allowance for flotation costs yields an estimate of 10.8 percent as the ex post risk premium cost of equity for Gulf. [*Id.;* Ex. 11, Sch. 3 and 4; Ex. 12, App. 5]

Dr. Woolridge criticizes Dr. Vander Weide's use of arithmetic average returns, rather than geometric mean returns, in calculating the historical returns used in the ex post risk premium study. [Woolridge, Tr. 1713-16] This criticism is not valid. As explained in the

Ibbotson SBBI Valuation Edition 2011 Yearbook, "[f]or use as the expected risk premium in either the CAPM or the building block approach, the arithmetic mean or the simple difference of the arithmetic means of stock market returns and riskless rates is the relevant number." [Vander Weide, Tr. 1864-65] The importance of using arithmetic means in the context of CAPM or risk premium studies is discussed further in Dr. Vander Weide's Exhibit 11, Schedule 5.

CAPM Methods

The CAPM is a model of the security markets in which the expected or required return on a given security is equal to the risk-free rate of return plus the company equity "beta" times the market risk premium. [Vander Weide, Tr. 335] The risk-free rate of return is the expected return on a risk-free government security; the equity beta is a measure of the company's risk relative to the market as a whole; and the market risk premium is the premium that investors require to invest in a market basket of all securities compared to the risk-free security. [Vander Weide, Tr. 336]

Dr. Vander Weide estimated the CAPM cost of equity in two ways, first using data on the historical risk premium for the S&P 500 for the period 1926 to 2009 (historical CAPM) and second using data on the DCF risk premium for the S&P 500 (DCF-based CAPM). [Vander Weide, Tr. 336-37] For "beta," Dr. Vander Weide used the average beta of 0.67 for his group of proxy companies and for the risk-free rate he used a forecasted yield of 4.45 percent for 20-year Treasury bonds. [Vander Weide, Tr. 336] These analyses produced a historical CAPM, including a 26 basis point flotation allowance, of 9.2 percent and a DCF-based CAPM, including flotation, of 10.7 percent. [Vander Weide, Tr. 338, 342-43; Ex. 11, Sch. 6, 8]

There is substantial evidence that the historical CAPM tends to underestimate the cost of equity for companies whose equity beta is less than 1.0 and that it is less reliable the further the estimated beta is from 1.0. [Vander Weide, Tr. 339] Because the current beta for the proxy group is 0.67, Dr. Vander Weide concluded that the CAPM results should be given little or no weight for purposes of estimating Gulf's cost of equity in this proceeding. [Vander Weide, Tr. 339-42, 343] It should be noted that both Dr. Woolridge and Mr. Gorman also performed CAPM analyses, and that both ultimately gave little to no weight to the CAPM results in making their final recommendations on the cost of equity. [Woolridge, Tr. 1693-94; Gorman, Tr. 1398-99]

Cost of Equity

Based on the results of his DCF, ex ante risk premium, and ex post risk premium analyses, Dr. Vander Weide concluded that the cost of equity for his proxy group is 10.8 percent, which is the simple average of the results of these three methodologies. [Vander Weide, Tr. 343-44] This cost of equity reflects the financial risk associated with the average market value capital structure of his proxy company group. [Vander Weide, Tr. 344] Because the financial risk associated with Gulf's capital structure is greater than the financial risk reflected in the cost of equity estimate for the proxy companies, Gulf's cost of equity will necessarily be higher than the cost for the proxy group. [Vander Weide, Tr. 344; Ex. 11, Sch. 9]

In order to properly account for the increased financial risk inherent in Gulf's more highly leveraged ratemaking capital structure, Dr. Vander Weide calculated the return on equity that would be required for Gulf to have the same weighted average cost of capital as the proxy companies. [Vander Weide, Tr. 345-46] This calculation shows that investors would require a fair rate of return on equity of 11.7 percent in order to compensate for Gulf's greater financial risk. [*Id.*; Ex. 11, Sch. 10] This is the cost of equity that the Commission should approve in this proceeding.

Dr. Vander Weide's Financial Risk Adjustment

As indicated above, Dr. Vander Weide's financial risk adjustment results in a cost of equity that is 90 basis points higher than the cost of equity for his proxy group. Both Dr. Woolridge and Mr. Gorman take issue with this adjustment and claim that financial leverage should be measured on a book value basis rather than a market value basis. [Woolridge, Tr. 1727-29; Gorman, Tr. 1404-07] This claim is not valid. [Vilbert, Tr. 1924]

The need for a financial risk adjustment arises from the fact that Gulf has more debt and preference stock in its capital structure (roughly 54 percent) than the companies in Dr. Vander Weide's proxy group (roughly 45 percent). [Vilbert, Tr. 1924, 1927] Because payments on debt are made before any payments to equity investors, the financial risk to equity investors increases as the percentage of debt in a company's capital structure increases. [Vilbert, Tr. 1924] Gulf has a higher percentage of debt (and lower percentage of equity) in its capital structure than Dr. Vander Weide's proxy group of companies. [Vilbert, Tr. 1924, 1927; Vander Weide, Tr. 344-45, Ex. 11, Sch. 9] This means that although Gulf has comparable business risk to the companies in the proxy group, it has more financial risk, for which investors will require compensation in the form of higher returns on their equity investment. [Vilbert, Tr. 1924-25]

In setting Gulf's return on equity, it is important that Gulf's overall rate of return (weighted average cost of capital) be the same as that estimated for the proxy companies. [Vander Weide, Tr. 345; Vilbert, Tr. 1925] This requires an upward adjustment to Gulf's return on equity to recognize its greater financial risk. Such a financial leverage adjustment is necessary in order to have an apples-to-apples comparison between Gulf and the proxy group. [Vilbert, Tr. 1925] This type of adjustment is required no matter what cost of equity estimate, or what proxy group, is used as the starting point. [*Id.*] The underlying principle that an adjustment is required to account for financial risk is recognized by the Commission in establishing the annual leverage graph that is used to estimate the cost of equity for water and wastewater utilities. Under that leverage graph, the lower a utility's equity ratio, the higher its allowed cost of equity. [Order No. PSC-11-0287-PAA-WS]

The fundamental flaw in Dr. Woolridge and Mr. Gorman's criticism of the financial leverage adjustment is their disregard of market value capitalization in measuring a company's financial leverage. [Vilbert, Tr. 1909, 1925] Their suggestion that financial risk is properly measured by a book value capital structure is incorrect, both theoretically and practically. [Vilbert, Tr. 1925] As a matter of theory, the risk to an equity investor is measured by the forward-looking variance of return on investment. [Vander Weide, Tr. 1870-71, 1887-88] The variance of return on investment depends on a company's market value capitalization, not its book value capitalization. [Vander Weide, Tr. 1871, 1888] The notion that financial leverage is and should be measured on a market value basis is supported by textbooks on corporate finance, professional valuation books, and Morningstar's method for deriving cost of capital estimates. [Vilbert, Tr. 1912, 1925] As a practical matter, consider the examples of a real estate investor or a mortgage lender. As illustrated in Dr. Vilbert's testimony, the return on equity to a real estate investor depends on the market value of his investment, not the original cost or net book value. [Vilbert, Tr. 1915-18] Similarly, in evaluating the riskiness of refinancing a home mortgage, a mortgage lender looks to the market value of the property, not its book value (the owner's purchase price), in calculating a loan-to-value ratio. [Vilbert, Tr. 1926]

There is no mismatch involved in comparing Gulf's book value capital structure to the proxy companies' market value capital structures. [Vilbert, Tr. 1910] This simply reflects the fact that the cost of capital for the proxy companies is based on the financial risk inherent in their market value capital structures while Gulf's risk is measured on the financial risk inherent in its regulatory capital structure, which is based on book value. [Vander Weide, Tr. 1872; Vilbert, Tr. 1910; Ex. 145 at 51-53, 57] It would be inappropriate to use book value capital structures for the proxy companies when adjusting Gulf's cost of equity. [Ex. 145 at 58] It is the market value capital structures of the proxy companies, not their book value capital structures, which are reflected in the estimate of their cost of equity. [Ex. 145 at 58, 62-64] Thus attempting to compare the proxy companies' book value capital structures to Gulf's book value capital structure would not be an apples-to-apples comparison. [*Id.*]

In summary, Dr. Vander Weide's financial risk adjustment is based on sound financial theory, is consistent with investors' practical evaluation of risk, and is absolutely appropriate in this proceeding in order to correctly estimate Gulf's cost of equity. [Vilbert, Tr. 1927]

Dr. Woolridge's Flawed Cost of Equity Analysis

Dr. Woolridge estimates Gulf's cost of equity at 9.25 percent, based almost entirely on his DCF model result of 9.3 percent. [Woolridge, Tr. 1694] That estimate is based on a flawed application of the DCF methodology and should be rejected.

There are a number of flaws in Dr. Woolridge's selection of a proxy group for his DCF analysis. First, he requires that a proxy company must be followed by AUS Utility Reports. This is an inappropriate criterion because the average investor does not rely on AUS Utility Reports as an important or widely used source of information. [Vander Weide, Tr. 1821] Second, he requires that a proxy company must derive at least 50 percent of its revenues from regulated electric utility services. [Vander Weide, Tr. 1821-22] This criterion inappropriately eliminates a number of companies with a combination of electric and natural gas operations, even though they are widely considered to be of relatively similar risk. [*Id.*] Third, he requires that a proxy company must have an investment grade bond rating as reported by AUS Utility Reports. However, AUS is an unreliable source of bond rating information, and erroneously reports investment grade bond ratings for some companies that are actually below investment grade. [Vander Weide, Tr. 1822-23]

Dr. Woolridge employs a version of the DCF model which is based on the assumption that dividends are paid annually. Since his proxy companies all pay dividends quarterly, the use of an annual model is inappropriate and underestimates the cost of equity. [Vander Weide, Tr. 1824-25] Dr. Woolridge further understates the cost of equity by including only one-half of the annual dividend growth rate in calculating the first period dividend in his model. [Vander Weide, Tr. 1825-26]

The DCF model requires an estimate of future growth rates in earnings, dividends and book values. Dr. Woolridge's final estimate of the growth rate that investors expect is an approximate average of Value Line's historical growth rates, Value Line's projected growth rates, Dr. Woolridge's internal growth rates, and his reported analysts' growth rates. [Vander Weide, Tr. 1826; Woolridge, Tr. 1679] The use of historical growth rates and internal growth rates causes his model to understate investors' growth expectations. First, Value Line's historical growth rates are about 100 basis points lower than its projected growth rates for Dr. Woolridge's proxy companies. [Vander Weide, Tr. 1827] Since analysts' forecasts already incorporate all relevant information regarding historical growth rates, separate use of historical growth rates will understate investors' growth expectations. [Vander Weide, Tr. 1826] The research literature also demonstrates that (a) analysts' growth forecasts are more accurate than forecasts based on extrapolation of historical growth rates and (b) changes in analysts' growth forecasts are a better predictor of changes in stock prices than are historical earnings growth rates. [Vander Weide, Tr. 1836-39]

The internal growth method that Dr. Woolridge relies on in part to develop his earnings growth rate is logically circular in that it requires one to estimate the expected return on equity in order to estimate the cost of equity. [Vander Weide, Tr. 1827] One's final estimate of the DCF cost of equity is therefore influenced by the expected return on equity input into the internal growth rate formula.

Beyond this logical inconsistency, Dr. Woolridge mistakenly used a zero percent projected rate of return for Xcel Energy when calculating his internal growth rate projection. [Vander Weide, Tr. 1828] If he had used the correct projected rate of return of 10 percent for Xcel, the average return on equity for his proxy company group would have been 50 basis points higher, or 10.3 percent rather than 9.8 percent. [*Id.*]

Mr. Gorman's Flawed Cost of Equity Analysis

Mr. Gorman estimates Gulf's cost of equity at 9.75 percent, based on his DCF and risk premium model which both produce results of 9.75 percent. [Gorman, Tr. 1398-99] There are flaws in his application of both models, and his resulting cost of equity estimate should be rejected. Further, Mr. Gorman's claim that a return of equity on 9.75 percent would allow Gulf to maintain its financial integrity is based on an incomplete analysis and is simply incorrect.

Mr. Gorman's application of the DCF model suffers from several of the same flaws as Dr. Woolridge's. He uses an annual version of the model despite the fact that the companies in his proxy group pay dividends quarterly, and he neglects to make a flotation cost allowance. [Vander Weide, Tr. 1876-77] (This adjustment alone would get his recommendation to at least 10.0%.) The sustainable growth rate version of his model is also logically circular, since each company's rate of return on equity must be known in order to estimate the sustainable growth rate. [Vander Weide, Tr. 1880] It is not possible for the rate of return on equity to be known before the sustainable growth rate and, at the same time, the sustainable growth rate to be known before the rate of return on equity. [*Id.*]

Mr. Gorman's risk premium analysis suffers from two fundamental flaws. First, he measures the risk premium by looking at historical allowed authorized rates of return, not at investors' required rates of return. [Vander Weide, Tr. 1882-83] This fails to recognize that the Commission has a responsibility to make an independent assessment of Gulf's required return on equity. [*Id.*] Second, he fails to account for the fact that risk premiums increase when interest rates fall. [*Id.*] Dr. Vander Weide used the data in Mr. Gorman's exhibits to perform a regression analysis of the relationship between the risk premium implied by the allowed rates of return used by Mr. Gorman and the interest rates on Treasury bonds and A-rated utility bonds. [Vander Weide, Tr. 1883-84] This analysis confirms that there is an inverse relationship between risk premiums and interest rates. [Vander Weide, Tr. 1884-85] If Mr. Gorman had appropriately adjusted for the effect of this relationship, his risk premium analysis would have produced cost of equity estimates of 10.5 and 10.7 percent, approximately 70 to 90 basis points above his unadjusted results. [Vander Weide, Tr. 1886] This is without recognizing flotation costs, which would add another 26 basis points, to a range of 10.75 to 10.95 percent.

Finally, Mr. Gorman claims that the adoption of his 9.75 percent recommended return on equity would be supportive of an investment grade bond rating including what he mistakenly described as Gulf's "current 'BBB' bond rating." [Gorman, Tr. 1360, 1402-03] Mr. Gorman's analysis was based solely on a review of S&P's quantitative credit metrics as they relate to a minimum investment grade bond rating of "BBB-." This in an incomplete analysis and is insufficient to support his conclusion that his recommended ROE would support Gulf's current "A" rating. [Teel, Tr. 1950-51] First, Mr. Gorman limited his evaluation to only one of the three credit rating agencies. [Teel, Tr. 1951] Second, he did not consider the qualitative factors that are key drivers of a utility's credit ratings, including the impact that his ROE recommendation would have on the rating agencies' assessment of the regulatory environment in Florida. [Teel, Tr. 1951-54] Contrary to Mr. Gorman's assertion, the adoption of his cost of equity recommendation could heighten the risk of a credit downgrade that would make it more difficult or costly for Gulf to access the capital markets and support the investment required to continue to provide its customers with reliable service. [Teel, Tr. 1955, 1956, 1958]

Summary

The Commission has the responsibility to establish a return on equity for Gulf that is based on the evidence in this record and that affords Gulf's investors the opportunity to earn a return on their investment that is commensurate with the returns being earned on other investments of comparable risk. As shown above, Dr. Vander Weide's recommended 11.7 percent return on equity is the appropriate measure of the return required by equity investors.

During the course of cross-examination of Gulf witnesses, the intervenors raised three themes that are intended to distract the Commission from its responsibility to set an appropriate return on equity. First, intervenors referred to mid-point returns on equity approved by the Commission two years ago for FPL (10.0 percent) and PEF (10.5 percent) and implied that those companies were "doing just fine" – continuing to issue debt, continuing to pay dividends, and earning close to the top of their authorized range of return. What the intervenors ignore is that after the Commission's final orders, both companies entered into stipulations approved by the Commission that gave them flexibility – not present in the final orders – to achieve at or close to the top of their authorized range (for example by controlling the amount and timing of the amortization of depreciation reserve surpluses). [Order Nos. PSC-11-0089-S-EI and PSC-10-0398-S-EI; Deason, Tr. 2188] The rates of returns authorized for these companies two years ago on different records is not a basis for establishing the appropriate ROE for Gulf in this docket.

Second, intervenors pointed to the fact that since mid-2010 Gulf has been earning below the bottom of its last authorized range of return and is currently earning less than a 6 percent ROE, yet its service to customers has not suffered. These facts have no bearing on Gulf's required rate of return. The reason that Gulf's service has not suffered is that it has continued to spend the dollars required to operate and maintain its system despite the fact that shareholders are suffering from greatly reduced returns. [Teel, Tr. 277-78] However, a weakened financial position will ultimately hinder Gulf's ability to access capital on reasonable terms. Access to capital is necessary for Gulf to be able to operate and maintain its system to continue providing reliable service to its customers. [*Id.*] After closely controlling costs for several years to avoid the need to file for a rate increase during the Great Recession, by 2010 Gulf could no longer continue to spend at those low levels. As Gulf's spending for 2010 and 2011 has returned to the levels required to provide service over the long term, its returns have suffered. It is now the time for the Commission to approve a base rate increase that will cover Gulf's reasonable and prudent operating expenses <u>and</u> provide its investors the opportunity to earn a fair rate of return on their investment, as required by law.

Finally, intervenors point to the fact that Gulf's service area in Northwest Florida has not completely recovered from the effects of the Great Recession and that consideration should be given to the economic circumstances faced by Gulf's customers when setting Gulf's rate of return. That is not the appropriate legal standard. Rates should be set based on the just and reasonable cost to provide service, including an appropriate cost of capital. Moreover, Gulf needs to be in the position to facilitate, not slow, the economic recovery in its service area, and a fair rate of return is essential to Gulf being able to provide service. [Crosswhite, Tr. 88] It would be wrong for a regulator to grant less than a fair rate of return simply to reduce rates and provide a temporary benefit for customers. [Deason, Tr. 2189-93] It is no more appropriate to artificially reduce the rate of return in tough economic times than it would be to artificially inflate the rate of return in prosperous economic times.

ISSUE 38: What is the appropriate weighted average cost of capital including the proper components, amounts and cost rates associated with the capital structure?

Based on an 11.7% cost of equity, the appropriate weighted average cost of capital for Gulf is 6.94% for the projected 2012 test year. The weighted average cost of capital has been revised from 7.05% as originally filed to reflect actual rates of all permanent financing impacting the projected test year, including senior notes and preference stock, revised rates for short-term debt and variable rate pollution control bonds.

This is essentially a fallout issue. The Commission has approved stipulations on Issues 33, 34 and 35 relating to the cost of preference stock, long-term debt and short-term debt. When combined with the 11.7 percent cost of equity and the cost of non-investor sources of capital such as deferred taxes, ITCs, and customer deposits, the appropriate weighted average cost of capital for Gulf is 6.94 percent.

ISSUE 39: Is Gulf compensated adequately by the non-regulated affiliates for the benefits, if any, they derive from their association with Gulf Power? If not, what measures should the Commission implement?

The Commission should not implement any measures to "compensate" Gulf Power for alleged benefits derived by Southern Company's non-regulated affiliates from their association with Gulf Power.

The Commission should not implement any measures to "compensate" Gulf Power for alleged benefits derived by Southern Company's non-regulated affiliates from their association with Gulf Power. Ms. Dismukes recommends that the Commission impute fictional revenues to Gulf Power in order to compensate the Company for "intangible benefits" allegedly enjoyed by Southern Company's non-regulated affiliates through their association with regulated utility operations. [Dismukes, Tr. 1619-1620] Imputed revenues do not represent real revenues or payments for actual services rendered. [Deason, Tr. 2111] Instead, they are amounts used for regulatory purposes to assign a benefit from one entity to another. [*Id.*]

Ms. Dismukes' recommendation should be rejected. Her proposal violates good regulatory policy, is contrary to the Commission's existing policy, is not supported by the facts and would penalize Gulf for merely being part of the Southern Company system. [Deason, Tr. 2118] The Commission's policy on cost allocation and affiliate transactions is firmly embodied in Rule 25-6.1351. [*Id.*] This rule does not require or contemplate the imputation of revenues from unregulated subsidiaries to regulated utilities. [*Id.*] Indeed, to Gulf Power's knowledge, the Commission has <u>never</u> imputed revenue from an unregulated company to a regulated electric utility. [*Id.*] The record in this case is devoid of any evidence that would justify a departure from this Commission's long-standing practice. As support for her recommendation, Ms. Dismukes cites to a Fitch Ratings report for Southern Company to suggest that Southern Company's non-regulated affiliates receive benefits to their credit ratings through their association with regulated operating companies. [Dismukes, Tr. 1613] She also references a 1988 order of the Commission involving United Telephone Company of Florida, Order No. 18939, Docket No. 870385-TI. [Dismukes, Tr. 1620-21] As discussed in connection with Issue

40 below, Ms. Dismukes' reliance on the Fitch Ratings report and the *United Telephone* order is, at best, wholly misplaced.

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

No. There is no such payment from non-regulated companies. The imputation of imaginary revenues serves no legitimate regulatory purpose and is inconsistent with Commission policy. The imputation would unjustly penalize Gulf for being part of the Southern Company and deny Gulf the opportunity to earn its authorized return.

Ms. Dismukes recommends that the Commission assess a two percent "compensation payment" on the revenue earned by non-regulated companies in order to compensate Gulf for "intangible benefits" allegedly enjoyed by Southern Company's non-regulated operations through their association with regulated utility operations. [Dismukes, Tr. 1619-20] Ms. Dismukes provides no competent or substantial evidence demonstrating that such benefits actually exist or that compensation is, in fact, warranted.

Instead, she cites to a Fitch Ratings report for Southern Company to suggest that Southern Company's non-regulated affiliates receive benefits to their credit ratings through their association with regulated operating companies. [Dismukes, Tr. 1613] However, as noted by Mr. Teel in rebuttal, this is simply not the case. [Teel, Tr. 1955-56] Southern Power Company ("SPC") is the only non-regulated affiliate of Southern Company that is rated by credit rating agencies. [Teel, Tr. 1956] None of the rating agencies incorporate Southern Company, or its subsidiaries, into their ratings of SPC. SPC is evaluated and rated independently of both the parent company and the core regulated electric utility companies. [*Id.*]

Ms. Dismukes also relies heavily on a 1988 order of the Commission involving United Telephone Company of Florida, Order No. 18939, Docket No. 870385-TI. [Dismukes, Tr. 1620-

21] Her reliance on the *United Telephone* order is sorely misplaced. Foremost, the paragraph quoted by Ms. Dismukes at page 23, lines 9 through 15 of her testimony is not correct. [Deason, Tr. 2113-14] She relies upon this paragraph to conclude that the Commission embraced the concept of imputing revenue as an ongoing policy. [Deason, Tr. 2113] However, she fails to mention that the Commission, on its own motion, struck this paragraph from the Order. [*Id.*] In its Order on Reconsideration No. 19734, dated July 27, 1988, the Commission stated:

> Our first modification to Order No. 18939 will be to delete the entire fourth paragraph on page ten of the order. We believe this paragraph contemplates a policy much broader than the one which may be drawn from our requirement of the compensatory payment in this docket. Accordingly, the paragraph will be stricken from the order.

[Deason, Tr. 2113-14]

Moreover, as detailed in the testimony of Mr. Deason, the *United Telephone* order was relevant only to the unique facts and circumstances applicable to the telephone industry at that time. [Deason, Tr. 2113] The facts and circumstances underlying the *United Telephone* order are in no way present in the instant case. The Commission, in subsequent orders, "backed away" from the decision, such that it does not represent the policy of the Commission. [*Id.*] In addition, the *United Telephone* order pre-dates the Commission's adoption of Rule 25-6.1351, which sets forth the Commission's policy on cost allocations and affiliate transactions. [*Id.*] This rule does not require or contemplate the imputation of revenues from unregulated subsidiaries to regulated utilities. [Deason, Tr. 2118] To Gulf Power's knowledge, the Commission has <u>never</u> imputed revenue from an unregulated company to a regulated electric utility. [*Id.*] The Commission should not depart from this long-standing practice in this case.

Acceptance of Ms. Dismukes' recommendation to impute $1.5 million in revenues from unregulated affiliates would mean that Gulf would not receive any actual cash from the unregulated companies, but would nevertheless have the amount of its going forward revenues reduced by a comparable amount (net of any taxes). [Deason, Tr. 2111] This would mean that there would be less <u>actual</u> revenue per year for Gulf to pay <u>actual</u> expenses or invest in infrastructure to serve its customers. [*Id.*] All other things being equal, Gulf's actual achieved ROE would decline, its interest coverage would decline and it would be more prone to go to the capital markets to cover short term cash needs, such as for restoring service after a hurricane. [Deason, Tr. 2112] Acceptance of Ms. Dismukes' ill-conceived recommendation would have real – not imputed – financial implications for Gulf Power. [*Id.*] The recommendation should be rejected.

<u>ISSUE 41</u>: Should an adjustment be made to increase test year revenue for Gulf's non-utility activities?

No. Gulf has properly accounted for and allocated all costs associated with its unregulated products and services, including labor and overheads. Gulf's customers are not subsidizing the Company's non-regulated operations. Consistent with the Commission's past practice, these costs and revenues should continue to be recorded "below the line" for ratemaking purposes.

Gulf Power offers two non-regulated products, one to residential customers and one to commercial customers. [Neyman, Tr. 2260] The products are called Premium Surge and Commercial Surge, respectively. [*Id.*] Customers are charged a fee for equipment installed at their home or business to help protect against electric surges. [*Id.*] Gulf also offers one non-regulated service to its customers called AllConnect. [*Id.*] AllConnect gives customers requesting new electrical service an option to be transferred to a third-party to assist in connecting other services (i.e., cable, telephone, home security, etc.) in their home. [*Id.*] Due to the large military presence in Gulf's service area, Company customer service representatives often receive questions from new military customers about connecting other services in their homes. [*Id.*] Gulf's customers are offered the AllConnect service at no cost to them. [*Id.*] Gulf's 2012 test year revenues for all of its non-regulated products and services total $1.298 million, less than 0.1% of its total revenues. [McMillan, Tr. 2353] These offerings are not a "profit center" for the Company. Gulf offers these products and services to its customers for one simple reason, to respond to customer needs and to serve them better. [Neyman, Tr. 2260]

Ms. Dismukes recommends that the Commission treat the revenues, expenses and investments associated with Gulf's non-regulated products and services "above-the-line" for rate-setting purposes. [Dismukes, Tr. 1628] Alternatively, Ms. Dismukes recommends that the Commission assess a two percent compensation payment on the annual revenue earned as a result of unregulated operations. [Dismukes, Tr. 1629] Both recommendations are without merit and should be rejected.

Rule 25-6.1351(2)(g), defines "nonregulated" products or services as "products or services that are not subject to price regulation by the Commission or are not included for ratemaking purposes and are not reported in surveillance." Consistent with this rule, Gulf's unregulated activities are properly recorded below-the-line and do not impact its revenue requirement request. [McMillan, Tr. 2353]

As support for her recommendations, Ms. Dismukes erroneously testifies that Gulf failed to allocate or assign overhead costs associated with its non-regulated operations. [Dismukes, Tr. 1626-27] As explained by Ms. Neyman in rebuttal, Ms. Dismukes is flatly mistaken in this regard. She simply overlooked or ignored documentation produced by Gulf to OPC in the course of discovery demonstrating that overheads were, in fact, properly charged to Gulf's non-regulated operations. [Neyman, Tr. 2261-62] Ms. Dismukes provided no evidence demonstrating that any specific costs were misallocated. Nor did she provide any precedential authority to support her recommendations. The only Commission order cited in support of her recommendation is the *United Telephone* order. [Dismukes, Tr. 1628] For the reasons articulated in Gulf's discussion of Issue 40 and in Mr. Deason's testimony, the Commission should give no weight to the *United Telephone* order for purposes of this proceeding. Surprisingly, Ms. Dismukes felt it appropriate to rely on a 1980's-era telecommunications order in her testimony, yet she makes no mention of Order No. PSC-10-0131-FOF-EI wherein the Commission rejected the same arguments proffered by Ms. Dismukes in Progress Energy Florida's most recent base rate proceeding. In that order, the Commission held as follows:

> We agree with PEF that non-regulated activities and their associated expense are recorded "below-the-line" and, as a result, do not impact the Company's revenue requirement request. As noted by the Company, Rule 25-6.1351(2)(g), F.A.C., defines non-regulated operations as "services or products that are not subject to price regulation by the Commission or not included for ratemaking purposes and not reported in surveillance."
>
> The basis for OPC witness Dismukes' belief that costs are not properly allocated is that the profit percentages have been large for non-regulated services. However, no evidence was provided that supports the allegation that specific costs were misallocated. No examples of a specific cost that was misallocated was provided. OPC witness Dismukes acknowledged that some governance costs for non-regulated operations are assigned to the non-regulated operations.

[Order at 133]

Lastly, even if the Commission were to accept Ms. Dismukes' misguided recommendation to move Gulf's unregulated operations above-the-line, the record demonstrates that Ms. Dismukes failed to correctly calculate her proposed revenue adjustment. [McMillan, Tr. 2353] As explained by Mr. McMillan in rebuttal, the mathematically correct adjustment would result in a reduction of $258,000 – not $572,000 – to the Company's 2012 test year revenue. [McMillan, Tr. 2354]

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)**

Yes. Gulf's projected level of Total Operating Revenues in the amount of $481,909,000 ($499,311,000 system) for the 2012 test year is appropriate.).

This is partially a fallout issue and partially an issue related to the amount of Sales for Resale to be included in Total Operating Revenues. Gulf's requested level of Total Operating Revenues is $481,909,000. [MFR C-1] As discussed in Issues 39, 40 and 41, the Commission should reject the intervenors' proposal to impute artificial revenues or royalty payments related to the activities of Gulf's non-regulated affiliates or its unregulated utility operations. As discussed below, no adjustment should be made to Gulf's projected test year Sales for Resale. Therefore, no change to Gulf's request of $481,909,000 is appropriate.

FEA's witness Meyer proposes to impute $1.9 million in additional base rate revenues associated with Sales for Resale based on an analysis of sales for the 12-months ending June 2011. [McMillan, Tr. 2363] However, Mr. Meyer fails to consider the actual results for years prior to 2011, which show amounts of Sales for Resale that are consistent with, or lower than, Gulf's forecast for 2012. [*Id.*] As shown by Mr. McMillan's rebuttal testimony, the factors that impact Gulf's Sales for Resale on a month by month basis are variable and volatile, and cannot be accounted for by a simplistic forecasting approach. [*Id.*] Instead, Gulf's Fuel/Interchange budgeting process uses a sophisticated model that simulates dispatch of the Southern electric system generating assets based on fuel price forecasts, generating unit operating assumptions, system transmission operating assumptions, and forecasted load and sales information. [*Id.*; MFR F-5 at 6-8] This is a more accurate way to predict Sales for Resale than analysis of the most recent 12 months of data.

In particular, the higher sales in 2011 compared to prior years are due in large part to lower market prices for natural gas and to transmission system and natural gas transportation system operating conditions that permitted the units to run more than forecasted. [McMillan, Tr. 2364] Because of existing transmission and natural gas transportation constraints, there is no assurance that system operating conditions in 2012 will allow the units to operate as they did in 2011. [McMillan, Tr. 2365]

Further, Mr. Meyers' proposed adjustment erroneously takes a historical sales margin and applies it to 2011 data to use in developing his proposed adjustment of $1,825,000. [*Id.*] This ignores that margins are a function of economic dispatch and are not based on fixed percentages and overstates his proposed adjustment by $752,000. [*Id.*] In summary, his adjustment is both overly simplistic and incorrectly calculated. It should therefore be rejected.

ISSUE 43: **Stipulated**

ISSUE 44: **Stipulated**

ISSUE 45: **Stipulated**

ISSUE 46: **Stipulated**

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

Yes. The Company has removed all non-utility activities from net operating income.

Gulf believes that its adjustments to remove non-utility activities are not at issue. The intervenors' positions on this issue merely refer to their positions on Issues 39-41, which relate to potential compensation related to the operations of non-regulated affiliates, and Issues 48-68, which relate to costs charged to Gulf by SCS for various services provided by the service company. None of these other issues relate to non-utility activities. Further, no intervenor has presented any testimony or evidence related to the removal of non-utility activities from net operating income.

Nevertheless, Gulf has made a number of regulatory adjustments to remove items from NOI that the Commission has previously held should not be recovered from ratepayers (NOI Adjustments 17 to 21, 23 and 34) and has properly accounted for its unregulated operations below-the-line. [McMillan, Tr. 1085-86, 2353; Ex. 21, Sch. 4] Thus there are no non-utility activities included in net operating income.

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

No adjustments should be made to the expenses allocated or charged to Gulf except for the two adjustments totaling $363,297 ($364,334 system) covered by the approved stipulations on Issues 53 and 58.

The intervenors' positions on this issue merely refer to their positions on Issues 49 to 68. The decisions on those issues will determine whether any adjustments – other than those covered by the stipulations on Issues 53 and 58 – are appropriate.

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

No. If the fixed allocation factors were updated to use 2010 data in order to include an allocation of SCS costs to Southern Renewable Energy, Gulf's O&M expenses would increase by approximately $1,159,000.

This issue arises because the allocation of SCS costs to Gulf for purposes of the 2012 test year budget uses allocation factors based on 2009 data. (See Issue 51 for a more detailed discussion of the calculation and use of SCS allocation factors.) Since Southern Renewable Energy (SRE) was not in operation during 2009, no costs were allocated to it for the test year. Ms. Dismukes proposes that this situation be remedied by assessing a 2 percent compensation payment on SRE (i.e. imputing additional hypothetical revenues to Gulf) analogous to that described in Issues 39-41. [Dismukes, Tr. 1618-19] This proposal should be rejected.

First, Ms. Dismukes' proposal for assessing a 2 percent compensation payment on SRE is inappropriate, and should be rejected for all the reasons discussed in Issues 39-41. Second, the evidence shows that if all of the SCS fixed allocation factors were updated based on 2010 data – which would include the operations of SRE – the total O&M allocation to Gulf would increase by approximately $1,159,000. [McMillan, Tr. 2347-48; Ex. 168, Sch. 1] Thus the absence of SRE in the 2009 data is not a basis for making any downward adjustment to Gulf's rate request.

ISSUE 50: **Dropped**

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

No adjustments should be made to any of the allocation factor calculations. The overall allocation methodology has been in use for over 25 years, was approved by the SEC, has not been changed by the FERC, and has been accepted as a basis for allocation by this Commission in prior Gulf rate cases. If the Commission finds that it is appropriate to update any fixed allocation factors, then it should update them all using the actual 2010 factors that will apply to 2012 costs. Using the recently developed 2010 fixed allocation factors would increase Gulf's share of SCS billings by approximately $1,262,500, of which approximately $1,159,000 represents increased O&M expenses.

Southern Company Services (SCS) is a subsidiary of Southern Company which provides various services to Gulf and the other subsidiaries of Southern Company at cost. [McMillan, Tr. 1101-02] Gulf receives many professional and technical services from SCS, such as general and design engineering for transmission and generation; system operations for the generating fleet and transmission grid; and various corporate services and support in areas such as accounting, supply chain management, finance, treasury, human resources, information technology, and wireless communications. [*Id.*] The existence of SCS benefits Gulf and its customers.

[McMillan, Tr. 1102] It avoids duplication of personnel in the various operating companies, provides economies of scale in purchasing and other activities, and enables Gulf to draw on shared experience from a centralized pool of professional talent. [*Id.*] As one of the smaller operating companies, access to these shared resources is particularly valuable to Gulf, which otherwise would have to employ, for example, a group of generation planning personnel who might not be fully utilized on a continuous basis. [*Id.*; Grove, Tr. 834]

All services provided by SCS are provided at cost. [McMillan, Tr. 1102] Costs are determined and billed in two ways. [*Id.*] Where possible, costs are directly assigned to the company receiving the services. [*Id.*] Where direct assignment is not possible, costs are allocated among the subsidiaries receiving services based on a pre-approved cost allocator appropriate for the type of services performed. [*Id.*] Typical allocators include employees, customers, loads, generating plant capacity, and a financial factor consisting of three equally weighted components – net fixed assets, operating expenses and operating revenues. [*Id.*; Ex. 196 at 001622] The allocators are approved by SCS and by management of the applicable operating companies. [McMillan, Tr. 1102]

The fixed allocation factors are typically recalculated once a year when the final data needed to calculate the factors becomes available. [McMillan, Tr. 2344] The new factors are used to develop the budget for the upcoming year and to allocate costs incurred during that year. [*Id.*] For example, new factors were calculated in 2010 based on 2009 data. [*Id.*] These factors are then used to develop the 2011 budget and to allocate 2011 costs. [*Id.*] The 2012 test year costs were also allocated based on the 2010 factors that use data from 2009 because this was the most recent actual data available at the time the projected test year budget was prepared. [McMillan, Tr. 2344; Ex. 113 at 00781]

This issue involves Ms. Dismukes' proposals to (a) totally modify the calculation of the financial allocation factor by excluding the operating revenue component and removing fuel and purchased power costs from the operating expense component, and (b) update some factors, but not all, to use 2010 data rather than 2009 data. The combined effect of these changes would be to reduce Gulf's O&M expense by $832,284. [Dismukes, Tr. 1617-18, 1622] These proposals are without merit and should be rejected.

As demonstrated by Mr. McMillan, there are serious flaws in Ms. Dismukes' rationale for proposing changes to the financial allocation factor. Contrary to her claims, the use of a revenue component in the financial allocation factor does not bias the factor and does not result in Gulf's customers being disadvantaged by a rate increase. [McMillan, Tr. 2346] Further, her proposal to exclude fuel and purchased power costs from the expense component is nothing more than an attempt to arbitrarily shift costs from Gulf and the other regulated operating companies to their non-regulated affiliates. [*Id.*] She ignores the fact that SCS provides extensive support for operating company activities related to fuel and purchased power. [McMillan, Tr. 2346-47] Ignoring these activities would result in an unfair allocation that does not match costs with benefits. [*Id.*]

More importantly, the three component method for developing the financial factor has been in place for over 25 years. [McMillan, Tr. 2347] It has been used as a basis for allocation by this Commission in Gulf's two prior rate cases since 1985 as well as by state regulators in Alabama, Georgia and Mississippi. [McMillan, Tr. 2343-44, 2347] At the time the current allocation methodology (including the financial factor) was adopted in 1985, it was submitted to and approved by the Securities and Exchange Commission as required by the Public Utility Holding Company Act (PUHCA). [McMillan, Tr. 2343; Ex. 196 at 001611-1631] Since the repeal of PUHCA, the Federal Energy Regulatory Commission, which now serves as the federal regulator, has made no changes in SCS's allocation methodologies, which are reported on an annual basis in SCS's FERC Form 60 filing. [McMillan, Tr. 2343-44, 2347] Because these allocation factors apply to all companies in the Southern system, a change in any factor by this Commission would result in total SCS costs being either under or over recovered unless and until a corresponding change was made by FERC and the other three state regulators. There simply is no basis to make such a change.

Nor should the Commission update selected fixed allocation factors to use 2010 data as recommended by Ms. Dismukes. The 2010 factors, which were not available at the time this case was filed, have recently been finalized. [McMillan, Tr. 2348] Using these new factors instead of the 2009 factors used in Gulf's filing would actually <u>increase</u> Gulf's share of SCS billings by approximately $1,262,000, of which about $1,159,000 represents increased O&M expenses. [*Id.*; Ex. 168, Sch. 1] Gulf has not asked to update the factors to reflect this increased revenue requirement, and Ms. Dismukes should not be allowed to pick and choose factors to update in order to artificially produce a reduced revenue requirement.

<u>ISSUE 52</u>: Should the Commission remove costs from the 2012 test year for costs associated with SouthernLINC?

No. SouthernLINC provides unique communication services to Gulf in support of service crew work management, interoperability between transmission and distribution automation systems, and voice/data communication. SouthernLINC's service characteristics are vital to Gulf's operations and its ability to provide reliable and efficient service to its customers.

The costs associated with SouthernLINC are reasonable and prudent and should be allowed in the test year. [Jacob, Tr. 2287] The SouthernLINC expenses included in Gulf's 2012 test year are for communication services that are necessary for the continued reliable operation of

Gulf's distribution and transmission system. [Jacob, Tr. 2283] Gulf uses the SouthernLINC communication services for digital wireless voice/data communication, automated work order dispatch and vehicle location for service crews, and interoperability between transmission and distribution automation systems associated with smart grid equipment. [Jacob, Tr. 2284-85] SouthernLINC's services to Gulf are unique and have no commercial comparison in the marketplace. [Jacob, Tr. 2283] The SouthernLINC service to Gulf is unique in at least two ways. First, SouthernLINC's network closely corresponds to the area served by Gulf Power's electric grid, including the rural areas that are not always covered by other wireless communication providers. [Jacob, Tr. 2286] Second, the SouthernLINC system is built to meet the rigorous standards of utility construction. [*Id.*] An example of this is that each tower has on-site generator and battery backup capabilities. [*Id.*] After Hurricane Ivan, the backup capabilities of SouthernLINC allowed it to be operational while other wireless carriers were able to provide only limited service for days after the hurricane made landfall. [Jacob, Tr. 2286-87] These unique service characteristics are vital to Gulf's operations and its ability to provide reliable and efficient service to its customers. [Jacob, Tr. 2287]

OPC witness Dismukes' proposed adjustment to the expenses associated with SouthernLINC is based on the faulty premise that Gulf is subsidizing SouthernLINC. The reality is in fact just the opposite. [Jacob, Tr. 2284] The commercial business part of SouthernLINC exists to reduce the cost of communication services provided to Gulf by SouthernLINC. [*Id.*] The contribution to fixed costs from the commercial business part of SouthernLINC serves to reduce the cost of ownership and operation of SouthernLINC. [*Id.*] SouthernLINC services are billed to Gulf at cost less the contribution to fixed costs obtained from SouthernLINC's commercial business. [Jacob, Tr. 2283] While it is true that the commercial business part of

SouthernLINC has seen a reduction in revenue and did not defray as much of the total cost of SouthernLINC as it has in previous years, the contribution to fixed costs from the commercial business part of SouthernLINC continues to reduce the overall cost to Gulf for the necessary communication services that it receives from SouthernLINC. [Jacob, Tr. 2284]

The costs associated with SouthernLINC are reasonable and prudent and should be allowed in the test year. [Jacob, Tr. 2287] The SouthernLINC expenses included in Gulf's 2012 test year are for communication services that are necessary for the continued reliable operation of Gulf's distribution and transmission system. [Jacob, Tr. 2283]

ISSUE 53: **Stipulated**

ISSUE 54: Dropped

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?

Gulf adequately documented and justified the costs associated with Work Orders 46EZBL, 46IDMU, 46LRBL, 47VSES, 47VSTB, 47VSTH, 47VSZ1, and 47VSZ5. In Gulf's response to OPC's Request to Produce Documents No. 108, the Company stated that the original approved work orders could not be located, but provided descriptions and justifications for the activities covered by the work orders. The total budgeted amount allocated to Gulf was provided in response to OPC's Request to Produce Documents No. 34, Attachment E. The allocation methods used for each work order were provided in response to OPC's Request to Produce Documents No. 34, Attachment B. This same information is summarized in Witness McMillan's Rebuttal Testimony, Exhibit RJM-2, Schedule 2.

Gulf adequately documented and justified the costs associated with work orders 46EZBL, 46IDMU, 46LRBL, 47VSES, 47VSTB, 47VSTH, 47VSZ1, and 47VSZ5. As a result of a clerical error, the actual work order authorization forms associated with these work orders could not be located among the 20,000 work order authorization forms that Gulf had on file. [Ex. 150 at 55] However, all of the information contained in those forms, in addition to other work order information, was available in Gulf's accounting system and was provided to the parties in discovery and as an exhibit to the testimony of Mr. McMillan. [Ex. 138 at 001492-94; Ex. 141 at 001534-35; Ex. 150 at 54-55; Ex. 168 Sch. 2] The information provided to the parties included a description and justification of the work to be performed [Ex. 117 at 001011-001033; Ex. 141 at 001534-35], how the work was accounted for along with total amount allocated to Gulf [Ex. 138 at 001492-94, Attachment E] and the allocation methods used for each work order [Ex. 138 at 001492-94, Attachment B]. Exhibit 168 Schedule 2, which is an exhibit to the rebuttal testimony of Mr. McMillan, has a summary of all of the information that was produced during discovery related to the associated costs and justifications for these work orders. [McMillan, Tr. 2348; Ex. 150 at 91]

Contrary to the position taken by OPC, the parties had access to all of the information necessary to examine the activities represented by these work orders. [McMillan, Tr. 2349] The activities represented by these work orders were necessary, and Gulf's allocated share of the costs was determined using the appropriate cost allocation factors. [*Id.*] No costs related to these work orders should be removed from operating expenses in the 2012 test year.

ISSUE 56: Should the costs related to Work Order 471701, associated with a Securities and Exchange Commission inquiry, be removed from operating expenses?

No. The work order form submitted for this item was an outdated form. This work order is no longer used for an SEC inquiry, and the work order number has been reused by the SCS Comptroller organization. The test year amount includes various special projects, including Enterprise Solutions transition and implementation, and the costs incurred were necessary, prudent and in the interest of Gulf's customers.

The costs associated with Work Order 471701 are for special projects in the SCS Comptroller organization. [McMillan, Tr. 2349] These costs are necessary, prudent and in the interest of Gulf's customers. [*Id.*] The work order form submitted for this item and provided through discovery was an outdated form, and the work order number has been reused by the SCS Comptroller organization for special projects. [*Id.*] The 2012 test year amount includes ongoing projects that represent the type and amount of special projects that are covered by this work order. [Ex. 150 at 56] In the 2012 test year, these projects include the transition and implementation activities associated with Enterprise Solutions and accounting research on new FASBs. [*Id.*] While specific special projects are typically for a finite period of time, Gulf projects to continue having this level of special projects in the test year and beyond. [*Id.*]

<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?

No. A number of benefits reviews are conducted on a recurring basis or an as-needed basis at various times throughout the years. Although the specific benefits reviews covered by this work order take place every other year, there are other normal benefits review activities that do not fall during the test year. The amount included in the test year is representative of an on-going level of benefits review activity.

The amount included in the test year is representative of an on-going level of benefits review activity. [McMillan, Tr. 2350] A number of benefits reviews are conducted on a recurring basis or an as-needed basis at various times throughout the years. [McMillan, Tr. 2349-50; Ex. 119 at 001106-07; Ex. 150 at 56] Although the specific benefits reviews covered by this work order take place every other year, there are other normal benefits review activities that do not fall during the test year. [*Id.*] The record shows that expenses associated with benefits review were incurred in each year since 2009. [Ex. 119 at 001106-07] The amount included in the test year is representative of an on-going level of benefits review activity, and Ms. Dismukes' proposal to amortize the amount of this work order over two years should be rejected. [*Id.*]

ISSUE 58: **Stipulated**

ISSUE 59: Should the costs related to Work Order 4Q51RC and a formerly CWIP classified Work Order 4QPA01, be removed from operating expenses?

No. Work Order 4Q51RC covers the on-going annual software costs, including maintenance and enhancements, associated with a new application that is necessary to effectively and efficiently manage the railcar maintenance program. Work Order 4QPA01 covers the ongoing support expenses associated with the control system integrity (CSI) which is used to manage and document the compliance requirements resulting from the NERC Cyber Security Standards.

Operating expenses should not be adjusted to remove expenses related to Work Order 4Q51RC and Work Order 4QPA01. Work Order 4Q51RC covers the on-going annual software costs, including maintenance and enhancements, associated with a new application that is necessary to effectively and efficiently manage the railcar maintenance program. [McMillan, Tr. 2352; Ex. 119 at 001100-01] This system will manage railroad and private repair shop maintenance invoices as mandated by railroad standards for railcar use. [*Id.*] The software will be expensed because it does not meet the accounting capitalization threshold. [*Id.*] The original in-service date for this software was December 2011. [Ex. 196 at 001608] The software is now projected to be placed in service in 2013. [*Id.*] The costs associated with this software have been redirected to other activities under this work order and are still representative of ongoing costs in the 2012 test year. [*Id.*]

Work Order 4QPA01 covers the ongoing support expenses associated with the control system integrity (CSI) which is used to manage and document the compliance requirements resulting from the NERC Cyber Security Standards. [McMillan, Tr. 2352; Ex. 119 at 001102-03] The expenses associated with this work order are for the ongoing support and updating of this software application and its related data support. [Ex. 150 at 69] This software will be placed in service at the end of 2011 and booked to expense in 2012. [Ex. 119 at 001102] The costs in the 2012 test year associated with these work orders are reasonable and appropriate. [McMillan, Tr. 2352]

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

> *No. This work order covers internal company publications that educate employees about industry, local and company issues, making them better equipped to serve customers. It also includes external public relations messages that are used to communicate billing, safety, and energy efficiency information to Gulf's customers. This helps customers by providing information on alternative ways to receive and pay bills, ways to prevent accidental injuries, and ways to use energy more efficiently, resulting in value and savings to the customer.*

The public relations expenses represent a reasonable and necessary business expense and should be allowed. [McMillan, Tr. 2351; Ex. 119 at 001090] This work order covers internal company publications that educate employees about industry, local and company issues, making them better equipped to serve customers. [*Id.*] It also includes external public relations messages that are used to communicate billing, safety, and energy efficiency information to Gulf's customers. [*Id.*] This helps customers by providing information on alternative ways to receive and pay bills, ways to prevent accidental injuries, and ways to use energy more efficiently, resulting in value and savings to the customer. [*Id.*] These costs are not related to nor are they similar to institutional or image-building/enhancing advertising, which has been disallowed by this Commission in the past. [*Id.*]

ISSUE 61: Should operating expenses be adjusted to remove legal expenses in Work Orders 473ECO and 473ECS charged by SCS?

> *No. The Chief Operating Officer and External Affairs functions provide services to Gulf, and any related legal advice is budgeted in these work orders. Each of these functions requires legal advice to ensure compliance with rules, regulations, contracts, and agreements. These activities benefit ratepayers.*

Gulf's operating expenses should not be adjusted to remove legal expenses in Work Orders 473ECO and 473ECS. The Chief Operating Officer and External Affairs functions provide services to Gulf, and any related legal advice is budgeted in these work orders. [McMillan, Tr. 2350] Each of these functions requires legal advice in the regular course of doing business to ensure they make the right decision to comply with rules, regulations, contracts, and agreements. [McMillan, Tr. 2350; Ex. 150 at 62-63] Gulf is in a heavily regulated industry and this work order covers costs for the legal advice to help Gulf management interpret and comply with those regulations. [Ex. 150 at 62-63] Gulf being in compliance with laws, regulations and rules benefits the customer because it allows Gulf to operate efficiently and cost-effectively. [Ex. 150 at 63; McMillan, Tr. 2350]

ISSUE 62: ***The deadline for briefing this issue was extended until January 11, 2012 in order to allow the Commission an opportunity to consider a Motion for Approval of Partial Settlement Agreements.***

ISSUE 63: ***The deadline for briefing this issue was extended until January 11, 2012 in order to allow the Commission an opportunity to consider a Motion for Approval of Partial Settlement Agreements.***

ISSUE 64: Should operating expenses be adjusted to remove investor relations expenses related to Work Order 471501 charged by SCS?

No. Investor Relations works with investors to preserve the value of Gulf's securities and to ensure continuous access to capital at favorable rates for the benefit of Gulf and our customers. This work order provides an on-going investor relations program to facilitate informed relationships with existing and potential investors in system equity and debt securities. This ensures that the Company's securities are fully valued by the investment community through regular communications that provide updates on the financial condition and plans of the Company. This type of Investor Relations activity is an essential function for any company with publicly traded securities.

Operating expenses should not be adjusted to remove investor relations expenses related to Work Order 471501. Investor Relations works with investors to preserve the value of Gulf's securities and to ensure continuous access to capital at favorable rates for the benefit of Gulf and our customers. [McMillan, Tr. 2351; Ex. 119 at 001093-94; Ex. 150 at 65] This work order provides an on-going investor relations program to facilitate informed relationships with existing and potential investors in system equity and debt securities. [McMillan, Tr. 2351; Ex. 119 at 001093-94] This ensures that the Company's securities are fully valued by the investment community through regular communications that provide updates on the financial condition and plans of the Company. [*Id.*] This type of Investor Relations activity is an essential function for any company with publicly traded securities. [*Id.*] Expenses related to this work order were included in Gulf's last rate case, and the 2012 test year amount is reasonable and prudent. [Ex. 119 at 001093]

ISSUE 65: **Stipulated**

ISSUE 66: Should interest on deferred compensation be included in operating expenses?

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

Gulf projected $815,104 of Other Employee Benefits for its 2012 test period. [MFR C-35, at 1] Other Employee Benefits, indeed all benefits, are charged to A&G, and Ms. Erickson testified that projected A&G expenses for the 2012 test period are "both reasonable and prudent." [Erickson, Tr. 937] They are based on an extensive budget preparation and review process that ensures that every item included in the budget is based upon the most accurate and up-to-date assumptions. [*Id.*]

Gulf provided five pages of detail regarding the $815,104 projection of Other Employee Benefits. [Ex. 115 at 000928-32] Within the $815,104 of projected 2012 test year Other

Employee Benefits, Gulf included a projection of $362,309 of Interest on Deferred Compensation. [Ex. 115 at 000928]

Ms. Ramas took issue with the entire projected amount of Interest on Deferred Compensation, arguing that there was no explanation of why interest on deferred compensation was being paid or how the deferred compensation balances resulted. [Ramas, Tr. 1482-83] She suggested that the interest costs and the interest rate had not been justified. [*Id.*] Ms. Ramas was the only intervenor witness who took issue with these projected costs.

In its rebuttal case, Gulf offered the testimony of Ms. Kilcoyne to address each of Ms. Ramas' alleged deficiencies in Gulf's initial justification. [Kilcoyne, Tr. 2001-03] Ms. Kilcoyne provided a detailed explanation of Gulf's Deferred Compensation Plan and explained how participants, customers and the Company benefit from the Plan:

> The Deferred Compensation Plan is an unfunded plan subject to the applicable provisions of the Employee Retirement Income Security Act of 1974 (ERISA). The plan allows participants an opportunity to defer their earned income as well as certain federal, state and local taxes until a specified date or their retirement. Employees who are in an exempt job, grade level 9 (upper management) or above, and have an annual base rate of pay of at least $100,000 are eligible to participate.
>
> This plan provides mutual benefits for the participants, the customer and the Company. The plan provides participants with a vehicle for retirement and tax planning. The Company benefits by offering a competitive compensation and benefits package that attracts and helps retain talent.
> [Kilcoyne, Tr. 2002]

Ms. Kilcoyne went on to address why Gulf pays interest on the deferred compensation. She stated, "[t]he plan provides a market interest rate to compensate participants for the opportunity cost of deferring their income into the future." [*Id.*]

This testimony completely addressed Ms. Ramas' initial argument that Gulf had not discussed why interest was paid or how the deferred compensation balances occurred.

They occur because eligible employees participating in a market competitive compensation plan choose to defer income for tax and retirement planning purposes, and the interest is paid to provide participants the opportunity cost for deferring their income into the future and making it available to the Company during the deferral.

Ms. Kilcoyne went on to explain that the interest rate used to determine the interest on the deferred compensation was established by the Plan Prospectus. [*Id.*] The budgeted interest rate, the interest rate used, "was derived from Moody's Analytics May 2010 Money market rates, prime rate, which was the most current information available to use at the time the 2012 budget was prepared." [Kilcoyne, Tr. 2003] This testimony fully addressed Ms. Ramas' criticism of the Interest on Deferred Compensation.

As discussed above, Gulf's projected 2012 test year Interest on Deferred Compensation is completely justified. Deferred Compensation is part of an overall compensation approach that is market competitive. [Kilcoyne, Tr. 2007] Gulf needs a market competitive plan to retain and attract skilled employees. [Kilcoyne, Tr. 1983-84] Gulf's compensation plan targets compensation at the 50th percentile and deferred compensation is part of that market competitive compensation plan. [Kilcoyne, Tr. 1997] The interest paid is consistent with the interest rate specified in the Plan prospectus, and it appropriately compensates participants for the opportunity cost of the funds they choose to defer while those funds are available to the Company in the form of working capital. [Kilcoyne, Tr. 2002] This aspect of Gulf's compensation benefits customers by assisting Gulf retain and attract qualified managerial employees. No disallowance of this expense has been justified. [*Id.*]

ISSUE 67: Should SCS Early Retirement Costs be included in operating expenses?

> *Yes. This expense is a cost of providing Gulf's electric service. It was incurred as part of SCS early retirement initiatives during the 1980s and 1990s that lowered overall SCS costs, including those paid by Gulf customers. Gulf's customers, having saved from these early retirements, should pay the continuing obligation associated with these early retirements. This SCS expense is not different from the expenses for other SCS benefit programs, and so it is properly included in operating expenses.*

Gulf projected $815,104 of Other Employee Benefits for its 2012 test period. [MFR C-35, at 1] Other Employee Benefits, indeed all benefits, are charged to A&G, and Ms. Erickson testified that projected A&G expenses for the 2012 test period are "both reasonable and prudent." [Erickson, Tr. 937] They are based on an extensive budget preparation and review process that ensures that every item included in the budget is based upon the most accurate and up-to-date assumptions. [*Id.*]

Gulf provided five pages of detail regarding the $815,104 projection of Other Employee Benefits. [Ex. 115 at 000928-32] Within the $815,104 of projected 2012 test year Other Employee Benefits, Gulf included a projection of $50,340 for SCS Early Retirement. [Ex. 115 at 000929]

Ms. Ramas challenged Gulf's projection of SCS Early retirements costs, arguing that in a discovery response there was no discussion of what the accrual was for or why it should be passed on to customers. [Ramas, Tr. 1483] Ms. Ramas was the only intervenor witness who took issue with these projected costs.

Once again, Gulf offered the rebuttal testimony of Ms. Kilcoyne to address Ms. Ramas' recommendation. Ms. Kilcoyne testified that this expense was associated with benefits provided to former SCS employees who opted for early termination during the 1980s and 1990s to lower SCS costs charged to Gulf's customers. [Kilcoyne, Tr. 2003] Gulf's customers, having saved from these early retirements, should pay the continuing obligation associated with these savings.

This SCS expense is not different from the expenses for other SCS benefit programs, and so it is properly included in the cost of service. [*Id.*]

ISSUE 68: **Stipulated**

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

Yes. Gulf's salary programs fall well within market norms and are not excessive in design or level of pay. These programs are necessary to attract, retain, and motivate employees. Retaining, attracting and motivating employees benefits customers through preserving a skilled and capable work force that provides exceptional customer service.

Gulf proposes a very modest increase in average salaries for the 2012 test period. As shown on MFR C-35, Gulf projects an increase in average salary from 2010 to 2012 of only $413 per employee. [MFR C-35 at 1, 2] This is a total percentage increase in average salary over two years of only .005 percent.

If Ms. Ramas' unsupported [Kilcoyne, Tr. 1983-85; Deason, Tr. 2092, 2093, 2097] and disingenuous [Deason Tr. 2167] compensation adjustments were made, Gulf's gross average salary per employee would decline over $11,000 from the 2010 level. [Kilcoyne, Tr. 1983; Ex 160, Sch. 2] This proposed 13.7 percent decrease in average salary "would have a serious adverse impact on Gulf's compensation competitiveness, Gulf's ability to retain and attract employees, and ultimately [Gulf's] customers." [Kilcoyne, Tr. 2006] In addition, it is inconsistent with sound regulatory policy and principles of ratemaking, and if adopted, would be detrimental to Gulf's customers. [Deason, Tr. 2091-92]

The total compensation program utilized by Gulf is consistent with the compensation practice throughout the utility industry and general industry. [Kilcoyne, Tr. 2006; Wathen, Tr. 2073] That compensation approach was approved in Gulf's last rate case and has undergone only very minor changes since then. [Kilcoyne, Tr. 2006] The approach of employing both base and "at-risk" compensation ensures that all employees are focused on the customer, making customer service and reliability paramount, while managing costs effectively. [*Id.*]

Gulf's approach to compensation and its use of at-risk compensation aligns the interests of customers, employees and shareholder. [*Id.*] The operational and financial goals work together to assure decision-making is done in a manner that balances service to customers with providing investors a fair rate of return, which ultimately ensures that Gulf will have capital necessary to serve customers. [*Id.*] Gulf's approach to compensation results in a market competitive level of compensation necessary to retain and attract employees essential to providing service to Gulf's customers. [Wathen, Tr. 2073; Kilcoyne, Tr. 2006; Ex 160, Sch. 1; Ex. 161, Schs. 1 and 2] The very modest increase to average employee salaries of less than one tenth of one percent between 2010 and 2012 is wholly justified.

<u>ISSUE 70</u>: Are Gulf's proposed increases in employee positions for Gulf appropriate?

> *Yes. The 159 additional positions are justified in the testimony of various Gulf witnesses, most of those positions have been filled, and most of the remaining positions are expected to be filled by the early 2012.*

Gulf's rate request assumes a full work force complement of 1,489 full time equivalent (FTE) positions for the test year. [McMillan, Tr. 1090] As of year-end 2010, Gulf's work force had declined to a level of 1,330 FTEs as a result of the Company's extraordinary efforts to reduce costs and defer a rate case. [*Id.*] The increase of 159 FTEs from the end of 2010 to the test year represents employees who are necessary and appropriate for Gulf to continue to provide safe and reliable service to its customers. [*Id.*] Thirty-one of the additional FTEs are employees whose salaries will be recovered through the ECCR and ECRC clauses and the salaries of another 42 FTEs are capitalized as part of the capital additions budget. [*Id.*; Ex. 21, Sch. 20]

Therefore the salaries for 73 of the additional 159 FTEs do not impact Gulf's test year O&M request. [*Id.*]

The witnesses with responsibility for Gulf's functional areas – transmission, distribution, other customer operations, and production – have provided detailed justification of the need for these additional positions. [Caldwell, Tr. 510-12; Moore, Tr. 574-80; Neyman, Tr. 674-78; Grove, Tr. 888-91, 912; Ex. 15, Sch. 11; Ex. 16, Sch. 4; Ex. 18, Sch. 12; Ex. 15, Sch. 11] A significant portion of the increased need is due to Gulf's aging workforce. As experienced employees retire, Gulf must have a pool of trained personnel ready to advance into those skilled positions. [Jacob, Tr. 474] As Mr. Grove and Mr. Moore explained, many of the additional positions in the production and distribution functions are entry level positions. [Grove, Tr. 890-91; Moore, Tr. 575-76] In the production area, entry level Utilitypersons are hired to form the pool for future mechanics, electricians and operators. [Grove, Tr. 890-91] In distribution, the entry level positions include Utilitypersons, Engineers in Training, and Fleet positions. [Moore, Tr. 575] In the distribution area, Utilitypersons are hired to become future Line Technicians. [Moore, Tr. 578-79] It typically takes seven years in Gulf's earned progression program for an employee to advance from the Apprentice classification to become a fully qualified Journeyman Line Technician. [*Id.*] A similar 18-month program has been established for Engineers in Training to introduce entry level engineers to the utility industry with a focus on building future leaders for the distribution organization. [Moore, Tr. 576-77] In the customer service area, the addition of 19 new customer service representatives is needed to maintain or improve service quality. [Neyman, Tr. 675-76] The addition of these employees enables Gulf to reduce the average hold time from 49 seconds to 21 seconds. [Neyman, Tr. 2273-75] This in turn lets Gulf answer 80% of the calls in less than 30 seconds. [*Id.*] The additional employees will also reduce

Gulf's abandoned call rate and will provide more time for employee training. [Neyman, Tr. 2275-76] No intervenor challenged the justification or need for any of these positions.

Gulf has been very successful in filling these positions. In Ms. Neyman's area, only four positions remained vacant as of the November 4th date of her prefiled rebuttal testimony and all of these positions are expected to be filled by year-end. [Neyman, Tr. 2263] As of December 12, 2011, there were a total of only 30 vacancies in the production, transmission and distribution functions. [Tr. 2435-37; Ex. 217] As of that date, there were offers outstanding to fill 15 of those 30 vacancies, and an additional 12 job listings had been posted as part of the hiring process. [*Id.*] If the outstanding offers are accepted and the posted jobs successfully filled, there will be only three vacancies by sometime early in 2012.

The December figures also show that the final 2012 budget is expected to eliminate 10 positions in the production area as compared to the original rate case estimate, reducing the total complement for 2012 to 1,479 FTEs. [Grove, Tr. 914-16; Ex. 217] However, this change will have no effect on test year O&M expense, since the dollars previously included in the Production Labor budget for these positions ($572,305) have been moved to Production Contract Labor and Overtime. [*Id.*]

Based on the demonstrated need for these additional positions, and Gulf's success in filling them, the Commission should make no adjustment to test year labor expense associated with these FTEs.

Mr. Meyer on behalf of FEA and Ms. Ramas on behalf of OPC recommend significant adjustments to the test year labor expense associated with these 159 additional positions. However, each of them uses faulty assumptions in calculating their proposed adjustments. Mr. Meyer calculates his proposed $5.2 million adjustment based on Gulf's vacancies at June 30, 2011 and the portion of those vacancies that he estimates would be supported by O&M dollars. [McMillan, Tr. 2357] However, as shown on Exhibit 217, Gulf has continued to aggressively fill these positions, and the vacancy situation at December 12, 2011 is substantially different than it was at June 30. There simply is no basis to support Mr. Meyer's assumption that the June 30 level of O&M vacancies will exist throughout 2012. In addition, Mr. Meyer calculated the dollar amount of his adjustment by using an average wage and benefit figure from MFR C-35. In fact, the average budgeted wages and benefits for unfilled positions are substantially lower, since many of them are entry level positions. [*Id.*]

Ms. Ramas calculates her recommended adjustment of $3.2 million by taking an average vacancy rate over the period 2006-2010 and multiplying that rate times the 1,489 budgeted positions to calculate 91 positions for which wages and benefits would be disallowed. Her calculation ignores the fact that during most of the historic period used to calculate her vacancy rate, Gulf was holding positions vacant as part of its efforts to avoid having to seek a rate increase. [Grove, Tr. 889; Moore, Tr. 576, 596-97, 626] Her recommendation also does not take into account that only a portion of any vacancies are included in O&M expense and it gives no consideration to the number of positions that have already been filled or the status of Gulf's efforts to fill the remaining vacancies. [McMillan, Tr. 2358]

Importantly, neither Mr. Meyer nor Ms. Ramas identified any specific position that could or should be eliminated nor did they challenge the detailed justifications provided by Gulf's witnesses regarding the need for the budgeted positions. [*Id.*] Instead, they arbitrarily used historical data to eliminate dollars that the evidence shows are required to operate Gulf's business at a level that will continue to ensure safe, reliable and efficient service for its customers. [*Id.*]

Even if Gulf were not expected to maintain a full employee complement during 2012, it would not be appropriate to make an adjustment of the magnitude recommended by the intervenors. The O&M portion of labor costs should not be looked at in isolation. [McMillan, Tr. 1091, 2355] Assuming that an unfilled position will result in funds not being spent ignores the real process that managers use in evaluating and prioritizing the use of their resources. [McMillan, Tr. 1091] A budget is only a planning tool. When faced with an unexpected cost or changing circumstances, resources can and will be redeployed from one budget category to another in order to meet customers' needs. [McMillan, Tr. 1091, 2355; Ex. 168, Sch. 5; Grove, Tr. 913-14; Moore, Tr. 596-97] It is therefore unlikely that any funds available from positions remaining unfilled would result in lower total O&M expenses. [McMillan, Tr. 1091] In fact, Gulf's data shows that except in recent years when efforts to control costs to delay a rate increase resulted in some positions being intentionally held vacant, Gulf has typically spent 100% or more of its O&M budget even while carrying some vacant positions. [McMillan, Tr. 2355; Ex. 168, Sch. 5]

If the Commission does determine that some hiring lag adjustment is appropriate, the amount of that adjustment should be calculated to reflect only the effect of normal employee turnover, not some assumed level of on-going vacancies. [McMillan, Tr. 2356] Any hiring adjustment should thus be calculated based on the estimated employee turnover during the year times the average time it takes to fill a vacant position times the average salary. [*Id.*] Based on employee turnover data from 2008 to 2010 and average salaries by employee classification for 2011, Mr. McMillan calculated a total company hiring lag of approximately $610,697, of which $439,149 ($448,069 system) represents O&M payroll. [McMillan, Tr. 2356, 2381; Ex. 150 at

81-88; Ex. 168, Sch. 6] This is the maximum hiring lag adjustment that the Commission should consider.

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

All of Gulf's employee compensation should be included in operating expenses, including all incentive or variable compensation. Gulf's total compensation approach, including variable compensation, was approved in Gulf's last case and remains the same. Gulf's compensation program is appropriately targeted at the median of the market and has allowed Gulf to retain valuable and attract new employees necessary to serve customers. Gulf's use of variable compensation aligns the interests of employees with customers and shareholders, making employees accountable for their performance. The proposed disallowance of variable compensation lacks any market analysis; it is based on an erroneous premise that it does not serve customers; and it completely fails to account for the adverse effects of such a disallowance on customers.

Each of Gulf's witnesses addressing functional O&M expenses testified that Gulf's proposed O&M expenses were reasonable and prudent. [Burroughs, Tr. 746; Grove, Tr. 849; Moore, Tr. 562; Caldwell, Tr. 503; Erickson, Tr. 940; Neyman, Tr. 679-80, 682, 688] Included in those reasonable and prudent O&M expenses was compensation. Included in compensation was what has been characterized as "at risk," "variable" or "incentive compensation" for every Gulf employee.[2] (Hereafter, Gulf will refer to it as "at-risk" compensation.)

In Gulf's last two rate cases, the Commission approved Gulf's total compensation approach, which included an element of at-risk compensation. Order No. 23573 and Order No. PSC-02-0787-FOF-EI. Gulf's compensation approach in this case is much the same as it was in Gulf's last rate case. [Deason, Tr. 2094, 2103] So, Gulf's case addressed the reasonableness and

[2] Also included in those expenses were labor expenses for additional employees that were added between year-end 2010 and the 2012 test year. Each of Gulf's functional witnesses addressed the reasonableness and prudence of Gulf's incurring the labor costs for these additional employees. The propriety of including those labor costs in the test year is addressed in Issue 70 and is not repeated here.

prudence of Gulf's total compensation approach, which includes at-risk compensation for every employee.

Ms. Ramas, whose qualifications conspicuously omit any experience in utility or corporate compensation,[3] recommended the disallowance of every dollar of projected 2012 at-risk compensation. [Ramas, Tr. 1478-79] She recommended a reduction to rate base of $1,217,206 for what she characterized as incentive compensation. [*Id.*] That is the subject of Issue 12. She also recommended a $12,623,632 reduction to O&M expenses to remove at-risk compensation costs. [*Id.*] That is the subject of this issue. (Because the rationale for each adjustment is the same, Gulf is only discussing the issue once in this brief.) However, she went further than a mere disallowance of these expenses. She disingenuously[4] recommended that they "be funded by shareholders." [*Id.*] Ms. Ramas' rationale for disallowance of all the expenditures associated with four different at-risk compensation programs was the same – she argued that each at-risk compensation program benefits Southern Company shareholders and not Gulf's customers.[5] [*Id.*] Ms. Ramas attempted to buttress her overall rationale with two other arguments levied against Gulf's Performance Pay Plan. First, she argued that two recent Commission rate case decisions supported her position. Order No. PSC-10-0131-FOF-EI (PEF)

[3] According to Ex. 36, Ms. Ramas is a certified public accountant (CPA) who has worked ten years as a professional witness with Larkin & Associates, PLLC, a CPA firm. There is no mention in this exhibit of compensation or Human Resources experience, much less expertise. Gulf points this out solely for the weight which should be given to this witness's compensation and HR recommendations- little or none.

[4] Mr. Deason in a particularly passionate exchange during cross examination explained just how disingenuous the suggestion is that shareholders fund this or any other expense. [Deason, Tr. 2167] He correctly pointed out that such a suggestion is a backdoor means of lowering the allowed return on equity below levels found by the Commission to be reasonable. [*Id.*]

[5] She recommended disallowance of the Stock Option Program expenses, "because these benefits provide direct benefits to Southern Company shareholders and not Gulf ratepayers." [Ramas, Tr. 1472] She recommended disallowance of Performance Share Program expenses, "for the same reasons discussed above regarding the Stock Option Program." [Ramas, Tr. 1473] She recommended disallowance of the Performance Dividend Program, because "the costs should be funded by the Southern Company's shareholders who are the beneficiaries and the prime focus of the goals within the plans." [Ramas, Tr. 1474] She recommended disallowance of the Performance Pay Plan expenses because, "the primary drivers and key focus of the program are financial goals that benefit Southern Company's shareholders but not Gulf's ratepayers…." [Ramas, Tr. 1477]

and Order No. PSC-09-0283-FOF-EI (TECO). Second, she argued that Gulf was projecting achievement of 125% of targeted performance goals, and that such an assumption raised a question of whether the goals were incenting employee performance. [*Id.*]

Because at-risk compensation is such an important part of Gulf's compensation approach – so important that every Gulf employee, including union employees, have some element of performance compensation at risk – Gulf rebutted Ms. Ramas' testimony with three different witnesses. Ms. Kilcoyne, whose HR and compensation expertise is unchallenged, provided 30 pages of rebuttal testimony, most of it focusing on the flaws with Ms. Ramas' at-risk compensation adjustment. [Kilcoyne, Tr. 1979 - 2012; Ex. 160] Mr. Wathen, another unchallenged expert in corporate and public utility compensation from Towers Watson, a well-respected compensation consulting firm, presented a competitive assessment of Gulf's compensation program as currently structured and as it would be structured without the at-risk compensation that Ms. Ramas argued should be disallowed. [Wathen, Tr. 2062-78; Ex. 161] Mr. Deason, an expert on regulatory policy, particularly Florida regulatory practice, was also brought in to address how Ms. Ramas' proposed adjustment was at odds with prior Commission policy and tenets of ratemaking. [Deason, Tr. 2088 - 2104; Ex. 162] The rebuttal of Ms. Ramas' at-risk compensation adjustment was complete.

Ms. Kilcoyne began by putting Ms. Ramas' at-risk compensation disallowances in context. Ms. Ramas' adjustment would reduce total compensation projected to be paid to Gulf employees in 2012 by 13.7 percent. [Kilcoyne, Tr. 1982] Ms. Ramas' adjustment would reduce total compensation to a level $4.5 million lower than it was in 2010, when Gulf had an intentionally reduced work force. [*Id.*] Ms. Ramas' adjustment would reduce the average total compensation of Gulf employees in 2012 to a level more than $11,000 lower than the average total compensation actually paid to Gulf employees in 2010. [Kilcoyne, Tr. 1983] On its face, the adjustment is unreasonable.

Ms. Kilcoyne then offered and developed seven different reasons Ms. Ramas' at-risk compensation adjustments should not be made. In doing so, she addressed not only each of Ms. Ramas' supporting arguments, but also other factors that Ms. Ramas failed to address.

First, Ms. Ramas failed to consider that Gulf's existing compensation plan is market competitive and successful in retaining and attracting employees and that it would no longer be market competitive with Ms. Ramas' adjustment. [Kilcoyne, Tr. 1983, 1986] Ms. Kilcoyne presented a study showing that Gulf's compensation plan is market competitive, with all employees being paid within a range of 7.5 percent below to 2.8 percent above the median of the market. [Kilcoyne, Tr. 1986; Ex 160, Sch. 1]

Second, Ms. Ramas' underlying premise that at-risk compensation benefits only shareholders and not customers is simply inaccurate. [Kilcoyne, Tr. 1983, 1986-89] At-risk or performance based compensation benefits customers; indeed, it is the portion of the compensation plan most aligned with customer interests. [Kilcoyne, Tr. 1990] Achievement of financial goals is in the interests of Gulf's customers; earning a fair rate of return helps maintain the Company's financial integrity, which, in turn, helps Gulf access capital markets to raise, at lower cost, the funds necessary to serve customers. [Kilcoyne, Tr. 1987] Similarly, achievement of operational goals benefits customers. [Kilcoyne, Tr. 2006] Even Ms. Ramas acknowledges that operational goals "could" benefit customers. [Ramas, Tr. 1476] As Ms. Kilcoyne pointed out, "the operational and financial goals work together to assure decision-making is done in a manner that balances our commitment to serving customers in the current year with providing investors with a fair rate of return, which ultimately ensures we have the capital necessary to serve the customers in the future." [Kilcoyne, Tr. 2006]

Third, Ms. Ramas' adjustment, if accepted, would impede Gulf's ability to attract and retain employees necessary to meet customer needs. [Kilcoyne, Tr. 1984, 1993] Ms. Kilcoyne presented a schedule and testimony showing the success of Gulf's existing compensation plan in retaining employees. [Kilcoyne, Tr. 1995; Ex. 160, Sch. 3] Ms. Kilcoyne explained the need to retain Gulf's highly skilled work force, which represents a huge investment in training over a long period of time. [Kilcoyne, Tr. 1992-94] "The skills those employees have are absolutely critical to providing safe and reliable service to customers.'' [Kilcoyne, Tr. 1994] It is this work force that Mr. Jacob testified made heroic efforts to restore service after Hurricanes Ivan and Dennis and that Mr. Moore testified has won the Emergency Recovery Award and the Emergency Assistance Award. [*Id.*] It is this work force that is marketable to other utilities and Gulf needs to retain. [Kilcoyne, Tr. 1994-95]

Fourth, Ms. Ramas fails to comprehend that performance based pay aligns the interests of customers, employees and investors. [Kilcoyne, Tr. 1984] "Customers benefit when the variable pay goals are met and the Company maintains its financial integrity." [Kilcoyne, Tr. 1989] "As I have noted, variable compensation aligns the interest of employees with our customers and investors. It does not pit shareholders against customers, as Ms. Ramas seems to suggest and would like the Commission to believe." [*Id.*]

Fifth, Ms. Ramas failed to address the serious adverse consequences to employees and customers if her adjustments were adopted. [Kilcoyne, Tr. 1984] Employees would face salary reductions ranging from 6-64%. [Kilcoyne, Tr. 1985] Average gross salary would decline more than $11,000 from 2010 levels. [Kilcoyne, Tr. 1983] "Ms. Ramas' proposed total compensation reduction will have a significant adverse effect on our ability to retain the experienced and skilled employees we currently have, and that proposed pay reduction would make it far more difficult to replace employees in the future." [Kilcoyne, Tr. 1995]

Sixth, Ms. Ramas' disallowance is at odds with prior Commission policy. [Kilcoyne, Tr. 1984; Deason, Tr. 2094-95, 2103-04] On this point Ms. Kilcoyne deferred to the regulatory expert, Mr. Deason.

Finally, Ms. Kilcoyne defended the "hard working employees that strive every day to put the customer first." [Kilcoyne, Tr.1985] She testified that, "Gulf's workforce is highly skilled in successfully providing high quality service to customers at all times in all weather conditions. This skill comes in part, from experience. They know Gulf's system, Gulf's generating units and Gulf's customers' expectations." [Kilcoyne, Tr. 1993] It is these employees whose pay Ms. Ramas would reduce by as little as 6% to as much as 64%. [Kilcoyne, Tr. 1985]

Mr. Wathen's rebuttal was much more focused. As an independent third party compensation expert, he addressed the competitiveness of Gulf's compensation program as proposed by Gulf and as modified by Ms. Ramas. His general conclusion is well worth restating:

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

[Wathen, Tr. 2068] As to Gulf's at-risk compensation programs at issue in this case, Mr. Wathen testified:

> Our review suggests that Gulf's Performance Pay Program design is comparable to and competitive with short-term at-risk compensation plan designs of the

> market perspectives examined. Also, it is important to note that Gulf puts equal weighting on all performance measures for all program participants (1/3 weight on corporate EPS, 1/3 weight on business unit ROE and 1/3 weight on operational goals) to emphasize and ensure employees have a vested interest in achieving all goals. . . . Based on our review, we found the Company's long-term at-risk compensation program design, reflecting annual grants of stock options and performance shares to be competitive with the market examined.

[Wathen, Tr. 2071-72]

Mr. Wathen also addressed Gulf's need and ability to attract and retain employees through its compensation plan:

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

[Wathen, Tr. 2073]

As to Ms. Ramas' proposed at-risk compensation disallowance, Mr. Wathen's testimony reinforces Ms. Kilcoyne's testimony in several significant ways. First, he states that, "the elimination of at-risk compensation, without any sort of replacement compensation, would result in total compensation at Gulf that is below market competitive levels and it will adversely impact the Company's ability to attract and retain employees." [Wathen, Tr. 2073; Ex. 161, Sch.3] He went on to observe that, "in an environment where utilities have aging workforces and the need to replace critical skills will only grow as employees retire, it is essential for Gulf to be able to attract and retain qualified employees." [Wathen, Tr. 2074]

Mr. Deason, Gulf's third at-risk compensation rebuttal witness, while picking up themes consistent with witnesses Kilcoyne and Wathen, challenged Ms. Ramas' at-risk compensation disallowance from another perspective. He testified that Ms. Ramas' 100% disallowance of at-risk compensation was, "inconsistent with sound regulatory policy and basic principles of ratemaking, is contrary to Commission precedent, is based on simplistic assumptions that are not factually correct, and, if accepted would be detrimental to the long term interests of Gulf's customers." [Deason, Tr. 2091]

Mr. Deason testified that Ms. Ramas' at-risk compensation disallowance violates at least two fundamental tenets of sound regulatory policy. Gulf will address each tenet in turn.

Mr. Deason testified that Ms. Ramas' at risk compensation adjustment violates the basic principle of ratemaking to include all reasonable and necessary costs as test year expenses in calculating net operating income. [Deason, Tr. 2091-92] He pointed out that Ms. Ramas made no allegation and presented no market analysis that at-risk compensation was unnecessary or unreasonable. [Deason, Tr. 2092] Her sole basis was a philosophical disagreement over the means of payment, <u>not</u> whether the total level of payment was appropriate. [*Id.*] He concluded that "Ms. Ramas' testimony is totally devoid of any consideration of reasonableness regarding either the overall amount of compensation or of the net amount that she has recommended." [Deason, Tr. 2093]

Mr. Deason testified that Ms. Ramas' adjustment also violated the fundamental tenet of encouraging regulated utilities to be efficient and provide high quality service to their customers over the long term. [Deason, Tr. 2091] He stated, "sacrificing efficiency or quality of service in the long term to achieve temporary rate reductions is not in the customers' interest." [*Id.*] He went on to explain how her adjustment failed to encourage efficiency or maintain or improve quality of service: "her recommendation takes away a valuable managerial tool that is effective in increasing efficiency and maintaining or improving the quality of service provided to customers." [Deason, Tr. 2098] "A compensation structure that pays employees regardless of performance diminishes management's leverage to motivate and focus employees on appropriate goals." [*Id.*]

Mr. Deason also elaborated on Ms. Ramas' adjustment being based on simplistic adjustments that are not factually correct.

> Ms. Ramas' recommendation is based upon two faulty assumptions. First, she assumes that financial goals benefit only shareholders. Second, she assumes that financial goals would be detrimental to customers through a reduced quality of service. Both of these assumptions are incorrect.
>
> Financial goals also benefit customers. Regulated utilities are profit making entities (hopefully) and must make a reasonable profit to be sustainable and to access capital when needed and on reasonable terms. This is the means by which customers receive the service they expect and deserve. A utility earning a reasonable profit is beneficial for both its shareholders and its customers. Therefore, financial goals used to establish compensation levels are also beneficial to customers.

[Deason, Tr. 2100]

Mr. Deason also testified that despite Ms. Ramas' invocation of the most recent PEF and TECO cases, her adjustment was inconsistent with long standing Commission precedent as well as Florida court cases. In doing so, he concluded that the recent PEF decision "is really a deviation." [Deason, Tr. 2095] The Commission has consistently allowed recovery for at-risk compensation, including both of Gulf's last two rate cases. [Deason, Tr. 2094-95] He explained the basis for the Commission's prior precedent [Deason, Tr. 2103-04] and concluded his explanation with a particularly insightful observation:

> While at-risk compensation has been and is currently being characterized as an "us vs. them" issue, in reality it is not. Incorporating at-risk pay as part of an overall compensation plan is a good example of a "win-win" situation. . . Including at-risk pay as part of an overall compensation plan enables all stakeholders to win. Shareholders get to invest in a company with employees motivated to achieve appropriate corporate goals. Management gets to apply compensation tools they think are best to motivate and fairly compensate employees. And most importantly, customers pay no more than a reasonable amount in their rates.

[Deason, Tr. 2104]

The Commission should also be mindful of the two court cases addressed by Mr. Deason. Both the Supreme Court of Florida and the First District Court of Appeals have overturned Commission compensation decisions (*See, Florida Bridge Company v. Bevis,* 363 So.2d 799 (Fla. 1978); *Sunshine Utilities of Central Florida, Inc. v. Florida Public Service Commission,* 624 So.2d 306 (Fla. 1st DCA 1993) "because the basis for the disallowance did not address the reasonableness of the salaries as compared to the market." [Deason, Tr. 2096] As Mr. Deason noted, "Ms. Ramas' analysis is similarly flawed." [*Id.*]

Mr. Deason's prefiled rebuttal testimony was reinforced during cross examination. He pointed out that the intervenors' repeated suggestion that at-risk compensation "be funded by shareholders" [Ramas, Tr. 1478] was disingenuous.

> Q. Really, I have two questions. First, it is similar to the question I asked the prior witness, and that is, if we assume that Gulf ratepayers do not have to pay some portion of the compensation plan but that it is paid by the shareholders, then the benefits that have been described by the compensation plan would still exist, would they not?
>
> A. I have to reject the basis of your question. It is impossible to have the shareholders pay this compensation to [employees]. Gulf could not send an invoice to its shareholders and get a check from its shareholders to pay its employees.
>
> It is disingenuous to ask a question about having shareholders pay this compensation to employees. It doesn't happen. When you have the shareholders pay it, Commissioners, what the intervenors are saying is we want to reduce the company's achieved rate of return.
>
> It goes back to my summary. These adjustments, all that they do would be [to] deny Gulf a reasonable opportunity to achieve its rate of return.
>
> I believe it has been calculated that the amount of at-risk compensation which the Intervenors suggest simply be denied in this case amounts to somewhere in the neighborhood of, I believe, $14 million. I believe Mr. Teel has testified that $10 million is equal to a hundred basis points on the return on equity.
>
> So if you were simply to disallow this at-risk or incentive compensation, the net effect is to be reducing Gulf's achieved rate of return by 140 basis points.

[Deason, Tr. 2167-68]

Ms. Ramas' proposed disallowance of at-risk compensation is fully rebutted. It is ironic that a consumer witness would take on the element of compensation that is most aligned with customer interests – performance based or at-risk compensation. Ironies aside, the evidence shows that Gulf's entire compensation approach, including at-risk compensation, is market competitive, necessary to retain and attract employees and is appropriately designed. All at-risk compensation projected for the 2012 test period should be allowed.

ISSUE 72: What is the appropriate amount of allowance for employee benefit expense be adjusted?

The appropriate amount of employee benefit expense to include in operating expenses for the 2012 test year is $26,281,520 ($26,816,341 system). This amount includes adjustments to Gulf's original request to remove additional Executive Financial Planning expenses in accordance with the stipulation on Issue 68.

This is essentially a fallout issue that depends upon the Commission's decision on Issues 66, 67 and 70. The appropriate starting point is the Company's projected total fringe benefits for the 2012 test year of $31,096,355. [MFR C-35 at 1] After accounting for the NOI adjustments proposed by Mr. McMillan, that fringe benefits number decreases to $26,329,520 ($26,864,341 system). [Ex. 115 at 927] These amounts then need to be reduced by an additional $48,000 ($48,000 system) to reflect the impact of removing additional Executive Financial Planning expenses pursuant to the stipulation of Issue 68. As discussed below, no further adjustments to employee benefit expense are appropriate.

Employee benefit expenses are A&G expenses. The testimony is clear and unrefuted that projected A&G expenses for the 2012 test period are "both reasonable and prudent." [Erickson, Tr. 937] The stipulated and uncontested testimony of witnesses Crumlish and Twery addressed why employee benefit expenses exceeded the O&M benchmark. [Crumlish, Twery, Tr. 1059 – 1071] The only adjustments to employee benefit expenses that are still contested [6] are addressed in separate issues and will not be readdressed in this issue: (1) interest on deferred compensation – Issue 66; (2) SCS Early retirement – Issue 67; and (3) any adjustment to employee benefits associated with the resolution of the issue addressing the number of employee positions for the test year – Issue 70.

ISSUE 73: **Stipulated**

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)**

The appropriate amount of Salaries and Employee Benefits to include in operating expenses for the 2012 test year is $110,151,832 ($112,390,277 system). This amount includes adjustments to Gulf's original request to remove additional Executive Financial Planning expenses in accordance with the stipulation on Issue 68.

This is a fallout issue that should reflect the Commission's decisions on Issues 64 through 73. Consistent with its positions on Issues 64 through 73, Gulf respectfully submits that the total Salaries and Employee Benefits to be included in operating expenses for the 2012 test period is $110,151,832 ($112,390,277 system). This amount has been adjusted to remove the additional $48,000 ($48,000 system) of Executive Financial Planning expenses Gulf has agreed should have been excluded from NOI (see Issue 68). All other proposed salaries and benefits should be recognized as a legitimate cost of providing service.

ISSUE 75: **Stipulated**

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[6] Three other types of employee benefits issues were initially raised, but they have been addressed by stipulations. Executive Financial Planning expenses have been stipulated in Issue 68. All pension expenses, including supplemental pension expenses, were stipulated in Issue 75. Other Post Employment Benefit expenses have been stipulated pursuant to Issue 73.

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

> *$6,539,091 ($6,800,000 system). Gulf's property damage accrual is based on Ms. Erickson's expert opinion which was heavily influenced by a Commission required storm study. That study uses a statistical model to consider a range of potential hurricane characteristics and corresponding losses and then computes Gulf's expected annual damage. Since Gulf's current approved accrual level is below the amount expected to be charged to the reserve each year based on the storm study, Gulf requested the accrual be increased. This is in line with the Commission's framework of (1) an accrual adjusted over time as circumstances change; (2) a storm reserve adequate to accommodate most, but not all storm years; (3) and a provision that goes beyond the reserve.*

Every intervenor asks the Commission to disregard the storm study that Gulf was required by Commission rule to file. The intervenors unsuccessfully challenged Ms. Erickson's expertise and ability to rely upon the Commission required storm study, yet they rely upon testimony criticizing the storm study by three different witnesses, none of whom are qualified as storm experts. OPC's witness on this issue, who has used historic averaging rather than prospective forecasting of various types of expenses, consciously chooses to ignore the two most relevant historic data points (Gulf's actual storm experience in 2004 and 2005) in computing his "average" for this expense. Gulf finds itself alone in standing up for customers on this issue.

This issue is all about what is best for Gulf's customers. Five different parties have five different opinions about what is best for Gulf's customers. Four of those parties have some of Gulf's customers as their clients. The remaining party, Gulf, is the entity actually providing service to customers each and every day. It is Gulf that regularly surveys its customers and takes feedback regarding customer satisfaction. It is Gulf that uses customer satisfaction surveys as a primary driver of business initiatives. It is Gulf who has daily contact with its customers. And in this instance, it is Gulf that is advocating the position most advantageous to Gulf's customers:

for an increase of slightly over a quarter a month, residential customers can mitigate the prospect of having to face a larger storm surcharge at a time when they can least afford it.

Gulf is asking that customers pay a small increased amount each month to diminish the prospect of a higher storm surcharge when, not if, the next storm hits. Gulf is not asking for the increased accrual because Gulf stands to earn more. This additional accrual to the property damage reserve will not increase Gulf's net operating income. [Deason, Tr. 2119] Gulf is asking for this because storm surcharges are particularly burdensome for customers. They are implemented in the wake of a storm when customers are paying for their own storm restoration efforts and facing higher insurance premiums. If such charges can be mitigated with a modest monthly charge applied to the property damage reserve, they should be.

As a utility providing service on the Gulf Coast, Gulf Power Company runs an annual risk of significant system damage from tropical storms and hurricanes. [Erickson, Tr. 963] There is no commercially viable insurance available to protect Gulf and its customers from that risk of loss to transmission and distribution facilities. [Erickson, Tr. 964, 2315; Deason, Tr. 2120] However, Gulf has to be in a position to restore service quickly and effectively when, not if, such storms hit.[7]

The Commission has approved a self-insurance approach consisting of an annual accrual to a property damage reserve for all Florida electric utilities. [Deason, Tr. 2119-20] In essence, the annual accrual takes the place of insurance premiums previously included in the cost of service. [Deason, Tr. 2120] The property damage reserve "provides a 'cushion' to absorb the sometimes severe fluctuations in storm-related costs that occur from year to year." [Deason, Tr. 2119] This self-insurance approach is intended to protect against most, but not all storms.

[7] As Mr. Jacob and Mr. Moore pointed out, Gulf discharged this responsibility extraordinarily after both Hurricane Ivan in 2004 and Hurricane Dennis in 2005. [Jacob, Tr. 457-58; Moore, Tr. 585]

[Erickson, Tr. 2303, 2306-07; Deason, Tr. 2125] The reserve is available for the most severe storms, but the Commission has chosen not to set the reserve level high enough to cover all storms. [Deason, Tr. 2125] For the most severe storms, the property damage reserve can be used, but once the property damage reserve is exhausted, the Commission envisions that a storm surcharge will be levied on customers to recover the remaining unrecovered costs. [*Id.*]

Gulf's request in this case is really rather conservative. [Deason, Tr. 2121] Even though recent experience has shown that Gulf's current property damage reserve levels are clearly too low and Gulf has asked that they be increased, Gulf is requesting an annual accrual that is designed not to fund those larger reserve targets, but only maintain the existing level of the reserve, assuming annual average damages. [Erickson, Tr. 2312; Deason, Tr. 2122-23] To fund the increased damage reserve targets, an annual accrual much larger than the $6.8 million requested by Gulf would have to be made. Gulf took this conservative approach to mitigate the rate impact in this case. [Ex. 149 at 150-51]

In deciding this case, it is important for the Commission to understand that Gulf's property damage reserve, the customers' insurance from storm surcharges, has been exhausted not once but twice in the last seven years. The negative balance first occurred as a result of Hurricane Ivan in the fall of 2004 and grew to as much as $94 million in September 2005, just after Hurricanes Dennis and Katrina hit. [Erickson, Tr. 965] The property damage reserve balance combined with the regulatory asset recorded for Hurricane Ivan expenses per Order No. PSC-05-0250-PAA-EI, resulted in a negative balance from September 2004 until August 2008.[8] It took storm surcharges ranging from $2.51 to $2.71 per 1,000 kWh for residential customers (and commensurate surcharges for other customer classes) each month for 51 months to recover

[8] If Gulf had not made voluntary reserve contributions of some $32.1 million during the period 2001 through 2006, that negative reserve balance would have been $32 million higher. [Crosswhite, Tr. 121; Ex. 115 at 000960-971]

the costs of Hurricanes Ivan, Dennis and Katrina. [Erickson, Tr. 965] It has taken four years of abnormally low storm activity [Deason, Tr. 2125-26] to get the current reserve balance up to around $30 million. [Ex. 115 at 000968-971]

Consistent with the applicable Commission rule, Rule 25-6.0143, Gulf undertook and filed a storm study with the Commission in January 2011. [Erickson, Tr. 962, 2304; Ex. 19, Sch. 5] The study was initiated before Gulf decided to file a rate case and was consistent with the filing requirement of the rule. [Erickson, Tr. 962, 2304] When Gulf decided to file a rate case, Ms. Erickson relied upon the storm study in determining the annual accrual to request for the property damage reserve. [*Id.*] Since Rule 25-6.0143 requires that a change in the requested level of the annual accrual be supported by a storm study, Ms. Erickson attached the storm study filed in January 2011 to her direct testimony filed in July 2011. [*Id.*] The storm study, which is a statistical study assessing probabilities of tropical storms and their probable damages based upon a sophisticated model and over 100 years of historic storm records,[9] [Erickson, Tr. 962, 2299], estimated an "expected annual damage" ("EAD") to Gulf from hurricanes of $8.3 million. [Ex. 19, Sch. 5 at p. 19] Using historic ratios of the portion of damages capitalized and expensed, the portion of that EAD which would be charged to the property damage reserve would be $6.8 million. [Erickson, Tr. 962] Based on this assessment, which was consistent with several other less sophisticated approaches examined,[10] Ms. Erickson determined that the appropriate level for the annual property damage accrual is $6.8 million, and that is what Gulf requested in its rate case filing. [Erickson, Tr. 961-67]

[9] Very detailed discovery addressing the details of the data employed and the models used were asked and introduced into the record. [See, Ex. 102 at 000469, 000472; Ex. 194, Citizens' ROGs 204, 206, 207, 208, 209 and Staff ROGs 220, 226, 229, 230, 231, 232, 233]

[10] In her deposition, Ms. Erickson explained several other less sophisticated approaches to determining the annual accrual that led to essentially the same value as that derived from the study. [Ex. 149 at 151-52]

Gulf's conservative approach of not requesting an annual accrual sufficient to fund increased reserve target levels but of essentially maintaining the level of the existing reserve under average conditions met with significant opposition. This has turned out to be perhaps the most contested issue in the case, where no two intervenors agree with each other.

The most reasonable intervenor position on this issue is FEA's. Their witness, Mr. Meyer, recognized that Gulf's current annual property damage accrual ($3.5 million) and property damage reserve target range of $25.1 million to $36 million were established by the Commission fifteen years ago. He recommended an increase of the annual accrual from $3.5 million to $5 million, the level to which the $3.5 million would increase if adjusted by the combined rates of CPI and customer growth since it was established. [Meyer, Tr. 1759] Mr. Meyer offered no criticism of the storm study; indeed, he found "some of the results from the analysis noteworthy." [Meyer, Tr. 1760]

FIPUG's witness, Mr. Pollock, who offered no qualification as a storm damage expert, [Pollock, Tr. 1341-42] took issue with the EAD calculated in the storm study, stating that he thought it was overstated because (1) it ignored the Commission's directive that the reserve should be adequate to cover most but not all storm years and (2) Gulf's actual experience since Hurricane Dennis in 2005 suggested annual property damage charges of less than a million dollars. [Pollock, Tr. 1332-40] He advocated keeping the existing annual accrual of $3.5 million.

OPC's witness, Mr. Schultz, who offered no qualifications as a storm damage expert, [Schultz, Tr. 1532; Ex. 38] severely criticized the Company's storm study, going so far as to suggest that Ms. Erickson, notwithstanding her sworn testimony to the contrary, did not rely on the storm study in determining the annual storm accrual:

> Even though the Company's witness Erickson states at page 29 of her direct testimony that "The $6.8 million represents the expected average annual storm loss to be charged to the reserve according to Gulf's Hurricane Loss and Reserve Performance Analysis (Storm Study)", it is my opinion that the storm study was not used to determine the level of the proposed accrual. Instead, the study reflects what the Company decided it wanted to collect in rates.

[Schultz, Tr. 1549] In Mr. Schultz's self-contradictory[11] argument attacking the storm study, two arguments emerge. First, he argues that the storm study did not calculate the effect of Gulf's storm hardening efforts implemented from 2007 through 2011. Second, he argues that Gulf's storm experience in 2004 and 2005 was extraordinary and therefore, that experience should be ignored.

FRF offered no witness on the storm study. It took the extreme position that there should be no prospective annual property damage accrual. Despite their best efforts at friendly cross, FRF could not get even Mr. Schultz to support their extreme position. [Schultz, Tr. 1576]

In Gulf's rebuttal case, Ms. Erickson offered a point by point rebuttal of the property damage accrual testimony by the intervenors. [Erickson, Tr. 2298-2312] It will not be repeated in its entirety here but three points warrant particular mention.

First, as to Mr. Schultz's suggestion that Ms. Erickson did not tell the truth on direct, Ms. Erickson politely responded that, "this allegation is without merit," and then she proceeded to set forth the real facts, which clearly showed the storm study was performed independently of the rate case with no communication by Gulf that tried to sway the outcome of the study. [Erickson, Tr. 2304-05]

Second, only 6% of Gulf's distribution system has experienced storm hardening since those efforts began in 2007. [Moore, Tr. 633] As both Ms. Erickson and Mr. Moore testified,

[11] He states he believes "that historical storm information is relevant." [Schultz, Tr. 1550] However, when developing his own storm accrual recommendation, he ignored Gulf's actual historical storm information for not one but two years (2004 and 2005). [Schultz, Tr. 1551-52] Even he cannot decide whether to use historical storm information. He wants to, unless it affects the result he wants to reach.

given the lack of storm activity since then, there is no forensic evidence of the potential effectiveness of those efforts in mitigating storm damage. [Erickson, Tr. 2309; Moore, Tr. 593-95, 606] Consequently, there was no data available for the storm study to consider regarding storm hardening activities. [*Id.*] This criticism of the storm study by witnesses Pollock and Schultz is without merit.

Third, while the effects of Hurricanes Ivan and Dennis were near catastrophic from an operational perspective [Jacob, Tr. 467; Moore, Tr. 598], they were not extraordinary in terms of monetary damage. [Erickson, Tr. 2319-22] Like Katrina they were Category 3 hurricanes, but they had total damages of $137 million and $59 million respectively, whereas Katrina caused Mississippi Power Company $396 million in damage. [Erickson, Tr. 2303] The efforts of Mr. Pollock and Mr. Schultz to characterize Hurricanes Ivan and Dennis as extraordinary storms that should not be covered by a storm reserve "would be an inaccurate summation of history and would be an abrupt change in Commission policy." [Erickson, Tr. 2304]

Gulf also presented the rebuttal testimony of Mr. Deason on this issue. Several points should be emphasized. Mr. Deason testified that the expected annual loss from storms "should be based upon a statistically valid study that looks at both the expected frequency of all potential storms and the expected dollar amount of storm losses to be incurred from each event." [Deason, Tr. 2123] Of course, that is what Gulf did, and as Mr. Deason pointed out, neither Mr. Pollock nor Mr. Schultz attempted such an approach. Mr. Deason then explained how the approaches suggested by Mr. Pollock and Mr. Schultz were "inconsistent with Commission policy." [Deason, Tr. 2123-25] He explained that both Mr. Pollock and Mr. Schultz "place too much reliance on recent history" and that "using only recent history and excluding larger storms skews Mr. Schultz's recommendation to the point that it is unreasonable." [Deason, Tr. 2125-26] And in response to a question from Commissioner Edgar, Mr. Deason described the overall conservative nature of Gulf's requested accrual and expressed his doubt that an explicit adjustment to Gulf's accrual is supported in the record of this case. [Deason, Tr. 2178-81]Mr. Deason explained why an appropriate storm cost accrual is a cost of service properly included in rates:

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

[Deason, Tr. 2126-27]

Mr. Deason closed his rebuttal with an admonition against placing greater reliance on storm surcharges and less reliance on reserves. Gulf closes its argument with this passage, because it appropriately focuses on the customer:

> Both Mr. Pollock and Mr. Schultz argue that surcharges are not only permissible but should be preferred. It is not in the customer's interest to be overly dependent on surcharges. An appropriate annual storm reserve accrual will lessen the likelihood of any surcharge being imposed. And when one is absolutely necessary, an appropriate annual storm reserve accrual will lessen its amount and thus the burden imposed on customers. While an appropriate annual storm reserve accrual might slightly increase rates currently, it can and will provide greater benefits to customers when they need it the most.

[Deason, Tr. 2128]

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

*No. The appropriate amount for Directors & Officers ("D&O") Liability Insurance expense of $116,265 ($118,767 system) is included in the 2012

> projected test year. D&O Liability Insurance helps to retain and recruit qualified and competent directors and officers who provide needed expertise in running a utility, both financially and operationally. Having a well-run utility benefits ratepayers and having adequate liability coverage helps protect the assets of the Company from lawsuits that could divert capital to cover any losses.*

D&O Liability Insurance expenses are recorded in Administrative & General ("A&G") accounts. The testimony is clear and unrefuted that projected A&G expenses for the 2012 test period are "both reasonable and prudent." [Erickson, Tr. 937] They are based on an extensive budget preparation and review process that ensures that every item included in the budget is based upon the most accurate and up-to-date assumptions. [*Id.*] Gulf's projected D&O liability insurance expenses for the 2012 test year are $118,767. [Erickson, Tr. 2293]

Mr. Schultz suggested that half of Gulf's D&O liability insurance expenses be disallowed. He offered two rationales: (a) in one of three Florida cases in which he testified regarding D&O liability insurance, the Commission disallowed half (in the other two cases the Commission <u>allowed</u> the entire expense), and (b) he believes that D&O liability insurance benefits "shareholders first and foremost" and in ratemaking, cost should follow the benefit. [Schultz, Tr. 1566-67]

In rebuttal to Mr. Schultz's proposed D&O Liability Insurance disallowance, Gulf presented the testimony of two witnesses: Ms. Erickson and Mr. Deason. Ms. Erickson testified that customers, not shareholders, are the primary beneficiaries of D&O Liability insurance. [Erickson, Tr. 2294] She stated:

> A well run company, such as Gulf Power, must have competent and skilled directors and officers to lead it. These individuals would be difficult to attract and retain if the Company did not have D&O liability insurance. Capable directors and officers help ensure proper oversight and management of the Company, which in turn benefits customers. D&O liability insurance also helps protect the assets of the Company, which are used to serve Gulf's customers. D&O liability insurance is a legitimate and necessary cost of providing service.

[*Id.*]

Mr. Deason testified that the amount of D&O liability insurance expense requested by Gulf is, "reasonable and is an ordinary and necessary cost of doing business for any publicly-held company, and as such, the entire amount should be recovered in rates." [Deason, Tr. 2107-08] He explained that such insurance is necessary to attract and retain knowledgeable, experienced and capable directors and officers, and that qualified people would be reluctant to assume the responsibilities of managing without such protection. [*Id.*] He stated that, "adequate liability coverage gives directors and officers the level of comfort necessary to enable them to make forward-looking decisions that will provide operational and cost-efficiency benefits for customers." [*Id.*] He then explained how such expenses benefit customers by helping to retain and recruit qualified and competent directors and officers that run the Company well; a well run utility benefits customers through delivery of safe and reliable service at a reasonable cost. [Deason, Tr. 2109] Mr. Deason also testified that in cases where there has been an adequate explanation of the need for the insurance and a reasoned analysis of the need, full recovery has been authorized. [*Id.*] Finally, Mr. Deason testified that a disallowance of a reasonable and necessary business expense such as D&O liability insurance "is nothing more than a backdoor approach to reducing the allowed ROE." [Deason, Tr. 2110]

The evidence in this case shows that the modest expense of D&O liability insurance ($118,767) is reasonable and necessary. It primarily benefits customers by allowing Gulf to attract and retain capable and skilled directors and officers who effectively manage a well run Company whose ultimate goal is service to customers. This is a legitimate and necessary cost of providing service and Gulf's rates should be set to recover its entire cost.

<u>ISSUE 78</u>: Stipulated

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

The appropriate amount of Gulf's tree trimming expense for the 2012 test year is $4,918,154. This level of funding is necessary to allow Gulf Power to meet its three-year main line and four-year lateral maintenance trim cycles as filed in its Commission approved storm hardening plan.

The appropriate amount of Gulf's tree trimming (vegetation management) expense for the 2012 test year is $4,918,154. [Moore, Tr. 564 and 2469] Gulf's distribution vegetation management activity includes expenses to clear, trim, and maintain distribution rights of way. [Moore, Tr. 564] In 2010, Gulf submitted, and the Commission approved, Gulf's storm hardening plan for the years 2010 to 2012. [Moore, Tr. 2468; Ex. 127 at 001404] This new storm hardening plan incorporated a four-year lateral and a three-year main line feeder trim cycle. [Moore, Tr. 2468; Ex. 102 at 000498 and 000507; Ex. 133 at 001451] The lateral trim cycle had previously been six years. [*Id.*] With this change, Gulf is now required to trim 33% more line miles of laterals per year than in the years 2007 through 2009. For the years 2007 to 2009 when Gulf was on a six-year lateral trim cycle, Gulf averaged $4.1 million per year on vegetation management. [Ex. 102 at 000486; Ex. 133 at 001448-49] The difference between the 2012 test year requested amount of $4.9 million and the $4.1 million average from 2007 to 2009 is the amount necessary for Gulf to stay on the new trim cycle approved by the Commission in Gulf's most recent storm hardening plan. [Moore, Tr. 2469]

Mr. Schultz's proposed adjustment to Gulf's vegetation management expenses is misguided. Mr. Schultz completely ignores the fact that Gulf's storm hardening plan changed in 2010 to have a shorter trim cycle for laterals in its vegetation management program. [*Id.*] The four year average calculated by Mr. Schultz has three years of data from periods where Gulf was on the longer trim cycle and is based solely on the 2007 to 2009 storm hardening plan without consideration of the fact that the storm hardening plan was updated in 2010. [Moore, Tr. 2468] The adjustment proposed by Mr. Schultz is without basis and should be rejected.

ISSUE 80: ***The deadline for briefing this issue was extended until January 11, 2012 in order to allow the Commission an opportunity to consider a Motion for Approval of Partial Settlement Agreements.***

ISSUE 81: **Dropped**

ISSUE 82: **Dropped**

ISSUE 83: **Dropped**

ISSUE 84: What is the appropriate amount of production plant O&M expense?

Gulf's request of $107,243,000 ($110,880,000 system) for production O&M expense is the appropriate amount to effectively maintain and operate Gulf's generating fleet. In 2009 and 2010, to help delay a rate case, Gulf was able to maintain and operate the generating fleet through extraordinary but prudent management of limited resources. This included production O&M expense levels below budget and reduced staff levels. However, beginning in 2010, Gulf could no longer maintain and operate its fleet with such reduced resources without jeopardizing customer service. The production O&M expense requested for the 2012 test year is reasonable and necessary to provide a reliable and efficient generating fleet that minimizes cost, and it is representative of costs in future years.

Both Mr. Burroughs, Gulf's Vice President of Power Generation and Senior Production Officer, and Mr. Grove, Gulf's Manager of Power Generation Services, testified that Gulf's 2012 test year projection of production O&M expenses of $110,880,000 is reasonable and prudent and representative of expenses going forward through 2015. [Burroughs, Tr. 746-47; Grove, Tr. 849-88; Ex. 17, Schs. 6 and 7; Ex. 18, Schs. 6-11; MFR C-4 at 2] They both testified that the projected level of production O&M expenses is the result of a rigorous multi-level budgeting process and that these expenses would be subject to demanding cost controls. [Burroughs, Tr. 747; Grove, Tr. 849-51]

In his direct testimony, Mr. Grove justified the 2012 test year production O&M budget of $110,880,000 in four different ways. First, he testified that the budget is the result of a rigorous multi-level process "implemented by experienced employees who know their jobs and their facilities," and he explained that budget process in testimony. [Grove, Tr. 849-88] Second, he testified that the 2012 level of production O&M expenses is representative of production O&M expenses going forward through 2016. [Grove, Tr. 852; Ex. 17, Sch. 7 and 11] Third, he identified five primary factors that are causing Gulf's projected level of 2011-15 production O&M expenses to increase from the historic level of production O&M expenses from 2006 through 2010: (1) the increased age of Gulf's generating fleet; (2) production costs increasing well in excess of inflation as measured by CPI; (3) Smith Unit 3 no longer being new; (4) the addition of the new Perdido units that did not operate in the historical period; and (5) Gulf's extraordinary efforts during the economic downturn to reduce production O&M expenses to help delay the need for a rate increase. [Grove, Tr. 853] Then Mr. Grove elaborated on each of these five factors. [Grove, Tr. 853-59] Fourth, Mr. Grove justified Gulf's 2012 projected production O&M budget by adding another twenty-eight pages of testimony justifying a production O&M benchmark variance of $14,381,000. [Grove, Tr. 860-888; Ex. 18, Schs. 10, 11] Mr. Grove left no stone unturned.

In his deposition, Mr. Grove elaborated on the rigorous O&M budget process employed. [Ex. 148 at 28-31, 81-110] Indeed, Mr. Grove's deposition established that: (a) when there is a rate case pending, the O&M budgetary process does not change [Ex. 148 at 106]; (b) the same budget process was used to develop the 2011-15 budget (which was used to develop Gulf's test year) that was used to develop the 2012-16 budget [Ex. 148 at 109-110]; and (c) that when a rate case is pending, O&M expenses are not moved up in the queue [Ex. 148 at 110]. Similarly, in his deposition Mr. Burroughs testified that (a) the $15 million increase in production O&M expense between 2010 and 2011 was not tied to the potential filing of a rate case [Ex. 147 at 62]; (b) when Gulf was preparing its rate case, no one in the production function was told to increase their O&M budgets above the 2010 level [Ex. 147 at 63-64]; and (c) neither Mr. Burroughs nor anyone else told plant managers to increase budgets, even incrementally. [Ex. 147 at 64]

In the face of this extensive justification of Gulf's 2012 production O&M budget, Mr. Schultz proposed an adjustment of $11,291,492 to Gulf's 2012 production O&M budget. [Schultz, Tr. 1564)] This 10.2% "averaging" adjustment to production O&M expense is simply unjustified.

In stating his qualifications, Mr. Schultz listed no experience in: maintaining or operating electric production equipment; formulating production O&M budgets or budget processes; or assessing what particular types of expenses are necessary to operate any electric utility production function, much less Gulf's. [Ex. 38] The closest experience Mr. Schultz states in his qualifications is that he is a professional witness. "He has presented expert testimony in regulatory hearings on behalf of utility commission staffs and intervenors on numerous occasions." [*Id.*]

The extent of Mr. Schultz's lack of expertise is demonstrated in his faulty quantification of his production O&M adjustment. As Mr. Grove pointed out in rebuttal, Mr. Schultz made multiple mathematical errors in his production O&M adjustment. [Grove, Tr. 2453-56)] The correction of just one of those math errors would reduce his proposed production O&M adjustment from $11.3 million to $2.7 million. [Grove, Tr. 2454-56; Ex. 164, Sch. 4] However, none of Mr. Schultz's production O&M adjustment is correct. [Grove, Tr. 2440-56]

Gulf's 2012 production O&M budget is fully justified. The only witness challenging it, Mr. Schultz, lacks credibility, and his misleading testimony and inaccurate adjustment should be summarily rejected. The appropriate level of Gulf's 2012 production O&M expenses is $110,880,000 as testified to and supported by Mr. Burroughs and Mr. Grove.

ISSUE 85: **Stipulated**

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

The total requested distribution O&M expenses for the 2012 test year of $41,538,000 ($41,596,000 system) are reasonable and necessary. The distribution expenses for the 2012 test year are necessary for Gulf to continue to provide reliable electric service to its customers and are lower than the level approved in Gulf's last rate case when adjusted for customer growth and inflation since that case (typically referred to as the Commission benchmark). The 2012 test year expenses are also representative of levels that will continue to be incurred going forward.

The total requested distribution O&M expenses for the 2012 test year of $41,595,585 are reasonable and necessary. [Moore, Tr. 562; MFR C-4 at 4] This is the level of distribution O&M expense that was approved as a result of Gulf's robust budget process, and is the level of 2012 distribution expense that is reasonable, prudent and necessary for Gulf to provide adequate and reliable electric service to its customers. [*Id.*] The requested distribution O&M expenses for the 2012 test year are representative of a going forward level of distribution O&M expenses beyond 2012. [Moore, Tr. 565; Ex. 15, Sch. 8] When compared to the Commission's O&M benchmark analysis, Gulf's requested distribution O&M expense level for the 2012 test year is $3,472,000 below the 2012 O&M benchmark. [Moore, Tr. 565, 632; Ex. 15, Sch. 8]

The only two proposed adjustments to Gulf's requested distribution O&M expenses for the 2012 test year are to tree trimming and pole inspection expense. These adjustments, which were proposed by Mr. Schultz, are without merit. Gulf's position and discussion on these two proposed adjustments is addressed in Issues 79 and 80 and will not be repeated here. The requested distribution O&M expenses for the 2012 test year of $41,595,585, including the expenses for tree trimming and pole line inspection programs, are reasonable, prudent and necessary for Gulf to provide adequate and reliable electric service to its customers. [Moore, Tr. 562]

<u>ISSUE 87</u>: **Dropped**

<u>ISSUE 88</u>: What is the appropriate amount of Rate Case Expense for the 2012 projected test year?

Gulf's requested amount of rate case expense of $2,800,000 ($2,800,000 system) is reasonable and appropriate. The appropriate amortization period for rate case expense is four years, which is consistent with the amortization period approved by the Commission in Gulf's last rate case.

Gulf projected that the total rate case expense would be $2,800,000. [Erickson, Tr. 958] Gulf proposes to amortize those rate case expenses over four years beginning in 2012. [*Id.*] This increases A&G expenses by $700,000 in the 2012 test year. [*Id.*] The $700,000 level of rate case expense was $249,000 above the level of rate expenses escalated from Gulf's last rate case by the O&M benchmark. [Erickson, Tr. 958-59] Ms. Erickson justified that O&M benchmark variance as follows:

> In the decade since Gulf's last rate case, the cost of rate cases has increased markedly. A review of recent rate case experience of other Florida investor owned electric utilities indicates more intervenors, more discovery, more contested issues and more witnesses than Gulf experienced in its last rate case. When putting together its anticipated rate case budget, Gulf assumed it would have a similar experience. To address these anticipated demands, Gulf will have to spend more on incremental internal resources as well as additional outside consulting and legal fees than it did in its last rate case as escalated by CPI and customer growth. The $2,800,000 level of expenses budgeted and amortized over four years at $700,000 per year is both reasonable and prudent, even though it exceeds the A&G O&M benchmark calculation by $249,000 annually.

[*Id.*]

Ms. Erickson's testimony proved prescient. Gulf did experience more intervenor witnesses, more discovery and more contested issues than in its last rate case. By the time of the hearing, well before the filing of the brief and the finalization of the case, Gulf actually exceeded its $2.8 million rate case budget. [Erickson, Tr. 2317] Despite exceeding its rate case budget with legitimately incurred costs, Gulf is not asking for an increase in 2012 test year rate case expense. [*Id.*]

One might think that in light of the known and uncontested fact that Gulf has exceeded its projected level of rate case expense before the end of the rate case that this issue would have been dropped or stipulated. However, that is not the case.

Ms. Ramas testified that Gulf's original estimate of rate case expense (which has been exceeded) was overstated, and she recommended a reduction of $482,273 to Gulf's estimate, leaving a total of $2,317,727, with the annual amortization in 2012 being reduced by $120,568, from $700,000 to $579, 432. [Ramas, Tr. 1483-89; Ex 35, Sch. C-6] She proposed three specific adjustments to rate case expense: (1) she argued for disallowance of $102,273 for what she felt was "an unreasonable number of people attending the hearing" as well as an incorrect assumption regarding the number of hearing days; (2) she removed the entire $321,000 direct charge to Gulf from SCS for the rate case because the costs did not appear to be incremental to costs already charged by SCS to Gulf; and (3) she removed $59,000 of overtime labor costs because Gulf's labor costs for 2012 were supposedly already in Gulf's budget. [*Id.*]

In her prefiled rebuttal, Ms. Erickson began by testifying that Gulf would exceed its $2.8 million rate case estimate. [Erickson, Tr. 2295] When she actually took the stand for rebuttal, she confirmed the accuracy of that projection. [Erickson, Tr. 2317] She also testified that some subcategories of expenses may be under the original estimate and other subcategories would be over the original estimate. [Erickson, Tr. 2295] Ms. Erickson went on to rebut each of Ms. Ramas' specific disallowances as well. She testified that Gulf would bring only the witnesses, technical support, legal, regulatory, administrative and logistical personnel necessary to support the hearing, however long it lasted. [Erickson, Tr. 2297-8] She testified that the proposed disallowance of SCS expenses would be "unreasonable and would disallow legitimately incurred expenses." [Erickson, Tr. 2296] She explained that SCS support of the rate case was all incremental and not duplicative of other SCS costs in the 2012 test year. [Erickson, Tr. 2296-7] She also explained why Gulf relied on SCS for rate case support of cost of service, human resources, accounting, financial planning and information technology. [*Id.*] The rate case costs are directly charged to Gulf; they are segregated and charged to a separate work order. [*Id.*] These costs are reasonable business expenses and are appropriately recovered through customer rates. [*Id.*] Similarly, rate case related overtime labor for non-exempt Gulf employees is also segregated and charged to a separate account. [*Id.*]

Rate case expenses are a necessary cost of doing business and providing service. They have historically been recognized as legitimate operating expenses recoverable in rate cases. In this case, Gulf has requested rate case expenses based on an estimate that is lower than the amount Gulf had to spend. The proposed partial disallowance of rate case expenses that in total have exceeded the original estimate lacks merit and has been completely rebutted. Gulf's 2012 A&G expenses should reflect a $700,000 amortization of rate case expenses.

ISSUE 89: What is the appropriate amount of uncollectible expense for the 2012 projected test year?

The amount of uncollectible expense of $4,143,000 ($4,143,000 system) included in the 2012 projected test year is appropriate for purposes of determining base rate revenue requirements.

Gulf projects a 2012 test year uncollectible expense of $4,143,000, assuming the entire base rate request is granted. [Erickson, Tr. 970] Ms. Erickson testified that this level of uncollectible expense is reasonable and prudent. [*Id.*] It is representative of a going forward level of uncollectible expense. [*Id.*; Ex. 19, Sch. 4] The projected uncollectible expense is based upon a forecasted write off percentage of 0.32 percent, which is slightly lower than Gulf's 2009 write off percentage of 0.33 percent. [Erickson, Tr. 971] It is reflective of a weak economy that has increased Gulf's actual write-offs for 2008, 2009 and 2010, but it also reflects Gulf's adjustments to revenues based upon Gulf's plan for increased collection efforts. [*Id.*]

Ms. Ramas was the only intervenor witness who took issue with Gulf's projection of uncollectible expense. [Ramas, Tr. 1462-64] She calculated her uncollectible expense value by computing a four year historical average of the bad debt factor of 0.3056% and applying it to total revenues to calculate net write-offs of $3,997,000, which she then adjusted by the same revenue adjustment made by Gulf for increased collection efforts. [*Id.*] Ms. Ramas' average does include at least one data point that is pre-recession, when Gulf and its customers were experiencing a stronger economy.

Gulf's approach is more reasonable than Ms. Ramas'. Gulf's proposed amount of uncollectible expense is more representative of future periods.

ISSUE 90: 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. The appropriate amount of O&M expense for the 2012 test year is $282,320,000 ($288,062,000 system). This amount includes adjustments to Gulf's original request to reflect the approved stipulations on Issues 53, 58 and 68.

This is a fallout issue. The appropriate starting point is Gulf's requested level of jurisdictional O&M expense of $282,731,000 as shown on MFR C-1. This should be reduced by $411,000 ($413,000 system) to reflect the approved stipulations on Issues 53, 58 and 68.

ISSUE 91: What is the appropriate amount of depreciation and fossil dismantlement expense for the 2012 projected test year?

The appropriate depreciation and amortization of property, including fossil dismantlement expense, for the 2012 test year is $96,432,000 ($98,469,000 system). This amount includes adjustments to Gulf's original request to reflect the non-AMI meter adjustments addressed in the stipulation on Issue 20, the ECCR adjustments addressed in the stipulation on Issue 44, and the Crist turbine upgrades discussed in Issues 8 and 9.

This appears to be essentially a fallout issue. The determination of the appropriate amount of depreciation and amortization of property, including fossil dismantlement expense, for the test year should begin with Gulf's jurisdictional adjusted amount for the test year of $95,180,000 as shown on MFR C-1. This amount should be reduced by $886,000 to reflect the stipulation on Issue 20 regarding a capital recovery schedule for the non-AMI meters. It should also be reduced by $23,000 to reflect the ECCR adjustments covered by the stipulation on Issue 44. Finally, it should be increased by $2,161,000 to reflect the annualized depreciation on the Crist 6 and 7 turbine upgrades. Based on Gulf's positions that there should be no adjustment to capitalized incentive compensation or transmission plant (see Issues 12 and 14) no additional adjustments are appropriate.

ISSUE 92: 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. The number cited in this issue is the depreciation and fossil dismantlement amount for 2011, and does not include amortization of investment tax credits. The appropriate Depreciation and Amortization expense for the 2012 test year is $95,478,000 ($97,495,000 system). This amount includes both the adjusted depreciation and fossil dismantlement amount from Issue 93 and the amortization of investment tax credits.

The $87,804,000 figure cited in the issue is the depreciation and amortization expense for 2011, not 2012, and does not include amortization of investment tax credits. [MFR C-1 at 2] The appropriate test year amount begins by netting the jurisdictional adjusted amounts on MFR C-1 for depreciation and fossil dismantlement expense of $95,180,000 and amortization of investment tax credits (ITCs) of ($954,000). The depreciation component is then adjusted upward to $96,432,000 as discussed in Issue 91. No adjustment is necessary to the ITC amortization. This produces a net amount of $95,478,000 for total depreciation and amortization expense.

<u>ISSUE 93</u>: What is the appropriate amount of Taxes Other Than Income Taxes for the 2012 projected test year?

The appropriate amount of Taxes Other Than Income Taxes for the 2012 test year is $28,753,000 ($29,455,000 system). This amount includes an adjustment to Gulf's original request to reflect the ECCR adjustment addressed in the stipulation on Issue 44.

The appropriate starting point is Gulf's requested level of Taxes Other Than Income Taxes of $28,763,000 ($29,465,000 system). [Ex. 21, Sch. 4 at 1; MFR C-4 at 6] That amount needs to be reduced by $10,000 to reflect the ECCR adjustment approved in the stipulation of Issue 44.

The only adjustment proposed to Gulf's projected 2012 test period value of Taxes Other Than Income Taxes is a $786,000 adjustment proposed by Ms. Ramas for payroll taxes associated with her proposed disallowance of Gulf's at-risk compensation. [Ramas, Tr. 1481] As is extensively discussed in Issue 71, Ms. Ramas' at-risk compensation adjustment is seriously flawed and should be rejected for the reasons advanced by witnesses Deason, Kilcoyne and Wathen. Therefore, this associated adjustment to payroll taxes should be rejected.

<u>ISSUE 94</u>: Is it appropriate to make a parent debt adjustment per Rule 25-14.004, Florida Administrative Code?

No. Gulf has rebutted the presumption that parent company debt has been invested in Gulf by demonstrating that the equity contributions from Southern Company since the date of the last rate case, in which no parent debt adjustment was made, have been supported by dividends paid to Southern by Gulf.

A parent debt adjustment is a ratemaking adjustment in which an amount of debt issued by a utility's parent company is imputed into the capital structure of the utility for purposes of calculating the amount of income tax expense to be included in rates. [Deason, Tr. 2135-36] Rule 25-14.004 creates a presumption that a parent's investment in the equity of a utility is supported by debt based on the ratio of debt in the parent's capital structure. However, the rule expressly states that the presumption is a rebuttable one. Once the presumption is rebutted, no parent debt adjustment is required. In this case, the evidence is more than sufficient to rebut the presumption.[12]

The Commission made no parent debt adjustment in Gulf's last rate case. [Teel, Tr. 210] Even if Southern subsequently issued additional debt, that is not a basis to make a parent debt adjustment in this case. Since the last case, Gulf has received $459 million in equity investment from Southern and Gulf has paid $655.8 million in dividends to Southern. Since that time, Gulf has received $459 million in equity investment from Southern and has paid $655.8 million in dividends to Southern. [Teel, Tr. 205-06; Ex. 10, Sch. 11] Gulf's dividend payments to Southern have thus been sufficient to support 100% of Southern's equity investments and still result in a

[12]In the event the Commission nevertheless decides to make a parent debt adjustment, the correct jurisdictional adjustment would $1,063,663 as described in Mr. McMillan's rebuttal testimony, not the $1,766,000 proposed by Ms. Ramas. [McMillan, Tr. 2360-61]

net payment of $196.8 million from Gulf to Southern. [*Id.*] By being a net returner of capital to Southern, Gulf has effectively provided the funding for Southern's equity investment in Gulf with its own internally generated funds. [Teel, Tr. 205-07] Thus, Southern's debt is not the source for its equity investment in Gulf. [*Id.*]

Dr. Woolridge contends that Gulf has not rebutted the presumption based in part on his conclusion that "in the absence of an all equity capital structure at the parent level, a PDA is appropriate for Gulf Power." [Woolridge, Tr. 1731] His view that only an all equity capital structure precludes a parent debt adjustment rule means he believes that the presumption can never be rebutted. This is inconsistent with the plain language of the rule. [Deason, Tr. 2142]

Dr. Woolridge also contends that Gulf has failed to rebut the presumption because of the impossibility of tracing dollars. Yet the rule itself presumes to trace debt dollars from the parent to the utility. [Deason, Tr. 2142] The only way to rebut that presumption – and thereby give meaning to all of the language in the rule – is to allow a utility to demonstrate that the most likely source of the parent's equity investment is something other than parent debt, as Mr. Teel has done in this case. [*Id.*; Teel, Tr. 208, 277]

In considering prior cases in which a utility has attempted to rebut the presumption, the Commission has appropriately taken into consideration the reasonableness of the utility's capital structure. Where the utility's equity ratio appears to be unusually high, as was the case in the Indiantown decision cited by Dr. Woolridge [Order No. PSC-00-2054-PAA-WS], the Commission has held that the utility failed to rebut the presumption that its high level of equity (80.17%) was supported by debt at the parent level. [Deason, Tr. 2143] Where the utility's capital structure is found to be reasonable, as was the case in a decision involving St. James

Island Utility [Order No. PSC-04-0755-PAA-WS], the Commission has declined to make a parent debt adjustment, stating:

> In this case, we do not approve a parent debt adjustment. The parent company, St. Joe, is capitalized with an equity ratio of 60%, whereas St. James's proposed capital structure consists of 40% equity and 60% debt. We find the utility's proposed capital structure to be reasonable and note that the parent company has significantly more equity.

[Deason, Tr. 2144] The facts of this case are like the situation in St. James, not the situation in Indiantown. Gulf's capital structure is reasonable and contains significantly less equity than Southern Company's unconsolidated capital structure. [Deason, Tr. 2143-44] As the technical staff indicated in its 1988 recommendation to repeal the parent-debt rule as inappropriate and unnecessary "the key is the reasonableness of the utility's capital structure," not the capital structure of the parent. [Deason, Tr. 2140]

Finally, the Commission should consider the financial implications to Gulf of making a parent debt adjustment. [Teel, 209-10] First, imputing to Gulf the tax benefits of parent company debt would effectively assume that the Company has more debt in its own capital structure than actually exists. [Teel, Tr. 209] Gulf's capital structure already has a relatively low equity ratio and includes as much debt as is practical to maintain its financial strength. [*Id.*] The parent debt adjustment would assume there are tax benefits of parent company debt accruing to Gulf without recognizing the associated financial risk in Gulf's capital structure. [*Id.*] Second, by artificially reducing the federal income tax expense used to establish Gulf's required rate relief, the adjustment would decrease the effective return on equity below the level the Commission otherwise determines to be required. [Teel, Tr. 210; Deason, Tr. 2145] Neither of these is an appropriate result.

In making its determination as to whether Gulf has sufficiently rebutted the presumption in the parent debt rule, the Commission should consider the evidence presented to rebut the presumption, the reasonableness of Gulf's capital structure, and the impact of making the adjustment on Gulf's opportunity to actually achieve the return on equity that the Commission ultimately determines to be reasonable. When all of these factors are weighed, the Commission should find that no parent debt adjustment is required in this case.

ISSUE 95: What is the appropriate amount of Income Tax expense for the 2012 projected test year?

The appropriate amount of Income Tax expense for the 2012 test year is $15,249,000 ($18,323,000 system). This amount includes adjustments to Gulf's original request to reflect the income tax effect of depreciation on the Crist 6 and 7 turbine upgrade and the income tax effect of the stipulations on Issues 20, 44, 53, 58 and 68. It also includes the impact of interest synchronization resulting from the rate base changes associated with these items, the rate base stipulations on Issues 18, 20, 21 and 26, and the updated long-term and short-term debt rates from the stipulations on Issues 35 and 36.

This is a fallout issue. The appropriate starting point is jurisdictional income tax expense of $15,234,000 as shown on page 1 of MFR C-1 at lines 14 to 19. This amount needs to be increased by $514,000 for the income tax effect of the stipulations on Issues 20, 44, 53, 58 and 68 and by an additional $820,000 for the interest synchronization effects of these items, other rate base stipulations, and updated long-term and short-term debt rates. It then needs to be reduced by $833,000 for the income tax effect of the Crist 6 & 7 turbine upgrades and by an additional $486,000 for the interest synchronization effect of those upgrades.

ISSUE 96: 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. The appropriate amount of Total Operating Expenses for the 2012 test year is $421,800,000 ($433,335,000 system). This amount includes adjustments to

Gulf's original request to reflect the impact of the Crist 6 and 7 turbine upgrades, the effect of the approved stipulations, and the related income tax and interest synchronization impacts as quantified in Issue 95.*

This is a fallout issue. The appropriate starting point is jurisdictional adjusted total operating expenses of $420,954,000. [MFR C-1 at 1] This amount is increased by $846,000, which is the net impact of all stipulations that affect operating expenses, of depreciation on the Crist 6 & 7 turbine upgrades, and of the tax impact and interest synchronization associated with all these adjustments. Each of these components has been quantified in the discussion of prior issues.

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. The appropriate amount of Net Operating income for the 2012 test year is $60,109,000 ($65,976,000 system). This amount includes adjustments to Gulf's original request to reflect the impact of the Crist 6 and 7 turbine upgrades, the effect of the approved stipulations, and the related income tax and interest synchronization impacts.

This is a fallout issue. The appropriate starting point is jurisdictional adjusted net operating income of $60,955,000. [MFR C-1 at 1] There are no adjustments to the operating revenues that affect the calculation of net operating income. [Issue 42] However, the requested NOI should be reduced by $846,000, which is the net impact of all stipulations that affect operating expenses, of depreciation on the Crist 6 & 7 turbine upgrades, and of the tax impact and interest synchronization associated with all these adjustments as discussed in Issue 96.

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 revenue expansion factor is 61.1768 and the appropriate net operating income multiplier is 1.634607 as identified on MFR C-44.

Mr. McMillan calculated both the revenue expansion factor and the net operating income multiplier on Exhibit 21, Schedule 15. The appropriate revenue expansion factor is 61.1768. [Ex. 21, Sch.15] The appropriate net operating income multiplier is 1.634607. [*Id.*]

Ms. Ramas recalculated the net operating income multiplier using her recommended bad debt factor rather than the factor used by Gulf. As Gulf previously stated in Issue 93, Gulf's bad debt factor and uncollectible expense should not be adjusted. Therefore, no change to the revenue expansion factor or the net operating income multiplier is warranted.

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

> *No. The revised requested annual operating revenue increase for the 2012 test year and for future years is $98,351,000, before a one-time reduction for 2012 of $3,485,000 in the form of an ECRC credit. This amount includes reductions to Gulf's original request totaling $3,194,000 to reflect the impact of the approved stipulations. It also includes an increase of $8,041,000 associated with moving the Crist 6 and 7 Turbine Upgrades from ECRC into base rates on an annualized basis. To prevent over-recovery in 2012, Gulf proposes a one-time ECRC credit of $3,485,000 ($4,303,000 annualized) so that the total recovered from customers in 2012 will reflect the 13-month average balance of plant in service.*

This is a fallout issue. The appropriate starting amount is the jurisdictional revenue deficiency of $93,504,000 shown on MFR A-1. This amount is then reduced by $3,194,000 to $90,310,000 in order to reflect the impact of all approved stipulations, including changes in rate base, net operating income and the cost rates for long term debt, short term debt, and preference stock. It is then increased by $8,041,000 to $98,351,000 in order to reflect the impact of moving the annualized cost of the Crist 6 and 7 turbine upgrades from the ECRC into base rates.

Because the Crist 6 and 7 turbine upgrades have been or will be placed in service at different dates, the annualization of these costs over-states the 13-month average revenue requirement for 2012 by $4,303,000. To ensure that customers pay the correct amount during

2012, Gulf proposes a one-time ECRC credit of $3,485,000 – representing the portion of the additional annual revenues of $4,303,000 that Gulf will collect through base rates in 2012 – to be effective at the same time the new base rates go into effect.

Thus the effective increase is $94,866,000 for 2012 and $98,351,000 for 2013 and future years.

ISSUE 100: **Stipulated**

ISSUE 101: **Stipulated**

ISSUE 102: **Stipulated**

ISSUE 103: **Stipulated**

ISSUE 104: **Stipulated**

ISSUE 105: **Stipulated**

ISSUE 106: ***The deadline for briefing this issue was extended until January 11, 2012 in order to allow the Commission an opportunity to consider a Motion for Approval of Partial Settlement Agreements.***

ISSUE 107: ***The deadline for briefing this issue was extended until January 11, 2012 in order to allow the Commission an opportunity to consider a Motion for Approval of Partial Settlement Agreements.***

ISSUE 108: ***The deadline for briefing this issue was extended until January 11, 2012 in order to allow the Commission an opportunity to consider a Motion for Approval of Partial Settlement Agreements.***

ISSUE 109: What are the appropriate customer charges and should Gulf's proposal to rename the customer charge "Base Charge" be approved?

The appropriate customer charges based on Gulf's original filing are shown in the table included as part of the discussion below. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues. The customer charge should be renamed "Base Charge." This change in terminology better reflects the purpose of this monthly, fixed charge.

Rate Schedule	Monthly Customer Charge (Base Charge)
RS, RSVP	$15.00
GS	$18.00
GSD, GSDT, GSTOU	$45.00
LP, LPT	$225.00
PX, PXT	$683.68

Customer (Base) Charges are rate components which recover those costs that are not related to the amount of electricity consumed. [Thompson, Tr. 1251] In developing this rate component Gulf considered the costs associated with providing service for the rate classes, fairness, equity, rate stability, customer acceptance, effects on conservation and objectivity in administration of rates. [Thompson, Tr. 1248] There are important reasons for ensuring that, to the extent practical, the costs of providing service to customers that do not vary with the amount of consumption are recovered from fixed Base Charges rather than from energy or demand charges. [Thompson, Tr. 1250] If these costs are included in the unit prices of energy consumed, then otherwise successful conservation efforts could result in revenue decreases for Gulf which exceed the associated savings. [Thompson, Tr. 1251] This would, in turn, increase or accelerate Gulf's need for future base rate increases. [*Id.*] Also, each month Gulf has thousands of residential customer accounts whose monthly electric usage is zero. [*Id.*] Customer-related costs that are included in energy charges are not recovered at all from those customers. [*Id.*] Thus, intra-class equity, or fairness, is better served by having Base Charges that cover those costs which are unrelated to amounts consumed. [*Id.*] Gulf's proposed Base Charge levels are set forth in the table above.

Gulf has proposed increases to the Base Charge rate component for each of the rate classes identified in the table above. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues. The customer-related unit costs from Mr. O'Sheasy's cost of service study support the proposed Base Charge levels.

[Thompson, Tr. 1251, 1254, 1257] Proposed Base Charges are set at not more than a 50 percent increase above the current Customer Charges. [*Id.*] With the exception of Rate Schedules GSD, GSDT and GSTOU, the Base Charges proposed by Gulf would be the same using the MDS and non-MDS methodologies. [Ex. 91 at 000168] Use of the non-MDS methodology would result in the proposed Base Charge for Rate Schedules GSD, GSDT and GSTOU decreasing from $45 to $40. [*Id.*] The Base Charges proposed by Gulf are reasonable and appropriate with considerations for the cost to provide service and the impact to customer classes.

Gulf's proposal to change the name of the rate component that has been called the Customer Charge to Base Charge is also reasonable and appropriate. [Thompson, Tr. 1248] This change in terminology better reflects the purpose of this monthly, fixed charge. [*Id.*] This charge exists to reflect the fact that a certain base level of costs is incurred by Gulf to provide electricity independent of the amount of service consumed. [*Id.*]

ISSUE 110: What are the appropriate demand charges?

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

Demand charges reflect the Company's cost of supplying service at the highest level of consumption required by Gulf's medium and large business customers. [Thompson, Tr. 1246] In developing this rate component Gulf considered the costs associated with providing service for the rate classes, fairness, equity, rate stability, customer acceptance, effects on conservation and objectivity in administration of rates. [Thompson, Tr. 1248] The overall levels of demand charges set forth in the table below have been designed to achieve the total 2012 test year base rate revenue requirement allocated to these rate classes. [Thompson, Tr. 1254, 1255, 1257] For rates with distinct demand charges, the proposed rate design preserves the relationship between demand and energy charges of the present rates and includes demand charges that are reasonably based on demand-related costs. [Thompson, Tr. 1255, 1257]

Rate Schedule	Monthly Demand Charge
GSD	$ 6.17
LP	$10.60
PX	$ 9.90
GSDT	$ 3.29 (On-Peak) $ 2.92 (Maximum) $ 1.65 (Critical Peak Option On-Peak) $ 2.92 (Critical Peak Option Maximum) $ 4.94 (Critical Peak Option Critical Peak)
LPT	$ 8.53 (On-Peak) $ 2.12 (Maximum) $ 4.27 (Critical Peak Option On-Peak) $ 2.12 (Critical Peak Option Maximum) $12.80 (Critical Peak Option Critical Peak)
PXT	$ 9.19 (On-Peak) $ 0.82 (Maximum)

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

ISSUE 111: What are the appropriate energy charges?

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

Energy charges reflect costs associated with providing the amount of electricity consumed throughout the month. [Thompson, Tr. 1246] In developing this rate component Gulf considered the costs associated with providing service for the rate classes, fairness, equity, rate stability, customer acceptance, effects on conservation and objectivity in administration of rates.

[Thompson, Tr. 1248] The overall levels of energy charges set forth in the table below have been designed to achieve the total 2012 test year base rate revenue requirement allocated to these rate classes. [Thompson, Tr. 1250, 1254, 1257]

Rate Schedule	**Energy Charge**
RS	4.615 ¢/kWh
GS	5.121 ¢/kWh
GSD	1.579 ¢/kWh
LP	0.790 ¢/kWh
PX	0.366 ¢/kWh
RSVP	4.615 ¢/kWh – P_1
	4.615 ¢/kWh – P_2
	4.615 ¢/kWh – P_3
	4.615 ¢/kWh – P_4
GSTOU	16.571 ¢/kWh (Summer On-Peak)
	6.268 ¢/kWh (Summer Intermediate)
	2.684 ¢/kWh (Summer Off-Peak)
	3.704 ¢/kWh (Winter All-Hours)
GSDT	1.579 ¢/kWh
LPT	0.790 ¢/kWh
PXT	0.362 ¢/kWh

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

<u>ISSUE 112</u>: What are the appropriate charges for the outdoor service (OS) lighting rate schedules?

The appropriate charges for the outdoor service (OS) are those shown in the Rate Schedule OS found in Schedule 3 of Exhibit 25, attached to the testimony of Mr. Thompson.

Rate Schedule OS covers outdoor lighting, facilities associated with outdoor lighting, and other unmetered non-lighting outdoor services. [Thompson, Tr. 1259] Gulf has updated its OS rates to recover the portion of the total revenue requirement allocated to the OS class. The appropriate charges for the OS lighting rate schedules are those shown in Rate Schedule OS found on pages 12 through 20 of Schedule 3 of Exhibit 25 to the testimony of Mr. Thompson. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.

<u>ISSUE 113</u>: Should Gulf's proposal to adjust annually existing lighting fixtures prices be approved?

> *Yes. Lighting technology changes, vendor changes, and material costs frequently render prices of existing fixtures stale. The ability to re-price existing fixtures, up or down, as costs change would benefit lighting customers. This proposal would allow Gulf Power to adjust the prices of fixtures as emerging technologies or other forces drive costs down in the market, thus benefitting Gulf's lighting customers. Similarly, if costs increase, the associated price increases are implemented gradually on an annual basis.*

Gulf Power is proposing modifications to its approved lighting template ("Form 4"). [Neyman, Tr. 652] In conjunction with Gulf's last rate case, the Commission approved the current version of Form 4 which allows Gulf to offer and price new lighting options to customers without filing amendments to its Retail Tariff. [Neyman, Tr. 651] This methodology allows Gulf to respond quickly to customer needs and offer new and innovative lighting products and services. [*Id.*] A good example of the value of the flexibility provided by Form 4 is LED lighting, the newest and most energy efficient lighting technology advancement. [*Id.*] As a result of having Form 4, Gulf presently offers several LED lighting fixtures which are more efficient than standard High Pressure Sodium or Metal Halide fixtures. [*Id.*]

Currently, Form 4 is only used for pricing new fixtures. [Neyman, Tr. 652] In this proceeding, Gulf is seeking approval to use Form 4 to also re-price <u>existing</u> fixtures or associated facilities. [*Id.*] There can be substantial changes from year-to-year in the Company's acquisition costs for existing lighting fixtures. [Thompson, Tr. 1277] While costs associated with the materials and overall provision of outdoor lighting do change, currently Gulf's prices do not. [Neyman, Tr. 653] Approval of Gulf's requested change will enable Gulf to maintain fixture prices that are consistent with the associated costs (both increases and decreases) in response to market conditions. [*Id.*]

Under Gulf's proposal, the Company will review the cost of each existing fixture annually. [Ex. 87 at 000101] If the annual review reveals a price variance of 10 percent or greater, the price would be adjusted up or down. [*Id.*] The driver of price adjustments will be changes in the Company's acquisition costs for the fixtures and associated facilities. [*Id.*] Changes in labor rates, man-hours or other costs would not be updated and would not drive price adjustments. [*Id.*] This proposal would allow Gulf to adjust the prices of fixtures as emerging technologies or other forces drive costs down in the market, thus benefitting Gulf's lighting customers. [*Id.*] Similarly, if costs increase, the associated price increases are implemented gradually on an annual basis. [*Id.*] This is also beneficial to Gulf's customers. [*Id.*] It is not uncommon for new types of fixtures or fixture technologies to enter the market at higher costs (and therefore prices) than the costs at which they settle when they reach product maturity. [*Id.*] As an illustrative example, a fixture that costs $650 (Gulf Power's acquisition cost) is priced using Form 4. [*Id.*] The resulting monthly price for this fixture is $12.92. [*Id.*] In a subsequent annual review the fixture cost is $450. [*Id.*] The use of Gulf's proposed Form 4 would then result in the monthly price being $9.62 or a 25.5% reduction. [*Id.*] The price of these fixtures, including those already in service, would then be changed and the customer would be charged $9.62 per unit each month. [*Id.*]

Finally, in addition to ensuring that Gulf's lighting products are priced at market, Gulf's proposal would result in greater administrative efficiency. If Gulf's proposal is not adopted, Gulf would be required to either hold its fixture prices constant until it next rate case, or petition the Commission to amend its Retail Tariff. Gulf views its proposal as one way to reduce regulatory lag and ensure that its customers avoid the transaction costs associated with requesting Tariff amendments each time a price adjustment is warranted. [Thompson, Tr. 1279]

During cross-examination, Commission Staff inquired as to whether Gulf's lighting customers would be able to "opt out" of their existing lighting contracts following a price adjustment using Gulf's proposed methodology. [Thompson, Tr. 1281] Gulf's proposal does not contemplate an opt out provision. [Thompson, Tr. 1281] This, however, is not a reason to reject the proposed methodology. The purpose of the change in methodology is to ensure that the Company's pricing for lighting products more closely aligns with the Company's ongoing costs of providing those products. Gulf's lighting customers have not traditionally been able to opt out of existing lighting contracts in response to changes in Gulf's fuel, purchased power, environmental and/or or conservation costs. Nor have these customers been permitted to opt out of existing contracts in response to pricing changes resulting from base rate increases. Gulf respectfully submits that there is no reason to draw a distinction between changes in lighting product costs and changes in costs associated with the generation of the electricity which powers those same lighting products.

ISSUE 114: What are the appropriate charges under the Standby and Supplementary Service (SBS) rate schedule?

The appropriate charges under Rate Schedule SBS are listed below. These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.

Contract Demand	100 to 499 kw	500 to 7,499 kw	7,500 kw & above
Demand Charge			
Local Facilities Charge	$2.73	$2.51	$0.95
On-Peak	$3.29	$8.53	$9.19
Reservation Charge	$1.00	$1.00	$1.00
Daily Demand Charge	$0.47	$0.47	$0.47
Energy Charge (per kWh)	2.249¢	1.370¢	1.359¢

These charges are subject to revision to reflect the impact, if any, of additional adjustments identified by Gulf in other issues.

ISSUE 115: What are the appropriate transformer ownership discounts?

> *The appropriate discounts are shown in the table included as part of the discussion below. When new rates become effective in this case, it will have been approximately 10 years since the voltage discounts were adjusted in Gulf's last rate case. Customers who own, operate, and maintain voltage transformation facilities need to be able to rely on consistency in the relationship between the charges in the rate(s) and the discounts available as they make decisions as to whether or not to provide their own voltage transformation.*

Gulf Power offers "voltage discounts" to certain commercial and industrial customers who choose to purchase their own voltage transformation facilities. Gulf Power has developed its proposed transformer ownership discounts by increasing the discount for each applicable rate class by the percentage increase in the proposed demand charge for each of the affected rate classes. [Ex. 86 at 000091] The proposed discounts are identified in the table below.

Rate Schedule	Voltage Discount
GSD/GSDT	($ 0.49) Primary Voltage Level
LP/LPT	($ 0.64) Primary Voltage Level ($ 0.81) Transmission Voltage Level
PX/PXT	($ 0.22) Transmission Voltage Level
SBS Contract Level	
100 – 499 KW	($ 0.44) Primary Voltage Level
500 – 7,499 KW	($ 0.84) Primary Voltage Level ($ 0.98) Transmission Voltage Level
Above 7,499 KW	($ 0.13) Transmission Voltage Level

Gulf is proposing this approach in order to preserve the relationship between the magnitude of voltage discounts and the associated demand charges. [Ex. 99 at 000429] When new rates become effective in this case, it will have been approximately ten years since the voltage discounts were adjusted in Gulf's last rate case. [*Id.*] Customers who own, operate and maintain their own voltage transformation facilities need to be able to rely on consistency in the relationship between their rate(s) and the discounts available as they make decisions as to whether to provide their own voltage transformation. [*Id.*] Gulf's approach to calculating transformer ownership discounts in this case differs somewhat from the approach utilized in its last rate case. [Ex. 99 at 000430-440] However, for the GSD/GSDT and LP/LPT rate classes, the two approaches yield very similar results. [Ex. 99 at 000440; Thompson, Tr. 1275-76] For rate schedule SBS, Gulf's proposed approach yields a higher ownership discount than the approach used in Gulf's previous rate case. [Ex. 99 at 000440] Presently, three of Gulf's customers take service under Rate Schedule SBS (Standby and Supplementary Service). [Thompson, Tr. 1275] These customers are unique in that they do not purchase the full electric requirements from Gulf. [*Id.*] They are large customers who own their own generation, but who nevertheless need backup service from Gulf. [*Id.*] The continuity offered through Gulf's proposal provides a more reasonable price to these customers who have invested in voltage transformation facilities. [Ex. 99 at 000440] Gulf's motivation for structuring the voltage ownership discounts in the manner proposed is to ensure that customers who have invested in their own voltage transformation facilities in reliance on Gulf's existing ownership discounts do not see those expected savings eroded as a result of base rate increases. [Thompson, Tr. 1273] Similarly, customers who are considering investing in their own voltage transformation facilities may be discouraged from doing so if it appears that savings associated with then-existing ownership discounts will be eroded as a result of future base rate increases. Gulf believes this is a reasonable and equitable approach to establishing ownership discounts for purposes of this proceeding.

ISSUE 116: **Stipulated**

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?

No. None of the $38,549,000 interim rate increase granted by Order No. PSC-11-0382-PCO-EI should be refunded.

By Order No. PSC-11-0382-PCO-EI, issued September 12, 2011, the Commission authorized Gulf to collect interim rates, subject to refund, in the amount of $38,549,000 pursuant to Section 366.071. For purposes of its interim request, Gulf used an overall cost of capital of 6.45 percent based on a return on equity ("ROE") of 10.75 percent and the capital structure for the historical year ended March 31, 2011. [Order No. PSC-11-0382-PCO-EI at 2] The Office of Public Counsel and other intervenors in this case have taken the position that Gulf should be required to refund, with interest, the difference between the Commission approved $38.5 million interim increase and the $16.2 million OPC recommended final increase.

"The calculation of any refund should be determined by application of Section 366.071(4), Florida Statutes." *In re Petition for increase in rates by Progress Energy Florida, Inc.*, Order No. PSC-10-0131-FOF-EI at 143. The intervenors' position demonstrates a fundamental misunderstanding of the requirements of the statute governing interim relief. Section 366.071(4), provides as follows:

> Any refund ordered by the commission shall be calculated to <u>reduce the rate of return of the public utility during the pendency of the proceeding to the same level within the range of the newly authorized rate of return which is found fair and reasonable on a prospective basis</u>, but the refund shall not be in excess of the amount of the revenues collected subject to refund and in accordance with paragraph (2)(b). In addition, the commission may require interest on the refund at a rate established by the commission.

(emphasis supplied)

According to the statute, the focus must be on the rate of return actually earned by Gulf during the pendency of the proceeding. A refund is appropriate only if that rate of return is greater than the newly authorized return. Regardless of whether the Commission reviews Gulf's actual returns over the course of calendar year 2011 or the twelve months ending February 2012, it is highly likely that the Company's actual rate of return will fall below the newly authorized rate of return. This would be true even if the Commission adopted OPC's extreme recommendation of a 9.25 percent ROE and overall rate of return of 5.98 percent for Gulf. [Woolridge, Tr. 1650] Mr. Teel testified that, even with the grant of interim rate relief, Gulf had already fallen below 6 percent on its returns as of December 2011. [Teel, Tr. 227, 242]

While Gulf projects that its actual rate of return will be similarly depressed between now and the Commission's decision in this proceeding, it will ultimately be incumbent upon the Commission to quantify the Company's actual rate of return following the Commission's decision in this proceeding and compare the same to the newly authorized return. If the actual rate of return is equal to or below the newly authorized return, no refund is permitted or required by the statute. One thing is certain, however; the intervenors' position regarding the triggering event for a refund of interim relief finds no support in the governing statute.

ISSUE 118: **Stipulated**

ISSUE 119: Should this docket be closed?

Yes. The docket should be closed after the time for filing an appeal has run.

The docket should be closed 32 days after issuance of the order (including any order on reconsideration), to allow the time for filing an appeal to run.

CONCLUSION

It has been nearly 10 years since Gulf's base rates were last set by the Commission. In that time, the Company has worked diligently to achieve and maintain the confidence of its retail customers by providing reliable electric service at reasonable rates. The Company has responded to changing conditions by seeking out and implementing new operating efficiencies; developing plans and programs to meet the wants and needs of its customers; recruiting, training and retaining a dedicated and talented workforce that is focused on customer satisfaction; and efficiently managing its resources in order to maintain low rates and fulfill shareholder expectations. Customer expectations are higher now than ever before, and Gulf remains committed to fulfilling those expectations for the long-term.

Gulf does not relish the prospect of having to raise prices for electric service. However, the demands of Gulf's expanding customer base for more capacity and energy, along with the higher reliability expectations that are part and parcel of the electronic age in which we live, require a response from Gulf if the Company is to maintain the high degree of customer satisfaction that we have worked so hard to achieve. That response comes in the form of new or expanded programs to ensure that Gulf's efficient generation continues to be available to provide energy to meet the demands of Gulf's customers. The response also comes in the form of new or expanded programs to ensure that Gulf's electric transmission and distribution systems continue to operate with the reliability our customers expect. It comes in the form of new or expanded communication programs to ensure that customers receive information necessary for them to use energy efficiently. It comes in the form of diligent efforts to maintain the financial integrity of the Company in order to be able to fulfill customer and investor expectations in both the near-term and in the long run. These new or expanded programs require significant financial resources.

Gulf simply cannot continue to meet the expectations of our customers or investors based on rates established nearly 10 years ago. It costs more now –10 years later– to generate, transmit and distribute electricity than it did the last time Gulf's rates were set. The important activities that Gulf is required to undertake to be responsive to its customers must be supported by the rates and charges this Commission authorizes for Gulf Power. Gulf has demonstrated that its requested increase is reasonable and necessary for the Company to be able to maintain its financial integrity and provide the resources necessary to continue fulfilling customer expectations for reliable electric service at reasonable rates. The Company's rates should be set at a level that will allow Gulf to support the capital investment and operating and maintenance activities detailed in its testimony and exhibits and fulfill investor expectations. The Company's rates should be set to achieve an 11.7 percent return on common equity.

For the reasons expressed in the discussion of the individual issues set forth above, Gulf Power Company respectfully requests the Florida Public Service Commission find and determine that the Company's present rates are insufficient to yield a fair rate of return and that the continued compulsory application of the Company's present rates and charges will result in the unlawful taking of the Company's property without just compensation, resulting in confiscation of the Company's property in violation of the guarantees of the state and federal constitutions. The Company further requests that the Commission authorize the Company to revise and increase its retail base rates and charges to generate additional gross revenues of $98,351,000 on an annual basis. The new rates resulting from this case should allow Gulf an opportunity to earn a fair overall rate of return of 6.94 percent, which equals Gulf's total cost of capital, including an

11.7 percent rate of return on common equity. The requested new rates will allow Gulf an opportunity to maintain the Company's financial integrity and its ability to serve the public adequately and efficiently.

Dated this 9th day of January, 2012.

Respectfully submitted,

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BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

IN RE: Petition for Increase in Rates by Gulf Power Company	))))	Docket No. 110138-EI

CERTIFICATE OF SERVICE

I HEREBY CERTIFY that a true copy of the foregoing was furnished by overnight delivery the 9th day of January, 2012, on the following:

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