IN THE SUPREME COURT OF FLORIDA

GULF POWER COMPANY, Appellant, vs. MICHAEL M. WILSON, etc., et al., Appellees.	)	CASE NO. 77,153

ON APPEAL OF ORDERS NOS. 23573 AND 23894
IN FLORIDA PUBLIC SERVICE COMMISSION
DOCKET NO. 891345-EI
PETITION OF GULF POWER COMPANY

ANSWER BRIEF OF
APPELLEES, CITIZENS OF
THE STATE OF FLORIDA

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STATEMENT OF THE CASE AND FACTS

Public Counsel accepts Gulf Power Company's statement of the case and facts as far as it goes. However, a complete procedural history is necessary to put this case into proper perspective.

The utility's request for rate relief really began on November 14, 1988, when Gulf filed its petition for increased revenues of $25,793,000. [Tr. 26-29][1] In its petition, Gulf asked for a 14% return on equity and interim revenues of $18,188,000 pending hearing and a final order. The request for interim relief was denied in Order No. 20603. In re: Petition of Gulf Power Company for a Rate Increase, 89 FPSC 1:142 (1989). [A-1].

Throughout the early part of 1989, Public Counsel actively engaged in discovery and sought Commission assistance to compel Gulf's responses. In re: Petition of Gulf Power Company for an Increase in its Rates and Charges, 89 FPSC 6:242 (1989) (Order No. 21372) [A-11]; In re: Petition of Gulf Power Company for Rate Increase, 89 FPSC 5:41 (1989) (Order No. 21157) [A-4]. Public Counsel sought information relevant to Gulf's internal investigation of inventory shortages, asset misappropriations, and theft by its employees or others.

Gulf sought a protective order for its internal audit and raised objections of relevancy, confidentiality and privilege. Order No. 21157, at 3-5. [A-6-8] Public Counsel countered that

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[1]The transcript of the June 11-21, 1990, hearings will be referred to as [Tr. __]; pleadings and other portions of the record will be referred to as [R. __]; the appendix to this answer brief will be referred to as [A-__].

> not only are issues of imprudent spending, fraud, and theft relevant to Gulf's burden of proof before the Commission as to its expenditures and rate base, an uncovered long-term high level pattern of abuse or misconduct could impeach the validity of Gulf's filing or provide a basis for imposing a penalty on Gulf's authorized return on equity as well as for disallowing O&M [operation and maintenance] expenses beyond [the] benchmark.
>
> Order No. 21157, at 4. [A-7].

The Commission agreed:

> Investigations as to the reasonableness of claimed or alleged expenses are made inherently relevant to rate changes by Section 366.06(1), Florida Statutes; if property is claimed, it must be 'used and useful,' and if money is invested, it must be done 'honestly and prudently.'
>
> Order No. 21157, at 4. [A-7].

The Commission found that Gulf was not entitled to a protective order and that the information was not confidential. Order No. 21157, at 7. [A-10].

In response to Gulf's second motion for protective order, the Commission found that Public Counsel had diligently pursued discovery and met his burden under Rule 1.280(b)(3), Florida Rules of Civil Procedure, by showing undue hardship and necessity. Order No. 21372, at 4. [A-14] The Commission agreed with Public Counsel's contention that information about Gulf's internal investigation of mismanagement would

> materially bear on the level of operating and maintenance expenses of the company, including legal expenses, marketing expenses, expenses for the security department, as well as expenses incurred through outside vendor purchases . . . . [and] to determine whether Gulf's inventory as well as certain portions of its rate base are overstated for the test year. Since all these items are relevant to the ratesetting process, Mr. Hale [Public Counsel's staff member] is of the opinion that this

> information is essential to determine the proper disposition of Gulf's rate increase petition.
>
> Order No. 21372, at 3. [A-13].

Gulf filed a notice of voluntary dismissal of its rate case on June 9, 1989, (despite its alleged need for rate relief) because of possible interference with a federal grand jury investigation into allegations of corporate wrongdoing. [Tr. 26-29; A-15] The Commission closed the rate case docket by Order No. 21537, issued July 13, 1989. In re: Petition of Gulf Power Company for an Increase in its Rates and Charges, 89 FPSC 7:262 (1989). [A-21].

Public Counsel responded to Gulf's voluntary dismissal with a motion to "spin-off" the investigation of irregularities into a separate proceeding. [A-22] Responding in opposition to the motion, Gulf stated that it "does not dispute this Commission's authority to investigate allegations involving the Company and to determine the propriety of a rate adjustment . . ." [A-32] Finding statutory authority under Section 366.076, Florida Statutes (1989), the Commission, in Order No. 21459, dated June 28, 1989, initiated a limited proceeding in Docket No. 890832-EI. In re: Investigation of Gulf Power Company, 89 FPSC 6:505 (1989). [A-35].

Thereafter, on July 10, 1989, the Commission staff initiated a case-assignment-and-scheduling-record (CASR) to control activities in the new docket. The only action identified in the original CASR was to "Pursue discovery" and then revise the schedule. [A-38] There have been no substantial docket activities in the spin-off investigation. When signed for the Chairman on

December 3, 1990, the only activity listed on the last CASR was to establish a date to set up a schedule. [A-41].

Twelve days later, on December 15, 1989, Gulf filed its second petition for rate relief, which was assigned Docket No. 891345-EI. [R. 25]. The petition alleged that $26,295,000 in increased revenues were necessary to afford Gulf an opportunity to earn a fair return on equity of 13% (in contrast to the 14% requested in the 1988 rate filing.) Gulf later revised its request to include a 13.5% equity return.

Contemporaneously with its petition, Gulf provided the prefiled testimony of its witnesses, including that of its president, Mr. Douglas L. McCrary, whose prefiled testimony was inserted into the record of the hearings held June 11-21, 1990. [Tr. 23-48] In response to a question asking the purpose of his testimony, Mr. McCrary stated, among other things:

> I would also like to address certain of the events of the past few years which could easily detract from the merits of our case. These events, including the numerous investigations of the Company, and the Company's recent plea of guilty are of understandable concern to the Commission. I believe we have been likewise concerned and have taken those actions necessary to prevent a recurrence. [Tr. 25]

Over eleven pages of Mr. McCrary's prefiled testimony was devoted to this subject. [Tr. 25-36]

At the hearing on June 11, 1990, Mr. McCrary was cross-examined on the subject of his prefiled testimony and on the issue of management imprudence generally. Over 200 pages of the hearing transcript are devoted to cross-examination questions and answers.

[Tr. 49-272] In the summary of his prefiled testimony given at the hearing, Mr. McCrary said:

> That is not to say that the Commission should not examine the events of the past; it should. But in the context of this rate case the question is have the events of the past impacted the rates and reliability of our service, and have sufficient measures been taken to reasonably assure that these events will not reoccur? [Tr. 49-50]

While the attorney for Public Counsel was questioning Mr. McCrary about Gulf's receipt of a 10-basis-point reward on its equity return for superior management in a prior rate case, Commissioner (then Chairman) Wilson interjected, after Mr. McCrary said a reward was appropriate but a penalty unjustified:

> CHAIRMAN WILSON: May I inquire? Does that mean a as a matter of principle that, if a company demonstrates superior management, it should be rewarded; but if it demonstrates deficient management, it should not be penalized?
>
> WITNESS McCRARY: No, sir, I didn't say that. . . .
>
> CHAIRMAN WILSON: Ignoring for the moment the specific facts of any prior rate case or the current rate case, but as a matter of general principle, should a company be rewarded for superior management?
>
> WITNESS McCRARY: If there are specific measures which can determine that, I think they should, yes.
>
> CHAIRMAN WILSON: All right. By the same token, should a Company be penalized for poor management?
>
> WITNESS McCRARY: If there are specific measures to determine that, I would have no objection to that. [Tr. 57-58]

Shortly thereafter, the following exchange took place between Mr. McCrary and Mr. Burgess for the Public Counsel's office:

> Q. [by Mr. Burgess]: [I]f the Commission finds that there has been mismanagement, you do think there should be a penalty?

A: Well, that, of course, is the prerogative of the Commission. I don't think there should be a penalty in this case. [Tr. 60-61].

The Commission exercised its prerogative, based on evidence of record, and reduced Gulf's equity return for a two-year period.

SUMMARY OF ARGUMENT

The appropriate rate of return on equity to be allowed by a utility commission is a matter of economic judgment based on future expectations. These expectations are reflected in the inclusion of known and projected expenses and other economic factors in a selected test year. Consideration of mismanagement as a factor in the Commission's rate-setting was a proper means of accounting for prospective market expectations. The Commission, therefore, did not abuse its discretion or violate the essential requirements of law in this case.

Article I, Section 18 of the Florida Constitution prohibits an agency from improperly penalizing wrongdoing. Since rate adjustment is remedial in nature and not a penalty for wrongdoing, the Florida Constitution does not prohibit the Commission's action in this case. Gulf has confused the quasi-legislative, price-setting "penalty" imposed by the PSC with the quasi-judicial, punitive penalties referenced in the constitution.

ARGUMENT

I.

THE PUBLIC SERVICE COMMISSION MAY REDUCE AN ELECTRIC UTILITY'S ALLOWED RETURN ON EQUITY FOR MISMANAGEMENT AS PART OF THE RATE-SETTING PROCESS.

Utility commissions serve several distinct functions. Their underlying purpose is to simulate competition in the rate-setting process by providing a marketplace surrogate for industries permitted to operate as monopolies. This role is forward-looking and quasi-legislative in nature.[2] It is an exercise of the police power to protect the public health, safety and welfare. § 366.01, Fla. Stat. (1989). The process culminates in an order establishing the economic relationship between a utility and its customers for the future. To this end, the agency may discipline prices in the same manner as the market; efficiency is rewarded and inefficiency is penalized over future periods.[3]

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[2]See United Telephone Company v. Mayo, 345 So.2d 648, 654 (Fla. 1977) ("The law is well established in this State that the matter of rate regulation is essentially one of legislative control. The fixing of rates is not a judicial function; hence our right to review the conclusion of the legislature or of an administrative body acting upon authority delegated by the legislature is limited."); Cooper v. Tampa Electric Company, 17 So.2d 785, 786 (Fla. 1944) ("[T]he power to prescribe rates for public utility service is a legislative prerogative which may be done directly or through a commission empowered to do so.").

[3]See United Gas Pipe Line Company v. Bevis, 336 So.2d 560, 564 (Fla. 1976) ("The State's regulation of commercial enterprise is generally a bilateral bargain. The enterprise gives up an unlimited right to compete in the marketplace and relinquishes, among other business prerogatives, the freedom to set its own prices. In exchange, the State guarantees (among other things) at least an opportunity to earn a reasonable return on capital and a forum in which to seek price adjustments."); Re Burlington

(continued...)

Use of the word "penalized" in this context is not improper, nor inconsistent with everyday usage. Perhaps the Commission's characterization of Gulf's return-on-equity adjustment as a penalty in Order No. 23573, at 7, was inartful given that Section 366.095, Florida Statutes (1989), which is not concerned with ratemaking, is entitled "Penalties." But use of the word does not, of itself, remove the adjustment from the quasi-legislative arena and invoke a punitive, retrospective process.

A rate of return is never guaranteed. Regulation only offers an opportunity for the common stockholder to earn a fair return after prudent expenses and debt service are met out of revenues. The estimation of a fair return has, accordingly, been recognized as an exercise of agency expertise. See Utilities, Inc. v. Florida Public Service Commission, 420 So.2d 331, 333 (Fla. 1st DCA 1982):

> [T]he fair and proper rate of return on equity capital for a utility of the type and size of appellant was not one susceptible to ordinary methods of proof; instead it was essentially a matter of opinion which necessarily had to be infused by policy considerations for which the PSC has special responsibility.

In United Telephone Company of Florida v. Mann, 403 So.2d 962, 966 (Fla. 1981), the Court explained the steps taken to arrive at an overall rate of return as follows:

> The method of calculating a rate of return is primarily based upon calculating the cost of investment capital. There are three main sources of investment

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[3](...continued)
Telephone Company, 73 PUR4th 209, 214 (Vt. Public Serv. Bd. 1986) ("Where a natural monopoly was determined to exist for the provision of an essential good, government often substituted economic regulation -- that is, price and rate of return regulation -- for the competitive marketplace.")

> capital: debt, preferred stock and common stock. The cost of the first two sources can be mathematically derived whereas the cost of common stock is a matter of economic judgment. Each of these costs expressed in terms of percentage is then multiplied by that particular source's capitalization ratio to achieve a weighted average. The sum of these weighted averages is the rate of return. After this figure is reached, the commission can make further adjustments to account for such things as accretion, attrition, inflation and management efficiency. [Emphasis added.]

Any adjustment the Commission might make for management efficiency would, in all likelihood, be characterized as a bonus, or reward, for competence or a penalty for inadequacy. Furthermore, the adjustment would necessarily take into consideration performance from prior periods. The modification, however, would still be part of a prospective, price-setting process.[4]

Utility commissions also serve a quasi-judicial function, levying fines for breaches of rules, orders and statutes.[5] This process involves the relationship between the utility and its regulator. Firms in the competitive environment are also subject to penalties imposed by various agencies governing such things as licensing and the manner in which goods and services are provided

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[4]In Hyman v. State, Dept. of Business Regulation, 431 So.2d 603, 605 (Fla. 3rd DCA 1983), the court observed that "[t]he over-ninety pages devoted to the word in 31A Words and Phrases 'Penalty' (1957) give eloquent witness to the wisdom of Justice Cardozo's remark that '"[p]enalty" is a term of varying and uncertain meaning.' Life and Casualty Ins. Co. v. McCray, 291 U.S. 566, 574, 54 S.Ct. 482, 486, 78 L.Ed. 987, 992 (1934)."

[5]For a general discussion of the history of the Public Service Commission and the Legislature's ability to delegate both legislative and judicial functions to it, see In re Advisory Opinion to the Governor, 223 So.2d 35 (Fla. 1969). See also Article V, Section 1, Florida Constitution ("Commissions established by law . . . may be granted quasi-judicial power in matters connected with their offices.")

to the public. A penalty of this nature is retrospective, depriving a business of earnings for infractions in the past. The penalty is independent of the return stockholders would otherwise earn from either real or simulated competition.

The Commission may impose fines for an electric utility's refusal to comply with, or willful violation of, any lawful rule or order, or of any provision of Chapter 366, pursuant to Section 366.095, Florida Statutes (1989). Unlike the rate-setting process, which may result in reduced rates or refunds to customers, fines levied by the PSC are paid into the State's General Revenue Fund. § 350.127, Fla. Stat. (1989). Rates cannot be reduced prospectively nor can excess rates from past periods be returned to customers under the provisions of Section 366.095.

This distinction served to differentiate between penalties and restitution in Hyman, supra, 431 So.2d at 603. In that case, the Third District Court of Appeal considered a rule adopted by the Division of Pari-Mutual Wagering. The rule required the owner of a race horse found to have been drugged to return his winnings. Id. at 604. The innocence of the owner was irrelevant. Id. The purse was distributed among other horse owners in relation to purses they would have received if the drugged thoroughbred had not run. Id. at 605. If the return of the purse were a penalty, payment would have to be made to the State, not to other owners. The court concluded the remedial nature of the rule served to distinguish it from a penalty for wrongdoing under Article I, Section 18 of the Florida Constitution. Id. at 604.

The difference between a penalty requiring payment to the State and a reduction in rates to customers points out the inconsistency in Gulf's basic position in this appeal. On the one hand, the utility contends that the Commission can only impose a penalty pursuant to its specific statutory authority under Section 366.095. On the other, it states in its Summary of Argument, at page 13, that it will make refunds to its customers if the Commission finds any impropriety in the other docket:

> Consistent with that statutory scheme, the PSC has instituted a proceeding to investigate whether the activities in question here adversely impacted upon Gulf Power's service or rates to its customers in the past. The Company has expressly agreed that it will make whatever refunds are found by the Commission to be required by any past adverse effect upon Gulf Power's rates or service. That is the appropriate remedy here -- not a massive, undifferentiated penalty imposed on the Company's future rates for past improprieties. [Emphasis by Gulf].

In other words, Gulf concedes the Commission's inherent authority to make adjustments in the rate-setting context, which is precisely what was done in Order No. 23573.

Contrary to Gulf's protestations, special significance cannot be attached to the creation of a special docket to evaluate managerial imprudence. The Commission had established a separate docket only because Gulf withdrew its 1988 rate filing. This action preserved the issue of mismanagement which would, otherwise, have been heard in the context of a rate case. The utility's rate filing in 1989 provided the occasion to return the issue to its original forum.

This is not the first time Gulf has appealed Commission action, claiming it is entitled to recover all its expenses and earn a fair return without regard to what might happen to a competitive firm. In Gulf Power Company v. Bevis, 296 So.2d 482, 487-88 (Fla. 1974), the Court responded as follows to the utility's claim that the Commission could not apportion the burden of a newly enacted state income tax between the company and its customers, because to do so would penalize the company by reducing its earned return:

> As pointed out by the Commission, it has considerable discretion and latitude in the rate-fixing process. In City of Miami v. Public Service Commission (Fla. 1968), 208 So. 2d 249, upon reviewing the statutes empowering the Commission to fix rates we concluded "these statutes repose considerable discretion in the Commission in the rate-making process."
>
> Although public utilities are in most instances monopolies and consequently governments fix their rates, it does not follow that they are wholly differentiated in respect to tax burdens from private corporations whose rates are unregulated. Assuming the "zone of reasonableness" of a utility's rate is just, there is latitude as in the case of a private corporation for it to earn, with the exercise of business incentive and enterprise and economy, profits sufficient to bear a fair share of the corporate income tax burden without deprivation or confiscation. Petitioners appear to want a guaranteed cost-plus arrangement in the rate-fixing process eliminating any sharing of this tax burden which unregulated corporations cannot altogether escape. Petitioners overlook that a fixed utility rate -- an estimated one -- which operates prospectively, if within the "zone of reasonableness" is very similar to the prices or charges that an unregulated corporation may reasonably require in the competitive market. The utility company and the unregulated company draw their sources of income from consumers. Neither one should expect to be able to "pass on" completely their tax burdens to their patrons or consumers without some impact on their profits. The Commission's rule realistically recognizes the inevitable necessity of both the regulated and the unregulated corporate entity sharing tax burdens from their profits.

Later, in Gulf Power Company v. Florida Public Service Commission, 453 So.2d 799, 801 (Fla. 1984), the Court rejected the utility's contention that an adjustment reducing rate base for unused capacity actually impaired its earned rate of return:

> Gulf raises the following argument[] in its appeal . . . that the commission's denial of rates that will produce a reasonable rate of return for Gulf Power Company constitutes confiscation in violation of the fifth and fourteenth amendments of the Constitution of the United States, articles I and X of the Constitution of the State of Florida, section 366.041, Florida Statutes (1981), and exceeds its authority. We disagree with appellant's assertions and affirm the order of the PSC.

Any disallowance of expenses actually incurred or investment actually made impairs a utility's earned rate of return. In Gulf's view, such adjustments would constitute penalties in contravention of Article I, Section 18, Florida Constitution, and Section 366.095, Florida Statutes (1989). Yet, the Court has repeatedly upheld the Commission's adjustments and disallowances. Furthermore, in each case, the action was taken within the ratemaking process, thus affecting the economic relationship of the utility and its customers. See, e.g., Gulf Power Company v. Florida Public Service Commission, 487 So.2d 1036 (Fla. 1986) and Florida Power Corporation v. Cresse, 413 So.2d 1187 (Fla. 1982) (ordering customer refunds because managerial imprudence caused fuel costs to be excessive).

Gulf has chosen, for its own purposes, to confuse the quasi-legislative, price-setting "penalty" imposed by the PSC with the quasi-judicial, punitive penalties referenced in Article I, Section 18 of the Florida Constitution, and Section 366.095, Florida

Statutes (1989). Acceptance of the utility's arguments would require the Court to conclude that the PSC's ratemaking authority is severely circumscribed, that even the most inefficient electric utility must be given the opportunity to earn for its shareholders what the most efficient utility is entitled to. Moreover, in Gulf's view, inefficiency can never be recognized unless particular acts are found to be violative of specific rules, orders or statutes.

In support of its position, Gulf cites (Initial brief, at 16) to Florida Telephone Corporation v. Carter, 70 So.2d 508 (Fla. 1954), which held that the Commission could not deny a rate increase as a penalty for inadequate service. However, that case was followed by United Telephone Company of Florida v. Mayo, 215 So.2d 609 (Fla. 1968), cert. dism. 22 L.Ed.774, 394 U.S. 995, 89 S.Ct. 1589. In this latter case, the Court upheld the Commission's refusal to grant a rate increase until improvements planned by the utility were finished:

> Squarely in the path of those who would oppose the ruling by the Commission is Fla.Stat. § 366.041 (1967), F.S.A., Ch. 67-326, Laws of Florida, which plainly authorizes what was done in this case. [Quotation from statute omitted.]

The Court noted that Section 366.041 was enacted after its decision in Florida Telephone, and "for ought we know, was intended to overcome that decision." 215 So.2d at 610. The company's attack on constitutional grounds -- denial of requested rate relief as a taking without due process -- was considered "unusual" and rejected by the court. Id. The statutory language relied on by the Court

appears today, virtually unchanged, in Section 366.041, Florida Statutes (1989).[6]

The Court addressed both Florida Telephone and United Telephone v. Mayo in Askew v. Bevis, 283 So.2d 337 (Fla. 1973). In that case the Court upheld the Commission's decision to authorize a rate increase but subject it to a bonding requirement so refunds could be ordered if service was not improved. Id. at 341. The Court found that the Commission was authorized but not required to withhold a rate increase if service was unsatisfactory under United Telephone v. Mayo. Id. at 339. The Court noted that the Legislature had responded to its decision in Florida Telephone by granting additional powers and greater flexibility to the Commission by adopting Section 366.041 (1967). Id. at 340.

This line of cases continued with North Florida Water Company v. Bevis, 302 So.2d 129, 130 (Fla. 1974):

> While Section 366.041, Florida Statutes, provides that no public utility shall be denied a reasonable rate of return, it in no manner compels the Commission to grant a rate increase where the applicant's existing service is shown to be inefficient. See United Telephone Company of Florida v. Mayo, 215 So.2d 609 (Fla. 1968).
>
> Our holding in Askew v. Bevis, 283 So.2d 337 (Fla. 1973), decided subsequent to the United Telephone Company case is not controlling. . . . To hold that Askew v. Bevis, supra, inflexibly mandates a 'fair return' increase no matter how extensive the applicant utility's

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[6]Although Chapter 366, generally, applies to electric and gas utilities, Section 366.041(3) provides that "[t]he term 'public utility' as used herein means all persons or corporations which the commission has the authority, power, and duty to regulate for the purpose of fixing rates and charges for services rendered and requiring the rendition of adequate service." On this basis, it has been found to be applicable in the cited telephone and water utility cases.

service defects, would be improper and contrary to statutory guidelines.

Together, these cases stand for the proposition that the passage in Section 366.041 that "no public utility shall be denied a reasonable rate of return upon its rate base" does not limit the Commission's authority to withhold rate relief in the face of management deficiencies. If the Commission can withhold rate relief altogether, it can certainly reduce rates for a limited period of two years.

The Court's decision in Deltona Corporation v. Mayo, 342 So.2d 510 (Fla. 1977) (Gulf's initial brief, at 17-18), does no violence to this interpretation. Deltona Corporation was engaged in the business of residential property development. Id.at 511. Deltona Utilities was a separate operating division providing water and sewer utility service in the corporation's residential communities. Id. The Commission ordered adjustments to the utility's rate base for what the Commission considered to be false representations by the corporation to home buyers. Id. at 512. The Court concluded that the Commission lacked the statutory authority to rectify perceived violations of land sale law, and quashed the order. Id.

This decision highlights the fact that a business in the competitive environment may suffer in the marketplace and still be subject to punitive action for statutory violations. If the sales representations were, in fact, false, Deltona would be expected to suffer reduced earnings prospectively independent of any penalties imposed by a court or state agency. Similarly, the Commission, acting as a surrogate for competition in Gulf's rate case, could

adjust the utility's prices in its quasi-legislative role. It might also impose a fine in its quasi-judicial capacity if statutory violations existed. Unlike Deltona Corporation's land sales, the Commission does not lack for jurisdiction over prices charged by Gulf.

This is where Gulf's "expressio unius" argument (Initial brief, at 18) misses the mark. Setting rates for Gulf is an exercise of the police power pursuant to Section 366.01. The standard to be applied to the Commission's action is therefore one of reasonableness, not strict construction. In North Broward Hospital District v. Mizell, 148 So.2d 1, 4 n. 11 (Fla. 1962), the Court quoted with approval from 1 Am.Jur.2d, Administrative Law, Section 116, as follows:

> 'The general rule, which requires an express standard to guide the exercise of discretion is also subject to the exception that where it is impracticable to lay down a definite comprehensive rule, such as where regulation turns upon a question of personal fitness, or where the act relates to the administration of a police regulation and is necessary to protect the general welfare, morals, and safety of the public, it not essential that a specific prescribed standard be expressly stated in the legislation. In such situations, the courts will infer that the standard of reasonableness is to be applied."

See Florida Waterworks Association v. Florida Public Service Commission, 473 So.2d 237, 245 (Fla. 1st DCA 1985) (Quoting above standard with approval.) The determination of a fair equity return is a matter of economic judgment that amounts to an exercise of Commission discretion within the range of returns supported in the record. In this case, the 12.05% awarded to Gulf for the first two

years is well within the 11.75% to 13.50% covered in expert testimony.

II.

A FAIR RATE OF RETURN IS BASED ON INVESTOR EXPECTATIONS WHICH NECESSARILY TAKES INTO CONSIDERATION PAST PERFORMANCE OF MANAGEMENT.

Utility regulation allows Gulf to recover all its prudent expenses and provides an opportunity to earn a fair return on its assets used and useful in the provision of service to its customers. Stated differently, rates will be set to provide sufficient revenues to cover prudent expenses with enough left over to cover interest on debt obligations and an opportunity to earn a fair return for the common stockholders. Gulf's cost-of-capital witness, Dr. Morin, stated it as follows:

> Under the traditional regulatory process, a regulated company's rates should be set so that the company covers its costs, including taxes and depreciation, plus a fair and reasonable return on its invested capital. [Tr. 1668]

The test year is an analytic tool to quantify expenses and investment for a representative period that will be indicative of future periods. Whether historic or projected, the test year is based on the past. "Rate base" measures the investment in long-term assets devoted to utility service in terms of original cost less accumulated depreciation, i.e., actual historic investment less the sum of depreciation charges in prior periods. Even

projected expenses are evaluated for reasonableness in terms of historic levels.[7]

Since rates are set for the future, the Commission cannot include in the test year expenses incurred in past periods that will not affect future operations, nor may it ignore expenses that are reasonably expected to affect future revenues. See, e.g., Florida Bridge Company v. Bevis, 363 So.2d 799, 801 (Fla. 1978) ("We have held that the Commission has discretion in rate-making proceedings to remove from a test year computation items which are non-recurring in nature.) The issue of out-period-adjustments, however, has never been construed to include consideration of the fair return to stockholders. Regardless of how expenses are quantified and investment is measured, the rate of return is a matter of economic judgment based on investor expectations. In Gulf's case the question would be: What return would investors in a competitive enterprise with similar risks expect to earn if the company had recently suffered the same experiences as Gulf's management?

Dr. Morin testified on the subject of investor expectation as follows:

> Investor return requirements are determined by the rates at which investors are discounting expected future

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[7]When asked why Gulf found it necessary to seek a rate increase, the utility's Vice President-Finance, Mr. Scarborough, answered in terms of the effects of historic events: "[T]he Company has expended more than $476 million for plant facilities necessary to serve our customers since our last rate increase. Also, the Company has incurred significant increases in operating and maintenance expenses, primarily due to inflation and customer growth. . . ." [Tr. 297-98]

> cash flows from Gulf or from companies of similar risk. [Tr. 1670]
>
> * * *
>
> The value of any security to an investor is the expected discounted value of the future stream of dividends or other benefits. [Tr. 1676]
>
> * * *
>
> Several studies in the academic finance literature demonstrate that growth forecasts made by security analysts are reasonable indicators of investor expectations, and that investors rely on analysts' forecasts and not just on historical growth rates. Studies of historical growth rates may be used by investors along with analysts' growth forecasts to assess the expected long-run growth rate of future dividends, insofar as they affect investor anticipations. [Tr. 1692]

Accordingly, the issue is not whether Gulf's managerial problems existed in the past, but whether such problems could affect investor expectations for the future. This is completely consistent with the forward-looking nature of ratemaking.

The proscription against retroactive ratemaking generally comes into play only with respect to a utility's earnings in prior periods. This is the reason the quote in Gulf's initial brief, at 23, to Los Angeles Gas & Electric Corporation v. Railroad Commission, 289 U.S. 287, 313, 53 S.Ct. 637, 647 (1943), speaks of "[d]eficits in the past" and "past profits." This means that, because ratemaking is legislative, future rates cannot be inflated to reimburse for past underearnings, nor can they be reduced to recover excessive profits. See Citizens of the State of Florida v. Florida Public Service Commission, 448 So.2d 1024, 1027 (Fla. 1984); City of Miami v. Florida Public Service Commission, 208 So.2d 249, 259 (Fla. 1968).

This, however, has nothing to do with the fact that the matters affecting Gulf's allowed return on equity for the next two

years occurred in the past; future expectations are always based on history. The Commission's action in this case is no different than that upheld by the Court in Gulf Power Company v. Cresse, 410 So.2d 492, 494 (Fla. 1982), in which the Court concluded that a ten basis-point increase in Gulf's allowed return on equity based on conservation efforts in the past did not violate the essential requirements of law or amount to an abuse of discretion.

CONCLUSION

In its function as a surrogate for market competition, the Commission has set Gulf Power Company's rates to reflect the effect of corporate mismanagement on the future expectations of investors. Without a clear showing of abuse of discretion or a violation of the essential requirements of law, this court must affirm the Commission's final action. Therefore, Citizens request the court to uphold the Commission's Order Number 23573 as a proper exercise of its statutory authority to set rates for regulated monopolies.

Respectfully submitted,

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CERTIFICATE OF SERVICE
CASE NO. 77,153

I HEREBY CERTIFY that a true and correct copy of the ANSWER BRIEF OF APPELLEES, CITIZENS OF THE STATE OF FLORIDA and APPENDIX (separately bound), has been furnished by U.S. Mail or by *hand-delivery to the following parties on this 14th day of March, 1991.

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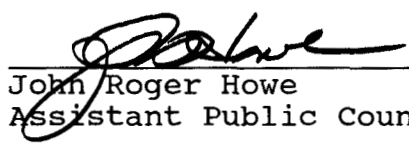

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