Gulf Power

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February 8, 2017

VIA ELECTRONIC FILING

Ms. Carlotta Stauffer
Commission Clerk
Florida Public Service Commission
2540 Shumard Oak Boulevard
Tallahassee, Florida 32399-0850

Re: Petition for rate increase by Gulf Power Company, Docket No. 160186-EI

Dear Ms. Stauffer:

Attached is the Rebuttal Testimony and Exhibit of Gulf Power Company Witness Xia Liu.

(Document 8 of 16)

Sincerely,

Robert L. McGee, Jr.

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Regulatory & Pricing Manager

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 160186-EI

Gulf Power

REBUTTAL TESTIMONY AND EXHIBIT

OF

XIA LIU

GULF POWER COMPANY

Before the Florida Public Service Commission
Rebuttal Testimony of
Xia Liu
Docket No. 160186-EI
In Support of Rate Relief
Date of Filing: February 8, 2017

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

A. My name is Xia Liu. My business address is One Energy Place, Pensacola, FL 32520, and I am the Vice President and Chief Financial Officer (CFO) of Gulf Power Company (Gulf or the Company).

Q. Have you previously filed testimony in this proceeding?

A. Yes.

Q. What is the purpose of your rebuttal testimony?

A. The purpose of my testimony is to discuss the effect on Gulf and its customers of the proposed adjustments to Gulf's revenue requirements set forth in the testimony submitted by the intervenors -- Office of Public Counsel (OPC), Federal Executive Agencies (FEA), and Sierra Club -- and the devastating impact on Gulf's financial integrity if their recommendations were adopted. In particular, I respond to portions of the testimony provided by Witnesses Woolridge (OPC), Dauphinais (OPC), Ramas (OPC), Gorman (FEA), and Mosenthal (Sierra Club).

Q. Are you sponsoring any rebuttal exhibits?

A. Yes. Exhibit XL-2 was prepared under my direction and control. The information contained in that exhibit is true and correct to the best of my knowledge and belief.

I. IMPACT OF INTERVENORS' RECOMMENDATIONS

Q. What is the magnitude of the intervenors' proposed adjustments to Gulf's revenue requirement in the test year?

A. If accepted by the Commission, the aggregate effect of the intervenors' recommendations would be to reduce Gulf's rate request by well over $100 million, resulting in a rate decrease of almost $3 million. My rebuttal testimony will focus on the three categories of intervenor recommendations that have significant negative impact on Gulf's ability to continue to provide high quality service to our customers: the proposed exclusion of costs related to Scherer 3; the intervenors' return on equity (ROE) and capital structure proposals; and some of Ms. Ramas's major rate base and O&M expense adjustments.

Q. What is the impact of the intervenors' recommendations?

A. As shown on Exhibit XL-2, without any rate increase, Gulf's projected retail ROE falls well below the bottom of our current authorized range in 2017. With a rate reduction as proposed by the intervenors, Gulf's ROE will continue to fall further beyond the test year. The aggregate recommendation of a rate decrease would have a devastating impact on Gulf's financial integrity and significantly impair Gulf's ability to continue to consistently provide quality service to our customers. The Commission should consider the detrimental effect on Gulf and our customers and reject these proposals.

II. TREATMENT OF SCHERER 3

Q. In your direct testimony, you asked the Commission to recognize that 76 percent of Gulf's ownership of Scherer 3 is now serving retail customers and to allow the corresponding portion of Scherer 3 non-clause costs to be recovered in the base rates. How did the intervenors address these issues?

A. OPC Witness Dauphinais and Sierra Club Witness Mosenthal propose to disallow recovery of Scherer 3 costs from the retail jurisdiction. If adopted, their recommendations would also disallow the recovery through the Environmental Cost Recovery Clause (ECRC) of the related environmental costs. Gulf Witnesses Burleson and Deason respond to a number of assertions made by the intervenors in support of their recommendations. I will focus on the financial aspects of their positions.

Q. Please respond to Witness Dauphinais's assertion that over the years Gulf has retained all of its profits from its wholesale unit power sales from Scherer Unit 3.

A. Witness Dauphinais's assertion ignores several key facts. First, over the past 30 years, Gulf's wholesale customers have been supporting Scherer 3, thereby relieving Gulf's retail customers from the obligation to pay the unit's revenue requirement, even though the investment was prudently made in order to ultimately serve them.

Second, with the contribution of revenues from the wholesale contracts, Gulf's total corporate return has been in line with the authorized range applicable to Gulf's retail return over the past fifteen years, and has been generally acceptable to its investors. This allowed Gulf to withstand achieved retail returns lower than its authorized range for 45 months during this same period and helped Gulf to avoid filing a rate case between 2002 and 2011.

Third, Witness Dauphinais's assertion ignores the fact that there are periods during which portions of Scherer 3 have served Gulf's retail customers, even though they have not paid to support the investment. Between 1987 and 1994, amounts ranging from 11 MW to 63 MW were not committed to wholesale contracts and instead served retail customers. In addition, even though 110 MW of Scherer 3 has been serving Gulf's retail customers since January 1, 2016, and an additional 50 MW has been serving them since June 1, 2016, Gulf's customers have not paid anything related to the non-clause portion of the revenue requirement for these portions of the unit. Due to the settlement agreement in Gulf's last rate case, Gulf did not request recovery of the non-clause costs of these portions of the investment for the 18-month period from January 1, 2016 through June 30, 2017. If the Commission were to disallow retail recovery of the asset, then Gulf would not recover either the base rate or environmental costs on a going-forward basis, and it would also be required to true up the environmental portion of the revenue requirement that is currently being collected through the ECRC.

Q. What would be the impact if the intervenors' recommendations to disallow Scherer 3 in retail were adopted?

A. The disallowance would immediately reduce Gulf's allowed annual retail revenues by approximately $35 million on an annual going-forward basis. This amount represents 76 percent of the total base and environmental costs associated with Gulf's ownership in the unit, and its disallowance would be equivalent to a 220 basis point reduction to Gulf's retail return. Gulf would have no way to overcome an adverse impact of this magnitude. In addition, there would be a one-time negative true-up to the ECRC of over $11 million, representing an additional 70 basis point reduction. Our returns would remain well below what our investors require; the investment community's perception of a constructive regulatory environment in Florida would be damaged; our financial integrity would be impaired; our credit quality would worsen; our financing costs would likely increase; and it would be difficult for Gulf to continue to confidently make the long-term investment decisions necessary to serve our retail customers.

Furthermore, as Mr. Connally states, Gulf would be forced to diligently pursue an immediate disposition of its ownership interest in Scherer 3 in order to minimize the adverse impact on Gulf's financial integrity. As Mr. Deason addressed in his direct testimony, if a utility asset is sold for less than its net book value, the typical ratemaking treatment is to amortize the loss and reflect the amortization in rates. Under the regulatory compact, Gulf's retail customers would be responsible for any remaining investment not covered by any proceeds of a sale. In addition, they would no longer receive any of the benefits of the continued ownership and operation of Scherer 3 that Mr. Burleson describes in his testimony.

None of these results would be good for Gulf's customers.

III. COST OF CAPITAL

Q. Please describe the intervenors' proposed adjustments related to cost of capital.

A. FEA Witness Gorman proposes that a 9.2 percent ROE coupled with a 49.88 percent equity ratio will be sufficient to satisfy equity investors and will be supportive of credit quality. OPC Witness Woolridge suggests that an 8.875 percent ROE and an equity ratio of 50 percent would be satisfactory.

Q. Are the intervenors' recommendations for ROE reasonable?

A. No. Neither OPC's ROE recommendation of 8.875 percent nor FEA's recommendation of 9.2 percent would be sufficient for investors. Gulf Witness Vander Weide recommends an ROE of 11.0 percent and addresses the intervenor recommendations in his rebuttal testimony.

Q. Do you agree with the analysis that Witness Gorman relies on to support the conclusion that his recommended ROE will support an investment grade bond rating for Gulf?

A. No. First, Gulf targets A category credit ratings, not just investment grade ratings. Gulf believes that A category credit ratings provide the best opportunity to access the capital markets on the most favorable terms for our customers. Second, Witness Gorman's analysis is based on a calculation of Gulf's financial ratios using his recommended capital structure and cost of capital. However, the cash flows he uses are based on Gulf's "cost of service for its retail jurisdictional operations." (Gorman, page 59) Witness Gorman's cash flows do not reflect the recommendations by other witnesses to disallow recovery of Scherer 3 and to make significant rate base and NOI adjustments. In other words, his financial integrity analysis assumes that but for his capital structure and ROE proposals, the Commission approves the balance of Gulf's rate request. Furthermore, if the Commission approves the balance of Gulf's request, the proposed ROE alone would send a very negative signal to the investment community and the rating agencies and could put Gulf's targeted credit ratings in jeopardy. It would not be beneficial to our customers.

Q. How do the intervenors' ROE recommendations compare with recent decisions by this Commission?

A. Their recommendations are substantially below the 10.25 percent established for Gulf in our last rate case, the 10.25 percent approved for Tampa Electric Company (TECO), the 10.5 percent reaffirmed for Duke

Energy Florida (Duke), and the 10.55 percent approved for Florida Power & Light Company (FPL) just a few months ago. Approval of their recommendations would cause Gulf's authorized return to be between 105 and 167.5 basis points lower than those currently authorized for TECO, Duke and FPL.

Such a result is unreasonable under the best of circumstances, and it would put significant stress on Gulf's financial integrity and our long-term ability to continue to provide quality service to our customers.

Q. What effect would an authorized ROE in the range of 8.875 percent to 9.2 percent have on Gulf?

A. An authorized return at those levels would have serious adverse impacts on the confidence of both equity and debt investors.

Q. Please explain the impact on equity investors.

A. With the lack of sales growth largely due to continued decline in use per customer, combined with continued infrastructure investment requirements to provide service to our customers, investors are faced with significant business risks. Investors are expecting an allowed ROE that will provide them an opportunity to earn a fair return on their investment. Establishing and setting rates based on an ROE at the levels recommended by the intervenors would significantly challenge the notion of providing a fair return for the investors. Consequently, it would put pressure on Gulf's ability to access the capital markets at the most favorable terms for our customers, as well as adversely impact Gulf's long-term ability to provide quality service to them.

Investors also consider the ratings of state regulatory environments published by Regulatory Research Associates (RRA). While the Florida regulatory environment is currently rated above average, during 2015 and 2016, the states that have awarded utilities ROEs at or below the levels recommended by Witnesses Gorman and Woolridge are all rated Average to Below Average by RRA.

Q. Please address the impact of unreasonably low ROEs on debt investors.

A. Debt investors will be looking to the credit rating agencies for reaction to the outcome of our case and its implications for Gulf's credit risk. Authorizing an ROE at the levels recommended by the intervenors would not be received well by the credit rating agencies. The utility regulatory environment in Florida has historically been viewed as credit supportive; however, accepting these recommendations would revive recent concerns about that environment in Florida – concerns that played a primary role in a rating downgrade of Gulf Power in 2010. In its credit opinion of Gulf Power (dated August 13, 2010), Moody's saw "the overall regulatory framework in Florida as substantially less supportive of credit quality" and cited this as a primary factor in downgrading Gulf's credit rating.

The rating agencies' opinions of Florida's regulatory environment have improved over the past several years. In its last credit opinion of Gulf dated August 15, 2016, Moody's cited a "credit supportive regulatory environment in Florida." As evidenced by the weights applied in their assessments and past rating agency actions, the perception of state regulatory environments is critical to the credit quality of utilities. Joining the ranks of the states authorizing unreasonably low ROEs would once again call into question the supportiveness of the Florida regulatory environment and could result in negative rating actions not just for Gulf, but for all electric utilities under the Commission's jurisdiction.

Q. Are the intervenors' recommendations for Gulf's equity ratio reasonable?

A. Absolutely not. As stated before, Witness Gorman proposes an equity ratio of 49.88 percent. Witness Woolridge recommends an equity ratio of 50 percent.

Q. What are your concerns with Witness Gorman's proposal?

A. First of all, Witness Gorman states that his proposed common equity ratio is based on Gulf's actual common equity ratio on September 30, 2016. He apparently overlooked the commitment in my direct testimony to issue additional common stock by January 2017 in order to raise our equity ratio. That commitment was fulfilled by Gulf's recent common stock issuance of $175 million in January, which brings our projected common equity ratio to approximately 53 percent for 2017.

Second, Witness Gorman's recommendation on Gulf's equity ratio is inconsistent with testimony he presented earlier this year in FPL's rate case. In this docket, he recommends a 49.88 percent equity ratio and 9.2 percent ROE for Gulf. In contrast, in FPL's recent rate case, Witness Gorman first stated that FPL's 60 percent equity ratio was "excessive." He then said, "I will consider FPL's excessive common equity weighted capital structure in recommending a fair risk-adjusted rate of return on equity for FPL in this proceeding." (Docket 160021-EI, Transcript p. 3840) Taking this "excessive" equity ratio into account, he nevertheless recommended an ROE of 9.25 percent for FPL. (Tr. 3872-3873) In other words, while Witness Gorman recommends a lower ROE for Gulf (9.20 percent) than for FPL (9.25 percent), he simultaneously recommends an equity ratio for Gulf that is more than 10 percentage points lower than the 60 percent equity ratio he accepted for FPL. This fundamental inconsistency calls his entire recommendation into question.

Q. Do you have other concerns about the equity ratio recommendations by Witnesses Gorman and Woolridge?

A. Yes. Both witnesses completely ignore the fact that these ratios clearly would put us at a disadvantage when compared to our peers in Florida.

As stated in my direct testimony, Gulf's last approved equity ratio is four to 13 percentage points lower than that of the other major Florida investor-owned utilities (IOUs). The average of the last approved equity ratios as a percentage of investor-supplied capital for Duke, FPL and TECO is 54.4

percent. As stated before, we have recently completed the process of increasing Gulf's equity by selling $175 million of common stock, resulting in a projected 2017 equity ratio of approximately 53 percent. This brings us more in line with our peers in the state, allowing us to compete for capital on a more comparable level.

In his testimony, OPC Witness Woolridge stated, ". . . as the amount of debt in the capital structure increases, its financial risk increases and the risk of the utility, as perceived by equity investors also increases." This means that everything else being equal, a utility with a lower allowed ROE implies that its financial risk is lower; therefore, it should have a higher equity ratio. However, although Witness Woolridge recommends an ROE for Gulf that is more than 130 basis points lower than the average of the major Florida IOUs, he also recommends an equity ratio (50 percent) which is more than 4 percentage points lower than the average of the other Florida IOUs.

IV. RATE BASE AND NOI ADJUSTMENTS

Q. OPC Witness Ramas proposes a number of rate base and NOI adjustments. Would you like to respond to any of those recommendations?

A. Yes. Other Gulf rebuttal witnesses address her NOI and rate base recommendations in detail. I would like to focus, as CFO, on a broader view of a few of her major proposed adjustments.

Q. Please address her recommendation regarding the treatment of vacant positions.

A. As Gulf Witness Ritenour discusses in more detail, Witness Ramas proposes to disallow compensation and benefit amounts associated with positions that were vacant in September 2016. This type of disallowance poses a challenge for Gulf. We must manage our business with the resources we are given. If the Commission does not provide revenues to fund needed positions, Gulf must either fill the positions at shareholder expense or continue to operate with a less than optimal complement of employees. In a very real sense the disallowance of positions is a self-fulfilling prophesy. If positions are vacant, dollars are disallowed, and funds are not available to fill the vacancies. The Commission should reject the temptation to focus on current vacancies. Instead, it should focus on the fact that Gulf has proposed the level of employees it believes are necessary to continue to operate the business in the way that best meets the needs of our customers.

Q. Do you have any other observations on her proposed labor adjustments?

A. Yes. In addition to her proposed vacancy adjustment, Witness Ramas recommends disallowing a large portion of Gulf's at-risk pay, an issue that is addressed in rebuttal by Gulf Witnesses Garvie and Deason. As CFO, I am deeply concerned that her adjustments to Gulf's compensation and benefits budget (excluding adjustments to affiliate labor costs assigned or allocated to Gulf) total approximately $20 million. This amount represents 17.2 percent of Gulf's overall O&M labor and benefits budget of $114.6 million.

Gulf would never expect to put its hard-working employees in a position to be compensated significantly below the market. Nor should the Commission expect Gulf's shareholders to bear $20 million of labor costs that are prudently incurred to serve our retail customers.

Q. Have you reviewed Witness Ramas's recommendation to disallow the year-end contribution that Gulf made to its pension plan?

A. Yes. She recommended total disallowance of the projected pension contribution included in Gulf's test year unless Gulf could demonstrate that the contribution had been made and benefitted Gulf's customers. As Mr. Garvie discusses in his rebuttal testimony, Gulf made a total pension contribution of $55.8 million in December 2016. The important thing I believe the Commission needs to know is that this funding decision was absolutely in the best interest of Gulf's customers. The contribution not only reduces Gulf's 2017 revenue requirement by $100,000, it also reduces Gulf's revenue requirement by almost $4 million on a net present value basis over the next 10 years compared to what it would have been if no contribution had been made.

Q. Witness Ramas also proposes some adjustments that involve the updating of selected test year information. Do you have any observation about these adjustments?

A. Yes. Witness Ramas recommends several adjustments based on updated information that was not available at the time the test year budget was prepared. For example, she suggests updates to the inflation rates used to project some O&M expenses and, as addressed by Gulf Witness Hodnett, proposes some updates to Southern Company Services (SCS) allocation factors. In addition, she states that “since the Company has not provided either its preliminary or its final 2017 Budget and Forecast, additional adjustments beyond those presented in this testimony may be appropriate.” (Ramas, p. 9) The specific adjustments she does propose all involve reductions in Gulf’s revenue requirement.

Q. Does Witness Ramas consider or acknowledge any updated information that would increase Gulf’s revenue requirement and offset any portion of her adjustments?

A. No. She chose not to address the fact that, as Gulf Witness Park discussed in his direct testimony, Gulf’s more recent sales forecast of 2017 base revenues showed a $5.7 million shortfall compared to the forecast on which the test year calculations were based. This shortfall has an impact of over 30 basis points on Gulf’s retail return on equity. More recent information shows that our use per customer continues to decline, and the revenue shortfall is currently projected to be greater than the $5.7 million identified at the time Gulf’s direct testimony was filed. If the Commission considers Witness Ramas’s recommended downward adjustments to revenue requirements based on more current data than what is contained in the MFRs, then fundamental fairness requires consideration of any offsetting updates – such as reduced sales revenues -- that would result in upward adjustments.

V. CONCLUSION

Q. What should the Commission do with regard to Witness Dauphinais's and Mosenthal's recommendations related to disallowance of Scherer 3?

A. It should reject them in their entirety. The portion of Scherer 3 for which Gulf is seeking recovery is currently providing service to the retail customers for whom it was originally planned, acquired and ultimately built. We ask the Commission to honor this regulatory compact and approve Gulf's request.

Q. Should the Commission accept the intervenors' recommendations related to ROE and capital structure, or OPC's overall recommendation to decrease Gulf's rates?

A. Absolutely not. The intervenors' objectives through both their proposals regarding ROE and their other adjustments seem to be simply to set rates as low as possible today, without concern for the impact on customers in the future. In their efforts to meet this objective, many of the proposed disallowances are evidence of a disregard for the expertise of Gulf's employees in determining what is required to provide safe and reliable service to our customers in both the near term and long term.

A Commission order establishing such low ROEs or decreasing rates would be detrimental and potentially devastating to Gulf's ability to access and raise capital on reasonable terms. Such a decision would damage Gulf's ability to provide quality service to its customers.

Gulf’s credit quality is under pressure. Moody’s, for example, states clearly that Gulf’s cash flow coverage metrics have been weak for its A2 rating. Strong scores on the qualitative factors, specifically Florida’s constructive regulatory environment, have been essential to maintaining that rating. Accepting the intervenors’ recommendations would not only further weaken Gulf’s financial ratios, but as importantly, cause alarm and reignite concerns about the regulatory environment in Florida. Those concerns would certainly affect Gulf and would likely also affect other utilities in Florida.

The intervenors’ recommended equity ratio is arbitrarily too low. Gulf’s current projected 2017 equity ratio helps improve its credit quality and moves Gulf closer to the average of its Florida peers. The Commission should recognize Gulf’s capital structure change and approve its requested equity ratio of 53.1 percent.

It is important to point out that even with 53.1 percent equity ratio and 11 percent ROE as proposed by Gulf Witness Vander Weide, Gulf’s customers will still enjoy a weighted average cost of capital that is among the lowest in Florida.

It is simply unreasonable for anyone to expect that a rate decrease or an unrealistically low ROE or equity ratio could be supportive of Gulf’s financial integrity or would be in the best interest of our customers.

Q. Does that conclude your rebuttal testimony?

A. Yes.

AFFIDAVIT

STATE OF FLORIDA)
)
COUNTY OF ESCAMBIA)

Docket No. 160186-EI

Before me the undersigned authority, personally appeared Xia Liu, who being first duly sworn, deposes, and says that she is the Vice President and Chief Financial Officer of Gulf Power Company, a Florida corporation, that the foregoing is true and correct to the best of her knowledge, information, and belief. She is personally known to me.

s/ Xia Liu
Xia Liu
Vice President and Chief Financial Officer

Sworn to and subscribed before me this 3rd day of February, 2017.

Gina S. Naar
Notary Public, State of Florida at Large

Commission No. FF 941451

My Commission Expires 04/07/2020

GINA S. NAAR
Commission # FF 941451
Expires April 7, 2020
Bonded Thru Troy Fain Insurance 800-385-7019

Exhibit

Florida Public Service Commission
Docket No. 160186-EI
GULF POWER COMPANY
Witness: Xia Liu
Exhibit No.______ (XL-2)
Schedule 1
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