M E M O R A N D U M

June 28, 1990

TO: PARTIES OF RECORD

FROM: Carol C. Causseaux, Chief
Bureau of Reporting

RE; DOCKET NO. 891345-EI, CORRECTIONS FOR VOLUMES XX and XXIII

Please note that Pages 18 through 22 of Mr. Seery's prefiled testimony were omitted in Volume XX. We are attaching these pages with the correct transcript page numbers so that you can insert them in your copy of the transcript.

In Volume XXIII, Pages 3464 through 3472 were a duplication of Mr. Howell's summary of his prefiled testimony and were inadvertently inserted. These pages have been removed, and we are attaching corrected copies of Pages 3462 and 3463 to be inserted in your copy of the transcript, which will take care of the duplication.

Please accept our apology for any inconvenience this may have caused you or members of your staff.

CC:pc
Attachments

Corrections were made in original transcripts

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'860004-EU, the Commission's own consultant supported Gulf's 20 to 25% planning reserve margin guideline as being reasonable and consistent with utilities practices. Mr. Rosen stated that Southern's reserve level for planning purposes is based on a minimum of 20%. However, he went on to say that capital expenditures for capacity additions have been limited to a 16% planning reserve margin.

The preamble to expansion plan 9081, which is a part of this case, states as follows: Although the operating companies have determined to maintain a minimum 20% planning reserve margin guideline, capital expenditures for capacity additions have been limited in this resource expansion plan based on a 16% reserve margin until detailed studies are completed before the adoption of the fall 1990 plan. Capacity to meet the minimum 20% planning reserve margin guideline can be met through short lead time options, such as purchases, and are not shown. Active DSO additions are shown as combustion turbine equivalent megawatts. Passive DSO additions are not explicitly shown but are reflected in the load forecast. Detailed economic and reliability studies will be made as appropriate to determine resource additions on a timely basis.

capacity, is within the level previously supported by this Commission. The Scherer capacity is available for use by our territorial customers. It has been used by territorial customers and is presently used and useful in 1990.

Mr. Larkin recommends excluding the Carrabelle site from rate base because there is no plan to build a generating unit at this site during the period covered by our present generation expansion plan. I strongly feel this site should be retained as plant held for future use as approved by the Commission in previous rate case dockets. For example, in Order 9628, the Commission supports this decision by stating, "We agree with the Company that its plans for the site are sufficiently definite to warrant its inclusion, and that to deny that request would be to the disadvantage of ratepayers in the long run."

The inclusion of the Carrabelle site and plant held for future is still a prudent decision. The associated subsurface investigation which was performed prior to site certification should be included in working capital as a valid analysis of geological conditions at the site and will be used during the design phase of plant construction. There is no doubt that future generation will be required as our

Power's cost of common equity.

As shown on Schedule 14, applying a 12.25% return on common equity, 30 basis points above the top of the adjusted range, results in a pretax times interest earned (TIE) ratio and pretax cost of capital comparable to that which would have been incurred by Gulf Power if their debt leverage and equity ratio were similar to the average of the utilities comprising the "A" rated index. The resulting TIE ratio also compares favorably with other "A" rated electric utilities and with the benchmark guidelines provided by S&P.

Q Why did you use annually compounded, rather than quarterly compounded, models in your analysis to determine the cost of common equity capital to Gulf Power?

A In Docket No. 880558-EI, the Commission expressed their opinion that the specificity obtained by recognizing the effects of compounding to determine the cost of equity was an unnecessary refinement. Therefore, I have conducted an analysis using annually compounded models, the results of which, in my opinion, approximate the appropriate point at which rates should be set to meet investor return requirements.

Q Please continue.

A In my opinion, the use of models that accurately reflect the receipt and timing of cash flows provides a better estimate of the cost of equity. However, using the results derived from a quarterly DCF model without making a ratemaking rate of return adjustment is inconsistent. The ratemaking rate of return adjustment recognizes the time value of money associated with the Company's monthly receipt of revenues. It is inconsistent to selectively recognize the time value associated with the investor's quarterly receipt of dividends, through use of a quarterly model, and then not recognize the time value associated with the Company's monthly receipt of revenues. Ignoring the Company's monthly receipt of revenues, as reflected in the 13-month average equity balance, overestimates the point at which rates should be set.

Q What is your recommendation regarding the appropriate regulatory treatment of non-utility related property and non-regulated subsidiaries?

A I recommend non-utility property and non-regulated subsidiaries be removed from the capital structure directly from equity unless the Company can show, through competent evidence, that to do otherwise would result in a more equitable determination of the cost of capital for regulatory purposes.

Q In making this recommendation are you assuming the investment in non-regulated assets can be traced directly to equity funds?

A No. Assets cannot be associated with specific sources of funds. Funds are fungible.

Q If funds cannot be traced, why do you recommend, in the absence of persuasive evidence to the contrary, non-regulated property and non-regulated subsidiaries be removed from equity?

A I recommend this treatment for two reasons. The first is the basic principle that the cost of capital allowed for ratemaking purposes should be the cost of capital associated with the provision of utility service. The second relates to the signals and incentives sent to the companies.

Q Please continue.

A The cost of capital is the minimum rate of return necessary to attract capital to an investment. It is a function of the risk of the investment. The greater the risk the greater the return investors require.

Regulated entities are of relatively low risk and have correspondingly low costs of capital. There are very few investments a regulated company can make that are of equal or lower risk. Therefore, investments in non-regulated subsidiaries will almost certainly increase a regulated utility's cost of capital. The effects may be difficult to quantify, but the fundamental risk-return relationship points to their existence. It is important that these effects be removed from the Company's overall cost of capital in order that ratepayers are charged only for the cost of capital associated with the provision of regulated service.

Removing the effects of investments in non-utility property can present a more difficult problem. For example, it may be difficult to quantify the cost of capital effects associated with a utility officer's purchase of an automobile for personal use. In this circumstance, I believe the signals and incentives associated with the Commission's policies should be of primary concern. If a utility can finance non-utility property at the utility's cost of capital rather than at market rates, it will have every economic incentive to do so. If this is allowed to occur, ratepayers will be subsidizing, through capital costs, investments not necessary for the provision of regulated service.

Q What is your position as to the appropriate regulatory treatment of cash and temporary cash investment balances?

A In my opinion, the appropriate regulatory treatment of either continuing cash balances or temporary cash investments should depend upon their prudency. If the utility can demonstrate, through competent evidence, that their cash balances or temporary cash investments are necessary for the provision of regulated utility service they should remain in rate base and earn at the utility's overall rate of return. Any earnings generated by these funds should then be used to offset revenue requirements. In general, short-term investments can be expected to earn less that the utility's overall cost of capital. Therefore, a blanket policy of excluding temporary cash investments from rate base could result in an asset, potentially necessary for the provision of regulated service, earning less than a fair rate of return.

However, if the utility fails to demonstrate the prudency of either their temporary cash investments or continuing cash balances, they should be removed directly from equity when reconciling the capital structure with rate base. Such treatment removes the capital structure implications of excessive cash or temporary cash investments. In a competitive environment the cost of poorly managed cash resources cannot be passed through to customers, instead, shareholders bear the cost. Similar treatment by the Commission would mirror the competitive environment and send appropriate signals to utility owners and managers regarding cash balances and working capital allowances.

Q Please summarize your testimony.

A The purpose of my testimony was to determine the appropriate cost of common equity capital for Gulf Power to use in determining an appropriate allowed overall rate of return. I also discussed the appropriate regulatory treatment of non-utility property and non-regulated subsidiaries, temporary cash investments, and continuing cash balances when reconciling rate base and capital structure.

Using the widely accepted discounted cash flow and risk premium methodologies I estimated a cost of common equity range of 11.00% to 11.50% for an index of "Aa/Aa" rated electric utilities. I then adjusted this range to account for the difference in risk between Gulf Power and the index. I determined that Gulf Power's cost of common equity fell within a range of 11.30% to 12.10%. Given Gulf Power's higher debt leverage, lower equity ratio, and lower coverage ratio relative to both the "AA" and "A" indices I examined, it is my opinion that the top of the range, 12.10% best represents Gulf Power's cost of common equity capital. Schedule 15 summarizes my conclusions regarding the cost of common equity capital.

I also recommend that non-utility property and non-regulated subsidiaries be removed from the capital structure directly from equity unless the company can show, through competent evidence, that to do otherwise would result in a more equitable determination of the cost of capital for regulatory purposes. In addition, I recommend that, absent a showing of their prudency, temporary cash investments and continuing cash balances be removed directly from equity when reconciling the capital structure with rate base.

Q Does this conclude your testimony?

A Yes, it does.