State of Florida

Public Service Commission

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-M-E-M-O-R-A-N-D-U-M-

DATE: September 23, 2004

TO: Director, Division of the Commission Clerk & Administrative Services (Bayó)

FROM: Division of Economic Regulation (Baxter, Wheeler, Slemkewicz, Lester, McRoy)
Office of the General Counsel (Brown)

RE: Docket No. 040442-EI – Petition for authority to implement proposed FlatBill rate schedule by Gulf Power Company.

AGENDA: 10/05/04 – Regular Agenda – Tariff Filing – Interested Persons May Participate

CRITICAL DATES: 8-Month Effective Date: 01/12/05

SPECIAL INSTRUCTIONS: None

FILE NAME AND LOCATION: S:\PSC\ECR\WP\040442.RCM.DOC

Case Background

On May 12, 2004, Gulf Power Company (Gulf) filed a petition for authority to implement a proposed FlatBill rate schedule. Gulf's FlatBill is an optional pricing program that offers residential and small commercial customers a fixed monthly electric bill regardless of kilowatt-hour (kWh) usage for 12 months. The Commission approved a FlatBill program (as a pilot project) in Order No. PSC-02-0787-FOF-EI in Docket No. 010949-EI, In re: Request for a Rate Increase by Gulf Power, issued June 10, 2002. The FlatBill pilot program was conducted during calendar year 2003.

The Commission suspended Gulf's proposed permanent FlatBill rate schedule in Order No. PSC-04-0717-PCO-EI, issued July 23, 2004, in order to allow staff to gather more information about the program. The program as proposed does not comply with Rule 25-6.100(2), Florida Administrative Code, with respect to the billing detail that must be provided on the customer bill. Gulf has indicated that it will apply for a waiver of the rule if the tariff is approved.

Staff has identified two issues relating to the FlatBill program. Issue 1 deals with matters that relate to the functioning of the FlatBill program and the terms and conditions included in the tariff. Issue 2 deals with the regulatory treatment of the revenues from the FlatBill program.

The Commission has jurisdiction over this matter pursuant to Sections 366.03, 366.04, 366.05 and 366.06, Florida Statutes.

Discussion of Issues

Issue 1: Should Gulf Power Company's proposed FlatBill rate program be approved?

Recommendation: Yes. Gulf's proposed FlatBill program should be approved, provided that: (1) all components used to calculate the FlatBill, including the consumption adder, risk adder, and normalized weather are described in the tariff; (2) all terms and conditions of service, including termination of service, and what happens when service is interrupted due to natural disaster are described in the tariff; (3) staff reviews all disclosure information supplied to customers to insure it complies with the Commission's requirements, including a statement that the customer is paying a premium for the service, that the FlatBill includes a consumption adder and risk adder, that the customer will be sent a notice at least 30 days prior to the expiration of the FlatBill contract that it will be renewing, and contains the new offer amount, and a statement of the obligations of customers who leave the program prior to the expiration of the FlatBill contract; (4) Gulf files quarterly reports no later than 30 days following the end of the quarter which identify: the total revenues collected under the FlatBill tariff versus the revenues that would have been collected under the traditional (Residential and General Service) tariffs, the revenues attributable to the risk adder, the actual billing cycle weighted cooling degree days minus normal cooling degree days, the actual billing cycle weighted heating degree days minus normal heating degree days, and the quarterly incremental number of participants on the tariff; (5) the consumption adder applied to the customer's forecasted annual kWh usage does not exceed eight percent (8%) and the risk adder, used to account for financial, weather, and other risks, does not exceed five percent (5%); and (6) Gulf obtains a rule waiver from the requirement to include all the information on customer bills required in paragraphs 1, 2, and 4 of Rule 25-6.100(2)(c), Florida Administrative Code prior to implementing the tariff. Gulf should be required to file new tariff sheets consistent with the Commission's vote in this docket for administrative approval. (Baxter, Wheeler, Lester, McRoy)

Staff Analysis: On May 12, 2004, Gulf Power Company filed a petition for authority to implement a proposed FlatBill rate schedule that is similar to programs offered by Southern Company affiliates Georgia Power Company and Alabama Power Company. The proposed FlatBill rate schedule represents a permanent program first proposed in pilot form by Gulf and approved by the Commission in Order No. PSC-02-0787-FOF-EI in Docket No. 010949-EI, In re: Request for a rate increase by Gulf Power Company, issued June 10, 2002.

Gulf's FlatBill is an optional pricing program that offers residential and small commercial customers a fixed monthly electric bill regardless of their kWh usage for a 12-month period. It is available to Residential (RS) and General Service Non-Demand (GS) customers in good credit standing who have valid billing information at their current address for the twelve months prior to enrolling in the FlatBill program. In determining the FlatBill monthly amount, a premium is applied to the customer's otherwise applicable rate schedule.

To calculate the FlatBill offer, Gulf first determines the customer's forecasted annual kWh usage by weather normalizing the customer's historic annual usage, which statistically adjusts the usage to remove the effects of unusual weather. The normalized kWh are then adjusted by a consumption adder that reflects the increase in usage expected when price is decoupled from usage. The company indicated that the consumption adder used will be different for initial customers entering the FlatBill program versus customers renewing on the program. The normalized, consumptive kWh are then multiplied by the otherwise applicable base rate and adjustment clause per-kWh charges. The resulting amount is then increased by a risk adder percentage, and the annualized customer charge is added. The risk adder is a factor that recognizes the various types of risk Gulf may incur in offering the program. The total is divided by twelve to arrive at the monthly FlatBill amount a customer pays. Each customer's FlatBill charge will be unique, reflecting that customer's specific kWh usage pattern. One month before the end of the 12-month period, the customer receives a new FlatBill offer that is recalculated based on the customer's most recent kWh usage.

Gulf has stated that the majority of customers in the pilot FlatBill program expressed a high degree of satisfaction with the program. Gulf conducted a customer satisfaction survey and received 214 responses from the 353 customers surveyed. Of the customers responding, 95% indicated they were satisfied or very satisfied with the program. Seventy-six percent of respondents indicated that they would continue on the program if offered the opportunity (See Attachment A for the full survey results). Based on its most recent customer data, Gulf states that there are 213,400 residential and 13,500 commercial customers eligible to participate in the program. Gulf has asserted in its petition that it expects between 12,000 and 18,000 total customers to sign up for the program in the first year.

Although staff is recommending approval of the proposed program, staff has some concerns with the tariff as filed. Based on its research and the results of the customer satisfaction survey conducted by Gulf in the pilot FlatBill program, staff agrees with Gulf that the FlatBill program will "meet the needs and expectations of a significant number of Gulf's residential and small business customers" and be of benefit to those on fixed incomes and those who seek predictable, level bills throughout the year. The program also benefits Gulf by making its revenues less subject to seasonal variation, and by allowing Gulf the opportunity to collect higher revenues than they would have from standard rate customers.

An area of initial concern to staff are the conservation effects of the FlatBill program. Staff notes that the pilot program resulted in an 8% increase in kWh consumption by participants. Typically, when monthly energy usage is averaged over an extended period of time, participants are not able to immediately see the fluctuations in their billing and adjust their usage quickly. Programs such as FlatBill even out the participant's usage and can result in increased kWh consumption by participants. In its discussions with staff, Gulf responded that while there were observed increases in kWh consumption, there was no effect on peak demand. In further conversations, Gulf explained that increased kWh usage had the effect of increasing load factor which is generally desirable as it spreads fixed costs over a larger kWh base.

<u>Changes</u>. Staff believes that customers interested in the program should be fully informed of how their bills are calculated and how the program will operate so they can make an informed decision. Staff has discussed these concerns with Gulf, and if staff's recommendation is approved, Gulf has agreed in principle to make certain changes to the tariff and its associated marketing materials as noted in the discussions below.

I. FULL STATEMENT OF ALL TERMS AND CONDITIONS IN THE TARIFF

Staff noted several concerns with the tariff filed by Gulf in its petition. First, the tariff mentions but does not define the risk adder used to compute the FlatBill offer. In discussions with the company, Gulf stated that the risk adder is a factor applied to the FlatBill that recognizes various types of risk the company may incur during the program. These include the risk of increased kWh usage, the risk of abnormal weather, regulated price risk, and the risk related to fuel price variability. During the pilot program, Gulf did not include a risk adder in the FlatBill offers made to customers. Under the permanent program, Gulf expects to initially set the risk adder at 5%. The risk adder will be the same for all FlatBill offers until Gulf changes it, and then the new adder will be used to calculate offers to all new and renewing customers. Gulf has indicated that it expects to change the risk adder no more than once per year in response to weather, consumption, and other external events that result in cost changes.

In discussions with staff, Gulf indicated that it uses a proprietary business model that utilizes a Value at Risk methodology to calculate the risk adder. Staff believes that full disclosure of the details of this methodology in the tariff and marketing materials is not necessary, but recommends that Gulf define the risk adder in general terms in the tariff, similar to the definition provided by Georgia Power Co. in its FlatBill tariff. Staff feels that a definition and disclosure of this premium used in calculating the FlatBill is important. Gulf has agreed to add language to the tariff defining the risk adder.

Second, Gulf should describe in the tariff how a customer's estimated annual kWh is determined. The estimated annual kWh includes a consumption adder and an estimate to adjust for normal weather. The consumption adder is designed to help compensate Gulf for the expected increase in kWh consumption that will occur when customers are allowed to pay a flat rate regardless of usage. The normal weather adjustment is designed to remove the impact of abnormal weather from the customer's historic consumption. As with the risk adder, neither the consumption adder nor the weather normalizing adjustment are explicitly stated or defined in the submitted tariff sheets. Staff recommends that Gulf should define the consumption adder and the adjusted normal weather in the tariff. Gulf has agreed to add language to the tariff to do so.

Third, the offer letter that Gulf sent to pilot FlatBill participants stated that if participants left the program prior to the end of 12 months, the participants agreed to pay Gulf the difference between what they would have paid for their usage under standard rates and the amount they paid on the FlatBill program. If this difference is negative, no refund is made to the customer. This provision, while stated in the petition, is nowhere stated on the proposed tariff sheets that Gulf filed. Since this clearly is a condition for taking service under the tariff, pursuant to Rule 25-9.002, Florida Administrative Code, staff believes that this language should be included in the tariff. Gulf has agreed to add such language.

Fourth, in discussions with staff, Gulf indicated that if a customer's service was interrupted or their premises were destroyed due to a catastrophe or natural disaster, Gulf would remove the customer from the FlatBill program for the remainder of the applicable contract period, and all remaining bills would be calculated at the normal tariffed rate. The exit compensation clause discussed above would thus not be applicable in this case. Staff recommends that this provision be included in the tariff as well, and Gulf has agreed to add this language.

II. FULL DISCLOSURE OF ALL TERMS AND CONDITIONS IN THE MARKETING MATERIALS

Staff believes Gulf's marketing and offer materials, as well as the tariff, should accurately reflect the nature of Gulf's program. The offer materials for the pilot program consisted of a brochure that was sent to customers and an offer/agreement letter that showed the actual amount of the proposed monthly FlatBill. Customers signed the offer letter and sent the bottom portion back to the company as confirmation. Gulf stated that since it was waiting for Commission approval before producing marketing materials for the full program, the actual marketing information was not yet available. Gulf also stated, however, that the materials used for the full program would be similar to materials used in the pilot program. Gulf has agreed to include in the program solicitation letter the customer's average monthly bill over the last twelve months as well as the customer's highest bill and lowest bill during that period. Staff believes this information will be helpful in providing customers the opportunity to evaluate whether the cost of participating in the program is appropriate for them. Staff has determined, however, that there are several other areas where additional disclosure or revision is needed.

First, staff recommends that the materials clearly indicate that the customer is paying a premium for the FlatBill service over the otherwise applicable rate schedule. While the pilot marketing and offer materials demonstrated the advantages of levelized bills, nowhere did the offer or marketing materials indicate that the customer was paying a premium over normal standard rates for the FlatBill service. Although Gulf should not be required to state the dollar or percentage amount of the premium, customers should be made clearly aware that they will be paying for the privilege of having the FlatBill service. Gulf has agreed to add a statement on the offer letter notifying the customer they are paying a premium for the service.

Second, staff believes Gulf's offer material should disclose that the offered FlatBill price includes a consumption adder as well as a risk adder. Staff does not believe that the company must provide a detailed explanation of how the consumption adder is calculated, but customers should be aware that the estimated kWh usage used in the FlatBill offer is adjusted due to their participation in the program. Gulf has agreed to include a statement in its offer that the customer's kWh consumption will be adjusted for usage growth.

Third, staff noted that the FlatBill contract automatically renews unless a customer contacts the utility to withdraw from the program. Staff recommends that the customer be sent a notice prior to the FlatBill contract expiration. In discussions with staff, Gulf indicated that the customer will be notified of the new monthly FlatBill amount at least 30 days before the new bill goes into effect.

Fourth, staff believes that all marketing materials for the permanent program must clearly state the potential payment required of customers who leave the program early, and that customers are not entitled to any refund due to early termination. Gulf has agreed to add this language to the offer letter.

Finally, staff recommends, and Gulf has agreed, that Gulf should submit all disclosure information to staff for approval prior to finalizing customer marketing information in order to insure that all agreed-upon disclosures are included.

III. REPORTING REQUIREMENTS

During its examination of Gulf's FlatBill tariff, staff determined that the FlatBill tariff could have a significant impact on Gulf's revenues. Based on its initial proposal, Gulf has projected approximately $1,700,000 in additional revenues above the otherwise applicable rate for the first year of the full FlatBill program. Given the impact that the FlatBill program could have on Gulf's revenues, staff recommends that Gulf keep the Commission informed by filing a quarterly report with the Commission. The report would be similar in format to reports that are currently filed on a monthly basis by Alabama Power Company, Georgia Power Company, and Progress Energy Carolinas, Inc. (for North Carolina) with their respective commissions.

Staff recommends that the reports contain the following information: the total revenues collected under the FlatBill tariff versus the revenues that would have been collected under the traditional (residential and general service) tariffs; identification of the amount collected under the risk adder; identification of the actual billing cycle's weighted cooling degree days minus normal cooling degree days; identification of the actual billing cycle's weighted heating degree days minus the normal heating degree days; and identification of the quarterly incremental number of participants on the FlatBill tariff. Staff believes that these reports would provide the Commission with an overview of the program and enable sound regulatory oversight. Gulf has agreed to these reporting requirements.

IV. CAPS ON RISK AND CONSUMPTION ADDERS

Gulf has indicated that two of the factors used to calculate a customer's FlatBill rate will be a risk adder and a consumption adder. The adders account for various types of risk that Gulf has identified in offering a customer the level bill. In the pilot program, Gulf noted that bills were adjusted by a 3.9% consumption adder only. The results of the pilot program showed an actual increase in kWh usage of 8%. The proposed permanent program utilizes both a consumption adder and a risk adder.

The risk adder recognizes that actual usage and response may differ from what Gulf expected. The risk adder reflects three sources of risk: modeling risk, weather risk, and price risk. Gulf estimated a 5% risk premium based on their Value-at-Risk methodology. This methodology requires as inputs an aggregate risk measure, which is based on the variability of the three sources of risk, and a cost of capital input. Gulf used 20% as the cost of capital input. The 20% is the pre-tax cost of equity using the company's 12% authorized return on equity and a 38.575% effective tax rate. The Commission last set Gulf's return on equity by Order No. PSC-02-0787-FOF-EI, issued June 10, 2002 in Docket No. 010949-EI. The authorized return on equity was 11.75% plus 25 basis points for Gulf's past performance and as an incentive for Gulf's future performance.

There is no limit on how often the consumption and risk adders may be changed, although in its discussions with staff, Gulf has indicated that it intends to change the risk adder no more than once per year. The same risk adder would apply to all customer offers. The consumption adder may be different for new customers entering the program versus renewing customers. This difference is due to the expected differences in behavior between customers who enroll for the first time and those who renew. However, the same percentage amount would be applied to all customers within each group.

In its initial proposal, Gulf did not place any limits or caps on either the consumption adder or the risk adder. Gulf responded to staff concerns by suggesting a 10% cap on the risk adder and a 10% cap on the consumption adder. Staff examined similar programs for comparison and found a variety of approaches. The Georgia Power Co. program capped only the risk adder, and set that limit at 10%. The Alabama Power Co. pilot program included caps on both adders, with the kWh growth (consumption adder) capped at 6% and the risk adder capped at 5%. The residential balanced bill programs of Progress Energy Carolinas, Inc. for North and South Carolina capped kWh growth at 5.8% and the risk adder at 4.4%.

Although Gulf has offered to cap the risk adder at 10% and the consumption adder at 10%, staff is concerned that these proposed caps are too high. Staff recognizes that the FlatBill tariff is an optional offering and there is a practical limit to what Gulf can charge before customers decide to opt out or not sign up for the program. Staff believes, however, that in the interest of insuring that FlatBill customers pay reasonable rates, lower caps on both the risk adder and consumption adder are appropriate. Therefore, staff recommends that the risk adder be capped at 5% and the consumption adder be capped at 8%, and that these caps be included in the tariff. These percentages reflect the initial levels Gulf intends to use to calculate its FlatBill offers. If, in the future, the company is able to collect data indicating that higher level caps are justified, the company may seek Commission approval to amend the existing tariff.

Staff does not believe adoption of caps at staff's proposed level will put the utility at any significantly greater financial risk. While the initial pilot program showed an increase of 8% in kWh usage, it is unlikely that this magnitude of increase will be maintained for customers who continue on the program, especially as customers realize that their prior usage will have a significant impact on future FlatBill offers. In addition, Gulf admits that the small size of the pilot program casts some doubt on the applicability of the results. Logic dictates that usage will level off at some point, or increase in negligible amounts. Even though Gulf indicated that the consumption adder will likely be lower in subsequent years for customers who remain on the program, staff believes the two adders, even if maintained at the proposed capped levels, should be compensatory.

V. RULE WAIVER REQUEST

Rule 25-6100(2), Florida Administrative Code, requires that certain specific information be listed on a customer's bill, including the customer charge, the energy charge and certain cost recovery factors. Gulf's FlatBill will list only a single composite charge. The issue of a rule waiver was not addressed in approval of the pilot program. Gulf has agreed to file a rule waiver request before implementation of the permanent program.

VI. CONCLUSION

Staff recommends that the FlatBill program be approved, provided that:

1. All components used to calculate the FlatBill, including the consumption adder, risk adder, and normalized weather be described in the tariff.

2. All terms and conditions of service, including termination of service, and what happens to customers when service is interrupted due to natural disaster, are described in the tariff.

3. Staff reviews Gulf's marketing information to insure it complies with the disclosure requirements of the Commission's order.

4. Gulf file quarterly reports no later than 30 days following the end of the quarter that identify the total revenues collected under the FlatBill tariff versus the revenues that would have been collected under the traditional (Residential and General Service) tariffs, the amount collected under the risk adder, the actual billing cycle weighted cooling degree days minus normal cooling degree days, the actual billing cycle weighted heating degree days minus normal heating degree days, and the quarterly incremental number of participants on the tariff.

5. The consumption adder applied to the customer's forecasted annual usage not exceed eight percent (8%) and the risk adder, used to account for financial, weather, and other risks not exceed five percent (5%).

6. Gulf obtains a rule waiver from the requirement to include all the information required in paragraphs 1, 2, and 4 of Rule 25-6.100(2)(c), Florida Administrative Code prior to implementing the tariff.

7. Gulf files new tariff sheets consistent with the Commission's vote in this docket for administrative approval by staff.

Issue 2: Should the Commission approve Gulf Power Company's request to remove any FlatBill program profit/loss from operating revenues for earnings surveillance and other regulatory purposes?

Staff Recommendation: No. Gulf Power Company should be required to include all FlatBill program revenues, including any profit/loss, in operating revenues for all regulatory purposes. In addition, FlatBill program revenues should be allocated first to fully recover the cost recovery clause charges based on actual kWh usage each month. (Slemkewicz)

Staff Analysis: Under the FlatBill program proposal, Gulf intends to determine the amount of revenues for earnings surveillance and other regulatory purposes by using the actual energy usage of the FlatBill customer and multiplying that actual energy usage by the otherwise applicable tariff rate including the appropriate cost recovery factors. The difference between the actual FlatBill revenues and the calculated "otherwise applicable" revenues would be excluded for all regulatory purposes. In other words, any FlatBill revenues in excess of the otherwise applicable revenues would flow to Gulf's shareholders. Conversely, the shareholders would absorb any loss if the FlatBill revenues were less than the otherwise applicable revenues. Per its petition, Gulf anticipates that the FlatBill program will generate an additional $1.7 million in revenues above the otherwise applicable rate during the first year of the program. Gulf has estimated that it will incur approximately $300,000 in administrative costs to initially implement the proposed FlatBill program as a regular offering to its customers. Gulf will also incur an unknown level of annual administrative costs to administer the FlatBill program on a going forward basis. These administrative costs will be borne by the ratepayers under Gulf's proposal.

The purpose of the FlatBill program is to provide a regulated service to a customer at the same monthly price for a year, regardless of actual usage or actual cost. Unlike Budget Billing, there is no true-up in the FlatBill program. Because there is no true-up, the FlatBill program will generate revenues that are either greater than or less than Gulf's calculated "otherwise applicable" revenues. As previously discussed, Gulf anticipates that the FlatBill program revenues will exceed the otherwise applicable revenues. In essence, the customers will be paying a premium to be in the FlatBill program. Staff would note, however, that the FlatBill program is strictly a voluntary program. It is staff's opinion that the FlatBill program provides a regulated service that should be treated in the same manner as all other regulated services. Therefore, staff recommends that all FlatBill revenues be included in operating revenues for all regulatory purposes. This treatment would match the revenues with the associated administrative costs. In addition, the staff recommends that the cost recovery clause charges be made whole by first allocating any FlatBill program revenues to the clauses based on the actual kWh usage on a monthly basis.

There are, however, alternative treatments that the Commission could consider. One option would be to allow Gulf to exclude any FlatBill program profit/loss and to also exclude the associated administrative costs for all regulatory purposes. Under this scenario, the costs of the program, as well as the profit/loss, would flow to the stockholders. This treatment would also match the revenues with the associated administrative costs. A second option that could be considered would be the sharing of both the profit/loss and the associated costs between the ratepayers and the stockholders. In staff's opinion, a 50/50 sharing would be reasonable. Again, there would be a matching of the profit/loss and the associated administrative costs.

Issue 3: Should this docket be closed?

Recommendation: Yes, if no person whose substantial interests are affected by the Commission's decision files a protest within 21 days of the issuance of the order, this docket should be closed upon the issuance of a consummating order. If the tariff is approved, Gulf should be required to file tariffs consistent with the Commission's decision. (Brown)

Staff Analysis: Yes, if no person whose substantial interests are affected by the Commission's decision files a protest within 21 days of the issuance of the order, this docket should be closed upon the issuance of a consummating order. If the tariff is approved, Gulf should be required to file tariffs consistent with the Commission's decision.