SSU
Southern States Utilities

BEFORE THE

FLORIDA PUBLIC SERVICE COMMISSION

DOCKET NO. 950495 - WS

APPLICATION FOR A GENERAL RATE INCREASE

VOLUME I
BOOK 22 OF 22

MINIMUM FILING REQUIREMENTS
PREFILED DIRECT TESTIMONY

Containing

HUGH GOWER

DIRECT TESTIMONY OF HUGH GOWER

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

ON BEHALF OF

SOUTHERN STATES UTILITIES, INC.

DOCKET NO. 950495-WS

Q. PLEASE STATE YOUR NAME, OCCUPATION AND ADDRESS.

A. My name is Hugh Gower, and I am self-employed. My address is 195 Edgemere Way South, Naples, Florida 33999.

Q. PLEASE STATE YOUR EDUCATIONAL AND PROFESSIONAL BACKGROUND.

A. I hold a bachelor of science degree in accounting and economics from the University of Florida, and I am, or have been, registered as a certified public accountant in Florida, Georgia, and several other states. I am a member of the American Institute of Certified Public Accountants and other professional organizations. Prior to retirement, I was a partner in Arthur Andersen & Co. with whom I was engaged in the practice of public accounting continuously for more than 30 years.

Q. PLEASE DESCRIBE THE FIRM OF ARTHUR ANDERSEN & CO. AND YOUR PARTICULAR EXPERIENCE.

A. Arthur Andersen is among the largest international firms of independent public accountants and serves as auditors for a major share of the electric, gas and telephone, as well as a large number of the other utilities operating in the United States. In addition to audits of financial statements, the firm performs tax work and designs and installs accounting systems for businesses of all types. The firm also provides expert testimony in connection with public utility rate applications before federal and state regulatory authorities on a variety of accounting, financial and rate-making topics.

I was a partner in the Utilities and Telecommunications Division of the Atlanta office of Arthur Andersen & Co., which serves as the concentration office for the firm's regulated industries practice in the southeastern United States. This area of the practice includes work for electric, gas, telephone, water and sewer utilities, motor carriers and airlines. I served as the southeastern area director of this practice for 17 years. I have had responsibility for supervising the work performed for Arthur Andersen & Co. clients, the training of firm personnel, and administrative matters. I have also had direct responsibility for the work done by the firm for numerous clients in this area of the practice.

Q. **PLEASE DESCRIBE THE NATURE OF THE WORK YOU HAVE PERFORMED WITH ARTHUR ANDERSEN & CO.**

A. By far, the greatest portion of my work has been devoted to the public utilities industries, but I also have substantial experience with other industries. I performed independent audits of public utilities, as a result of which Arthur Andersen & Co. issued reports on the financial statements of such companies, and I participated in and supervised work in connection with audits of various statements, schedules and other data required either annually or in connection with rate applications before federal or state regulatory authorities. I have also supervised work in connection with the issuance of billions of dollars of securities by public utilities. I participated in management audits, the purpose of which was to assess whether management systems and procedures promote economy and efficiency of operations. I also participated in the development of accounting and management information systems as well as operating systems designed to promote close control over utility resources, such as materials, fuel and construction costs. In addition, I directed the preparation of financial forecasts or projections, conducted reviews of financial forecasts and directed the development of financial forecasting models.

I have directed depreciation studies which, based on the analysis of utility plant investments, retirement experience, salvage and cost of removal, developed equitable depreciation rates with which to effect capital recovery during the service lives of the properties. I also developed plans which were accepted by regulators as equitably assigning the future costs of spent nuclear fuel disposal, nuclear plant decommissioning and fossil plant dismantlement costs to customers receiving service, considering the effects of inflation, the time value of money and other variables.

I have directed revenue requirement studies involving the analysis of rate base, operating revenues and expenses as well as the analysis of specific transactions or alternative rate-making treatment of various cost-of-service components. I have also directed studies to determine the proper assignment of cost of service between customer classes, regulatory jurisdictions or between regulated and unregulated operations. I have and do consult with public utilities and others regarding the economic effects of business transactions or rate-making matters as well as the proper accounting for the economic effects of such transactions or matters. I participated in the preparation of Arthur Andersen & Co.'s position statements on utility accounting and rate matters which were under consideration by legislative bodies and regulatory agencies. I was a representative of the American Institute of Certified Public Accountants on the Telecommunications Industry Advisory Group ("TIAG") to the Federal Communications Commission in connection with its adoption of its new Uniform System of Accounts (Part 32). In this connection, I chaired the Auditing and Regulatory Subcommittee of TIAG which dealt with issues regarding compliance with generally accepted accounting principles ("GAAP") when regulatory rate-setting practices are based upon methods other than GAAP.

I have assisted clients in the preparation of testimony and exhibits and have given expert testimony in cases before federal courts and federal and state regulatory commissions.

Q. **WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

A. The purpose of my testimony is to explain why Southern States has not imputed CIAC (or service availability charges) anticipated to be collected in the future beyond the test period against that portion of the plant investment designated "margin reserve" included in rate base in this filing. My testimony also shows:

- that Southern States is entitled to a return on the capital which finances margin reserve plant until that capital is recovered;
- that imputing anticipated future CIAC collection against margin reserve plant denies investors that opportunity;
- that imputing anticipated future CIAC collections by the Commission is inconsistent with its treatment of other utilities in whose cases no imputation of future capital recovery is made; and
- that assigning current customers the cost of carrying the unrecovered investor-supplied capital which financed the investment in margin reserve plant is appropriate.

Q. **DO YOU RECOGNIZE THAT THE COMMISSION HAS CONSISTENTLY IMPUTED CIAC AGAINST MARGIN RESERVES INCLUDED IN RATE BASE SINCE 1988 WHEN IT STATED ITS POLICY IN ORDER NO. 20434?**

A. Yes, I do, but having reviewed the Commission orders dealing with CIAC imputation in most (if not all) prior cases as well as the evidence presented in several, I strongly believe that the prior records were not sufficiently clear and the issue was confused. Therefore, I respectfully ask that careful consideration be given to the matter in this case.

Q. **IS IT TRUE THAT BY NOT IMPUTING POSSIBLE FUTURE CIAC**

COLLECTIONS AGAINST ITS MARGIN RESERVE INVESTMENT IN THIS CASE, SOUTHERN STATES IS ASKING FOR A RETURN ON PLANT INVESTMENTS PAID FOR BY CUSTOMERS?

A. No, Southern States is not asking for a return on plant investment paid for by the customers. What Southern States appropriately asks is the opportunity to earn a fair return on investors' capital until that investment has been recovered.

Q. **BUT IF CUSTOMERS IN THE FUTURE DO MAKE CIAC PAYMENTS TO SOUTHERN STATES, WHAT INVESTORS' CAPITAL IS THERE WHICH REQUIRES ANY RETURN?**

A. It is the capital supplied by investors to finance the construction of plant prior to its being available to serve customers, and, after it is available, until customers' demands grow to equal the service capacity of the plant and CIAC payments are collected.

Q. **PLEASE EXPLAIN.**

A. It may be useful to state the obvious so that it can be put aside. It is well-established that investors in utilities are entitled to both recovery of and return on the capital they provide. In the case of investments in utility plant, capital recovery has historically been effected through inclusion of depreciation (or amortization) provisions in cost of service in a rational, predictable manner over a period of years. Investors' capital which requires a return is measured by the amount of undepreciated plant investment and inclusion of this amount -- plant, less accumulated depreciation times rate of return -- in cost of service provides investors the opportunity to recover this as well.

Q. HAVE YOU PREPARED AN EXHIBIT TO ILLUSTRATE CAPITAL RECOVERY THROUGH DEPRECIATION?

A. Yes, Exhibit ___(HAG-1) shows this in Figure A. This hypothetical exhibit assumes a $10,000 plant investment depreciated on a straight-line basis over five years. At the beginning of the period, unrecovered investor capital is $10,000. This is reduced annually by ratable provisions for depreciation included in cost of service. Each year, accumulated provisions for depreciation ("accumulated capital recovery") reduce the original capital investment until it has been fully recovered.

Over the five year useful life, the average unrecovered investor capital is $5,000. In other words, on average over the 5 year useful life, investors would be entitled to a return on the $5,000 unrecovered invested capital (although, of course, this amount is different each year).

Q. BUT ISN'T IT TRUE THAT TO THE EXTENT THAT CUSTOMERS PAY CIAC CHARGES THERE IS NO INVESTOR SUPPLIED CAPITAL TO BE RECOVERED OR WHICH CARRIES A RETURN REQUIREMENT?

A. No, it isn't true. That assertion loses sight of the fact that before customers pay CIAC charges, investors first supply the capital to construct new plant capacity and continue to finance that plant investment until it is recovered through CIAC charges. In other words, just as with depreciation provisions included in cost of service, CIAC charges are the vehicle by which the recovery of investors' capital is effected. Until the capital previously provided by investors is recovered by collection of CIAC charges, any unrecovered capital investment requires a return. Neither depreciation nor CIAC charges provide return on investor's capital.

Although the pattern of capital recovery which results from CIAC charges is different than when capital recovery is handled through depreciation, the investor capital which requires a return is measured by the amount of plant investment in excess of CIAC collections at any point in time, or over a period of time.

In the case of Southern States, it historically takes from one to ten years to recover applicable plant investments through CIAC charges. Until the capital financing such investments is recovered by CIAC charge collections, such capital is entitled to a return and should be included in rate base without imputation of offsetting future CIAC collections so that investors will have that opportunity.

Q. **CAN YOU ILLUSTRATE HOW UNRECOVERED INVESTOR-SUPPLIED CAPITAL WHICH REQUIRES A RETURN EXISTS WHEN PLANT COSTS ARE RECOVERED THROUGH CIAC (OR SERVICE AVAILABILITY CHARGES) INSTEAD OF**

DEPRECIATION?

A. Yes. Figure B on Exhibit ___(HAG-1) illustrates this as well. This hypothetical assumes a $10,000 investment is recovered over five years. The amount recovered is not ratable and varies from year to year. Based on the original $10,000 invested and the assumed CIAC charges, the average unrecovered investor capital is $7,500. In other words, on average over the five year period, this is the amount on which investors would be entitled to a return.

Q. WELL, ISN'T IT TRUE THAT THE FAILURE TO IMPUTE CIAC CHARGES ANTICIPATED TO BE COLLECTED OVER THE PERIOD COVERED BY THE MARGIN RESERVE WILL RESULT IN OVER-EARNING BY THE UTILITY?

A. No, it will not. Rates will be set on the basis of a test period thoroughly tested by all parties in the proceeding to provide assurance that revenues, expenses, capital invested and all other elements of cost of service will be representative of future conditions for which rates will be set. Absent complete failure of this ratemaking process, over-earning due to lower than expected investment in plant (margin reserve) capacity is unlikely. In fact, Southern States' recent operating history shows quite the opposite of over earnings. Since the Commission's order in Docket No. 920199-WS, actual realized returns have been less than the authorized return.

On the other hand, the imputation of CIAC charges anticipated to be collected beyond the end of the test period is bound to prevent the utility from realizing its authorized return, at least on the capital which finances the margin reserve plant capacity.

Q. WHY IS THAT TRUE?

A. Imputation of CIAC charges anticipated to be collected in future periods beyond the end of the test period is the financial equivalent of assuming that plant investments whose capital recovery is to be effected through depreciation is already fully depreciated. Obviously, to assume that plant which is, say 20% depreciated at the end of the test period, is instead 100% depreciated means there is no financial basis (cost less accumulated depreciation) upon which a return could be provided in the cost of service calculation. In simple terms, a rate of return times zero equals zero.

The fact that unrecovered investor-supplied capital exists regardless of whether capital recovery is provided through depreciation provisions or collection of CIAC charges is clearly illustrated on my Exhibit ___(HAG-1). It is no more appropriate to assume that plant capacity investments not yet recovered through CIAC charges have already been fully recovered than it is to assume that accumulated depreciation accruals equal to 20% of the related plant cost are instead equal to 100% of the plant cost.

Q. DID THE IMPUTATION OF ANTICIPATED FUTURE CIAC COLLECTIONS IN DOCKET NO. 920199-WS HAVE AN ADVERSE EFFECT ON SOUTHERN STATES' REALIZED RETURNS?

A. Yes, it did. In that case the Commission imputed anticipated future CIAC collections of $974,596 against the actual investment in margin reserve plant included in rate base. Actual post-test year CIAC collections during the respective margin reserve periods amounted to $478,957 -- less than 50% of the amount imputed.

Q. DOESN'T THE INCLUSION OF THE ALLOWANCE FOR FUNDS PRUDENTLY INVESTED ("AFPI") IN COLLECTIONS FROM FUTURE CUSTOMERS PROVIDE A RETURN ON UNRECOVERED INVESTOR-SUPPLIED CAPITAL FINANCING MARGIN RESERVE PLANT?

A. No, as Commission orders state, the AFPI charge is designed to allow investors to recover a fair rate of return on prudently constructed plant facilities excluded from rate base as "not being used and useful." Hence, AFPI charges -- when and if collected -- provide no return on margin reserve plant which is "used and useful."

Q. ARE THERE OTHER INAPPROPRIATE ASSUMPTIONS MADE IN APPLYING THE ADJUSTMENT TO REDUCE RATE BASE FOR THE IMPUTATION OF CIAC ANTICIPATED TO BE COLLECTED AFTER THE END OF THE TEST PERIOD?

A. Yes. The way this adjustment has been applied in other cases carries an implicit assumption that the CIAC funds collected have not been, or will not be, reinvested in the utility operations.

Q. **PLEASE EXPLAIN.**

A. Based on data from prior cases, it appears that the CIAC imputation adjustment was based upon the service availability charges times the number of ERC's implicit in the margin reserve plant investment. These amounts -- up to the limit of the net margin reserve plant -- increased accumulated actual CIAC collections offset against the plant component of rate base. No accounting for the uses of the funds which the assumed CIAC collection would provide was reflected in the CIAC imputation adjustment. The failure to account for the use of the assumed CIAC collections implies that the funds were not, or will not be, reinvested in the utility operations.

Q. **WHY IS THIS AN INAPPROPRIATE ASSUMPTION?**

A. In the case of Southern States, at least, CIAC funds collected have been included with other corporate funds and used to pay for operating expenses, plant construction costs, or for other normal uses in carrying on the utility business. Since the Commission insists on the balance sheet method to construct other components of rate base, fairness and consistency suggests that if a CIAC imputation is made, it should account for the <u>entire transaction</u> in a manner which correctly reflects the actual practices of the utility. Clearly, application of this adjustment in (at least) some prior cases has been based on inappropriate assumptions. Previous applications of the CIAC imputation adjustment also have an implicit unwarranted assumption that additional margin reserve capacity serves only new customers.

Q. **BUT ISN'T IT CORRECT THAT THE PLANT CAPACITY REPRESENTED BY THE "MARGIN RESERVE" IS AVAILABLE TO SERVE FUTURE CUSTOMERS EXCLUSIVELY?**

A. No. The margin reserve capacity is available to serve both increases in consumption by existing customers as well as for any new customers. The association of margin reserve with only new customers connecting to the system appears to be a common misconception based on transcripts of earlier testimony as well as wording used in certain prior Commission orders, probably due to the margin reserve calculation being based on increased consumption expressed as "Equivalent Residential Connections (ERC's")."

But the fact is that when the utility calculates expected growth over the period covered by the margin reserve to be, for example, 1000 ERCs, it does <u>not</u> mean that the utility expects 1000 new service connections. Rather, it means that over the margin reserve period, the utility expects an increase in consumption from present and new customers, the total volume of which would equal the consumption of 1000 average residential customers.

Imputation of future anticipated CIAC collections against margin reserve plant investments as done in a number of previous cases, improperly insulates present customers completely from any responsibility whatsoever for return on investor capital which finances that plant. This treatment is vividly inconsistent with the Commission's treatment of electric, gas or telephone companies whose plant has the capacity to serve future increases in sales.

Q. **HOW IS THE IMPUTATION OF ANTICIPATED FUTURE CIAC COLLECTIONS FOR WATER AND WASTEWATER UTILITIES INCONSISTENT WITH THE TREATMENT OF OTHER UTILITIES BY THE COMMISSION?**

A. As my testimony has previously shown, whether capital recovery is provided through CIAC collections or depreciation provisions, it occurs over a period of time measured in years. In no case of which I am aware has this (or any other) commission imputed additional accumulated depreciation to electric, gas or telephone utilities because actual plant investments in service had the capacity to -- and likely would in the future -- serve more customers or increased sales to existing customers.

Q. **IF THE COMMISSION AGREES WITH SOUTHERN STATES' PROPOSAL AND DOES NOT IMPUTE CIAC COLLECTIONS ON MARGIN RESERVE PLANT, DOESN'T THIS SHIFT THE ENTIRE CAPITAL RECOVERY BURDEN TO PRESENT CUSTOMERS?**

A. No. Present customers would have responsibility <u>only for return on capital</u> which finances the margin reserve plant <u>until that capital is recovered</u>.

This is perfectly appropriate since having that capacity available provides benefits to current customers and investors are entitled to a return currently.

Q. WHY ARE INVESTORS ENTITLED TO A RETURN ON MARGIN RESERVE PLANT CURRENTLY?

A. Aside from the obvious -- that the plant is "in-service" and does benefit current customers -- is the fact that the risk of capital recovery through CIAC charges remains on investors. History shows that not all potential new customers materialize and pay CIAC charges.

This risk is heightened by the fact that the needed return on invested capital for a period, if not then recovered, cannot be recaptured in the future. Fairness dictates that prudent investments made to meet public service obligations have a reasonable opportunity to earn a fair return. This opportunity would be provided by including margin reserve plant investments in rate base without imputation of anticipated future CIAC collections.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. The inclusion of Southern States' investment in margin reserve plant without imputation of anticipated future CIAC collections in rate base is necessary and appropriate to provide investors an opportunity to earn a return on their capital until it is recovered.

It is appropriate that investors receive the return on capital currently in view of the inherent risks not compensated for by AFPI charges.

It is also appropriate that current customers provide this return through rates since they receive benefits from the margin reserve plant.

Finally, inclusion of margin reserve plant without imputation of anticipated future CIAC collections is necessary so that Southern States' investors will be treated fairly in regard to capital recovery compared to investors in electric, gas or telephone utilities.

Q. **DOES THIS CONCLUDE YOUR TESTIMONY?**

A. Yes.

SOUTHERN STATES UTILITIES
ILLUSTRATION OF CAPITAL RECOVERY

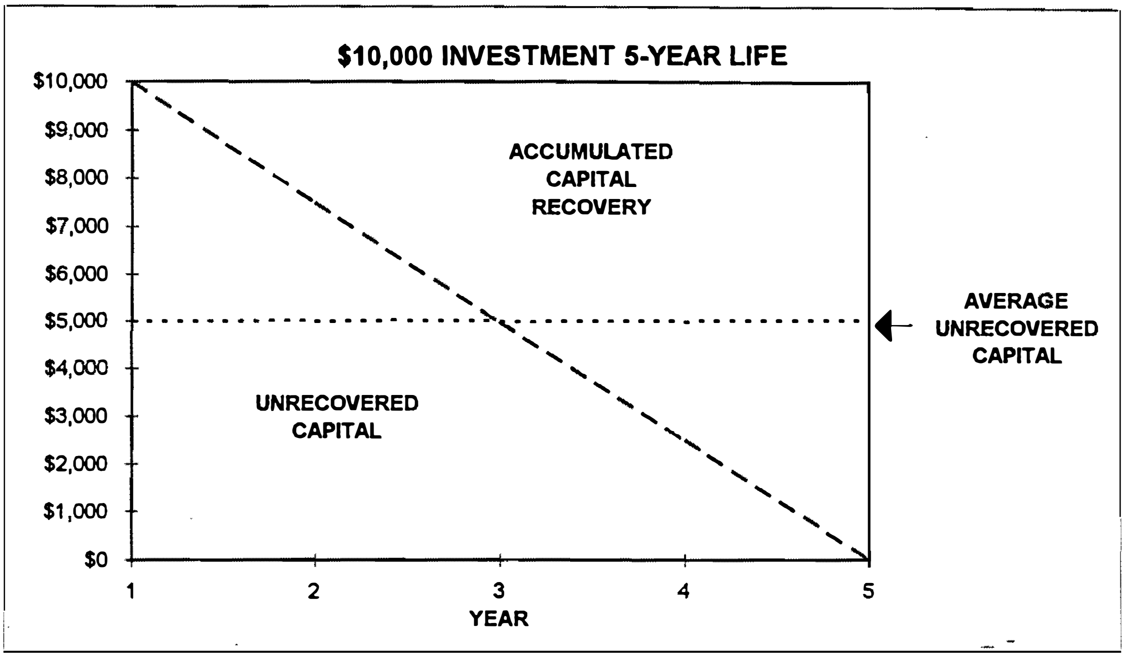

FIGURE A

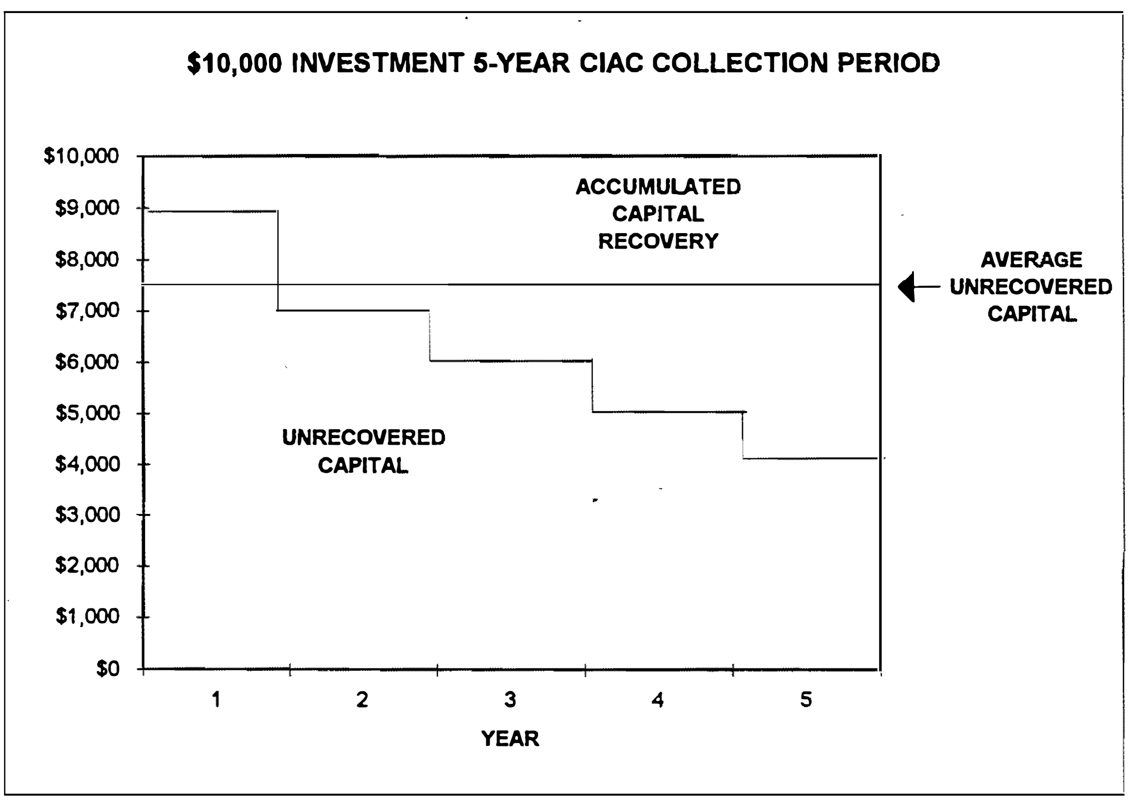

FIGURE B