BEFORE THE
FLORIDA PUBLIC SERVICE COMMISSION

In the Matter of:

DOCKET NO. 160021-EI

PETITION FOR RATE INCREASE BY FLORIDA POWER & LIGHT COMPANY.
_______________________________/

DOCKET NO. 160061-EI

PETITION FOR APPROVAL OF 2016-2018 STORM HARDENING PLAN BY FLORIDA POWER & LIGHT COMPANY
_________________________________/

DOCKET NO. 160062-EI

2016 DEPRECIATION AND DISMANTLEMENT STUDY BY, FLORIDA POWER & LIGHT COMPANY.
________________________________/

DOCKET NO. 160088-EI

PETITION FOR LIMITED PROCEEDING TO MODIFY AND CONTINUE INCENTIVE MECHANISM, BY FLORIDA POWER & LIGHT COMPANY.
_________________________________/

CORRECTED
VOLUME 26
PAGES 3176 - 3682

PROCEEDINGS: HEARING

COMMISSIONERS PARTICIPATING:
CHAIRMAN JULIE I. BROWN
COMMISSIONER LISA POLAK EDGAR
COMMISSIONER ART GRAHAM
COMMISSIONER RONALD A. BRISÉ
COMMISSIONER JIMMY PATRONIS

DATE: Monday, August 29, 2016

TIME: Commenced at 2:55 p.m.
Concluded at 7:45 p.m.

PLACE: Betty Easley Conference Center
Room 148
4075 Esplanade Way
Tallahassee, Florida

SEE NEXT PAGE FOR EXPLANATION

REPORTED BY: DEBRA KRICK
Court Reporter
(850) 894-0828

APPEARANCES: (As heretofore noted.)

CORRECTED TO INCLUDE DIRECT TESTIMONY OF RANDALL WOOLRIDGE INADVERTENTLY OMITTED IN ORIGINALLY FILED VOLUME 26

PREMIER REPORTING
114 W 5TH AVENUE
TALLAHASSEE, FLORIDA
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I N D E X

WITNESSES

EXHIBITS

NUMBER:		ID	ADMTD
166-179			3309
710		3181	3313
711	10	3185	~~3185~~
149-162			3437
712		3427	3439
713		3440	
714		3444	
715		3447	
180-188			3530
179			3588
716		3592	
193-197			3668

P R O C E E D I N G S

(Transcript follows in sequence from Volume 25.)

CHAIRMAN BROWN: Would you like us to label that for identification purposes?

MR. DONALDSON: Yes.

CHAIRMAN BROWN: Okay. We are going to label that as Exhibit 710.

MR. DONALDSON: And you can disregard where it says Lawton. It should be really for all of -- all of OPC's witnesses.

CHAIRMAN BROWN: It says Dismukes. Is says Dismukes. Is that the right one?

MR. DONALDSON: They may be handing out the wrong one.

MS. BROWNLESS: Okay. I am totally confused, I am so sorry. I don't --

CHAIRMAN BROWN: This is a Public Counsel's exhibit. Yes. That's okay.

MR. MOYLE: I assume these are impeachment.

MS. BROWNLESS: I have got an exhibit that says Dismukes.

CHAIRMAN BROWN: Yeah, don't worry. Staff is collecting those. Those are the incorrect ones. And Mr. Donaldson is making sure we have the

correct ones.
All right. Don't worry -- no worries.
Thanks, all right. So it says Lawton, so --
MR. DONALDSON: And it's really for all of the witness -- all of OPC's witnesses. So I apologize for that -- that scrivener's error.
CHAIRMAN BROWN: Okay. So we are going to label this -- the exhibit that is being passed out to everybody, we are going to label it as -- number it as Exhibit 710, and it's titled OPC's responses to FPL's first request for admissions. And we will have that marked as such.
(Whereupon, Exhibit No. 710 was marked for identification.)
MS. BROWNLESS: This is witness Woolridge, is that correct?
CHAIRMAN BROWN: He said it applies to all of OPC's witnesses. Got it?
MR. DONALDSON: And just as a matter of record, Madam Chair. Under Florida Statute 90.803, subsection 18, which talks about admissions, these are statements by a party opponent and don't need to be really authenticated by anyone. And they actually just are able to be entered into the record as a matter of law, subject to your

discretion. But most of the cases that typically deal with this, there is a Florida Supreme Court case, 327 So.2d 192, it's Hunt versus Seaboard Coastline, which essentially stands for the proposition that any admission by a party opponent can be entered into the record as evidence, and so that's what we are seeking to do at this point in time so that it when it comes to cross-examination, we can certainly question OPC's witnesses to statements and admissions that themselves, as a party, has made in this record.

CHAIRMAN BROWN: Thank you, Mr. Donaldson.

Okay. Any other housekeeping items before Mr. Woolridge goes?

MR. MOYLE: I guess I would just object on these coming in to the extent that they contain --

CHAIRMAN BROWN: They are not coming in right now.

MR. MOYLE: Okay.

CHAIRMAN BROWN: OPC, it's your floor.

MR. SAYLER: Thank you, Madam Chair.

Whereupon,

J. RANDALL WOOLRIDGE

was called as a witness, having been previously duly sworn to speak the truth, the whole truth, and nothing but the truth, was examined and testified as follows:

EXAMINATION

BY MR. SAYLER:

Q Good afternoon, Dr. Woolridge, how are you today?

A Good afternoon.

Q We heard earlier that you are a Penn State --

A Yes.

Q -- that you are Penn State.

All right. You were previously sworn, is that correct?

A I was.

Q All right. An would you please state your name and business address for the record?

A My name is initial J. Randall Woolridge, and spelled W-O-O-L-R-I-D-G-E. 120 Haymaker Circle, State College, Pennsylvania.

Q And have you prepared and caused to be filed 93 pages of direct testimony, along with an Appendix A and B to your testimony in this proceeding?

A I have.

Q All right. And on August 5th, 2016, the Office of Public Counsel filed two replacement pages to your direct testimony, is that correct?

A Yes.

Q And beyond those changes in your replacement pages, do you have any further changes or revisions with these your prepared testimony?

A No.

MR. SAYLER: Madam Chair, I do have a copy for the court reporter of the changes to his testimony if necessary, so --

CHAIRMAN BROWN: Thank you. Please -- please provide those to her.

And, Dr. Woolridge, I am so sorry I called you Mister.

THE WITNESS: That's okay.

CHAIRMAN BROWN: My apologies.

THE WITNESS: Thank you.

MS. BROWNLESS: Madam Chair, may I just ask, are -- normally what we have been doing with the errata sheets is marking them as an exhibit and providing copies to all the parties, is that -- does Public Counsel intend to good that?

CHAIRMAN BROWN: Mr. Sayler.

MR. SAYLER: I hadn't for Dr. Woolridge, but we can certainly do that. If it's your pleasure, let's mark that, and I will make sure an errata -- or these sheets are copied and presented later on in this proceeding, because we had filed them with all the parties several weeks ago, that's why I didn't do an errata sheet at this time, but I am happy to do so.

CHAIRMAN BROWN: Is that the pleasure of staff?

MS. BROWNLESS: I believe that would keep the record straight.

CHAIRMAN BROWN: Okay. So what I am going to do is label it, and you will provide that to all the parties, Exhibit 711 --

MR. SAYLER: All right.

CHAIRMAN BROWN: -- will be labeled as Woolridge errata.

MR. SAYLER: Thank you, Madam Chair.

CHAIRMAN BROWN: You are welcome.

(Whereupon, Exhibit No. 711 was marked for identification.)

MR. GUYTON: May I inquire as to what pages are being substituted?

CHAIRMAN BROWN: Mr. Sayler.

MR. SAYLER: Yes. On August 5th, we e-mailed to all the parties this change. We substituted the table of contents page to clarify that JRW-1 exhibit was revised. We substituted page four of

Dr. Woolridge's direct testimony, line five of page four, after it says "my recommended ROE for the company is 18.75", this was added "as shown on JRW-1 revised", and we then circulated to the parties the revised JRW-1 exhibit.

MR. GUYTON: Thank you.

CHAIRMAN BROWN: Mr. Sayler, please proceed. Where are you going?

MR. SAYLER: And when we get to the exhibits part, we also revised his Exhibit JRW-4, which was e-mailed to the parties on August 15th, but that will also be part of that same errata.

CHAIRMAN BROWN: Okay.

MR. SAYLER: All right.

CHAIRMAN BROWN: Please proceed.

BY MR. SAYLER:

Q Dr. Woolridge, with those changes, if I asked you the same questions contained in your direct testimony, would your answers be the same?

A Yes.

Q All right.

MR. SAYLER: Madam Chair, I would ask that his testimony be inserted into the record as though read.

CHAIRMAN BROWN: Okay. We will insert Mr. --

Dr. Woolridge's testimony into the record as though read.

MR. SAYLER: All right.

(Prefiled direct testimony inserted into the record as though read.)

DIRECT TESTIMONY

OF

J. RANDALL WOOLRIDGE

On Behalf of the Office of Public Counsel

Before the

Florida Public Service Commission

Docket No. 160021-EI, et al (consolidated)

I. IDENTIFICATION OF WITNESS AND PURPOSE OF TESTIMONY

Q. PLEASE STATE YOUR FULL NAME, ADDRESS, AND OCCUPATION.

A. My name is J. Randall Woolridge, and my business address is 120 Haymaker Circle, State College, PA 16801. I am a Professor of Finance and the Goldman, Sachs & Co. and Frank P. Smeal Endowed University Fellow in Business Administration at the University Park Campus of Pennsylvania State University. I am also the Director of the Smeal College Trading Room and President of the Nittany Lion Fund, LLC. A summary of my educational background, research, and related business experience is provided in Appendix A.

A. Overview

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. I have been asked by the Florida Office of Public Counsel ("OPC") to provide an opinion as to the appropriate return on equity for Florida Power & Light Company ("FPL" or

"Company") and to evaluate FPL's rate of return testimony in this proceeding.

Q. HOW IS YOUR TESTIMONY ORGANIZED?

A. First, I review my cost of equity recommendation for FPL, highlight several factors that have changed since the Company's last rate case, and discuss the primary areas of contention between FPL's rate of return position and my position. Second, I provide an assessment of capital costs in today's capital markets. Third, I discuss the selection of a proxy group of electric utility companies for estimating the market cost of equity for FPL. Fourth, I discuss the relationship between a utility's capital structure and the return on equity that should be associated with that capital structure. Fifth, I provide an overview of the concept of the cost of equity capital, and then estimate the equity cost rate for FPL. Finally, I critique the Company's rate of return analysis and testimony.

Q. WHAT COMPRISES A UTILITY'S "RATE OF RETURN"?

A. A company's overall rate of return consists of three main categories: (1) capital structure (i.e., ratios of short-term debt, long-term debt, preferred stock and common equity); (2) cost rates for short-term debt, long-term debt, and preferred stock; and (3) common equity cost, otherwise known as return on equity ("ROE").

Q. WHAT IS A UTILITY'S ROE INTENDED TO REFLECT?

A. An ROE is most simply described as the allowed rate of profit for a regulated company. In a competitive market, a company's profit level is determined by a variety of factors, including the state of the economy, the degree of competition a company faces, the ease of entry into its markets, the existence of substitute or complementary products/services, the company's cost structure, the impact of technological changes, and the supply and demand for its services and/or products. For a regulated monopoly, the regulator determines the level of profit available to the utility. The United States Supreme Court established the guiding principles for establishing an appropriate level of profitability for regulated public utilities in two cases: (1) *Bluefield* and (2) *Hope*.[1] In those cases, the Court recognized that the fair rate of return on equity should be: (1) comparable to returns investors expect to earn on investments with similar risk; (2) sufficient to assure confidence in the company's financial integrity; and (3) adequate to maintain the company's credit and to attract capital.

Thus, the appropriate ROE for a regulated utility requires determining the market-based cost of capital. The market-based cost of capital for a regulated firm represents the return investors could expect from other investments, while assuming no more and no less risk. The purpose of all of the economic models and formulas in cost of capital testimony (including those presented later in my testimony) is to estimate, using market data of similar-risk firms, the rate of return equity investors require for that risk class of firms in order to set an appropriate ROE for a regulated firm.

Q. PLEASE REVIEW THE COMPANY'S PROPOSED RATE OF RETURN.

A. The Company has proposed a capital structure from investor-provided capital of 40.40% long-term debt and 59.60% common equity. FPL witness Robert B. Hevert has

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[1] *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*") and *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) ("*Bluefield*").

recommended a common equity cost rate of 11.0% for FPL.

Q. WHAT ARE YOUR RECOMMENDATIONS REGARDING THE APPROPRIATE RATE OF RETURN FOR FPL?

A. My recommended ROE for the Company is 8.75%, as shown on JRW-1 (Revised). This equity cost rate is based on OPC witness Kevin O'Donnell's capital structure. This figure is at the upper end of my equity cost rate range of 7.90% to 8.85%. If the Commission were to adopt the Company's recommended capital structure with a 59.60% common equity ratio, a ROE below 8.75% would be appropriate.

To estimate an equity cost rate for the Company, I have applied the Discounted Cash Flow Model ("DCF") and the Capital Asset Pricing Model ("CAPM") to my proxy group of electric utilities ("Electric Proxy Group"). I have also used Mr. Hevert's proxy group ("Hevert Proxy Group") for purposes of comparison to my Electric Proxy Group analysis. Mr. Hevert has also employed an alternative risk premium ("RP") approach, which he calls the Bond Yield Plus Risk Premium approach. I have reviewed the Company's proposed capital structure and overall cost of capital. FPL's proposed capitalization has much more equity and much less financial risk than the average current capitalizations of electric utility companies. OPC witness O'Donnell presents OPC's capital structure position, which includes a capital structure with a common equity ratio of 50.00%.

B. Since FPL's Last Rate Case

Q. PLEASE REVIEW THE COMMISSION'S ORDER IN FPL'S LAST RATE CASE.

A. On January 14, 2013, the Commission issued Order No. PSC-13-0023-S-EI approving the revised stipulation and settlement ("Settlement") between parties in Docket No. 120015-EI. The Settlement, dated August 15, 2012, was between FPL and the Florida Industrial Power Users Group ("FIPUG"), the South Florida Hospital and Healthcare Association ("SFHHA") and the Federal Executive Agencies ("FEA"). OPC did not sign on to the Settlement, which included a rate increase of $350 million and a ROE of 10.5%.

Q. WHAT HAS CHANGED IN CAPITAL MARKETS SINCE 2012?

A. Interest rates and capital costs have decreased in reaction to Federal Reserve monetary policy and changes in the economy. The Federal Reserve has made some significant monetary policy moves, including its Quantitative Easing III ("QEIII") program in September of 2012.[2] Over the next two years, the economy improved, and at its October 2014 meeting, the Federal Open Market Committee ("FOMC") announced a scheduled winding down of the QEIII program. Subsequently, in December 2015, the Federal Reserve increased its target rate for federal funds to a range of 0.25-0.50 percent from 0.0-0.25 percent.

[2] Under QEIII, the Federal Reserve extended its purchase of long-term securities to about $85 billion per month and kept its target for the federal funds rate between 0.0 to 0.25 percent.

Figure 1 shows the thirty-year Treasury yield over the 2013-2016 time period. The movement of long-term interest rates over this period has been driven primarily by slow economic growth and low inflation. During 2013, the thirty-year Treasury yield increased from 3.0% to 4.0% due to improvements in the economy and the speculation about Federal Reserve policy. The thirty-year Treasury yield subsequently decreased to below 2.5% due to continued slow economic growth and low inflation. Then, after increasing to above 3.0% in mid-2015, this yield has subsequently decreased to back below 2.5%.

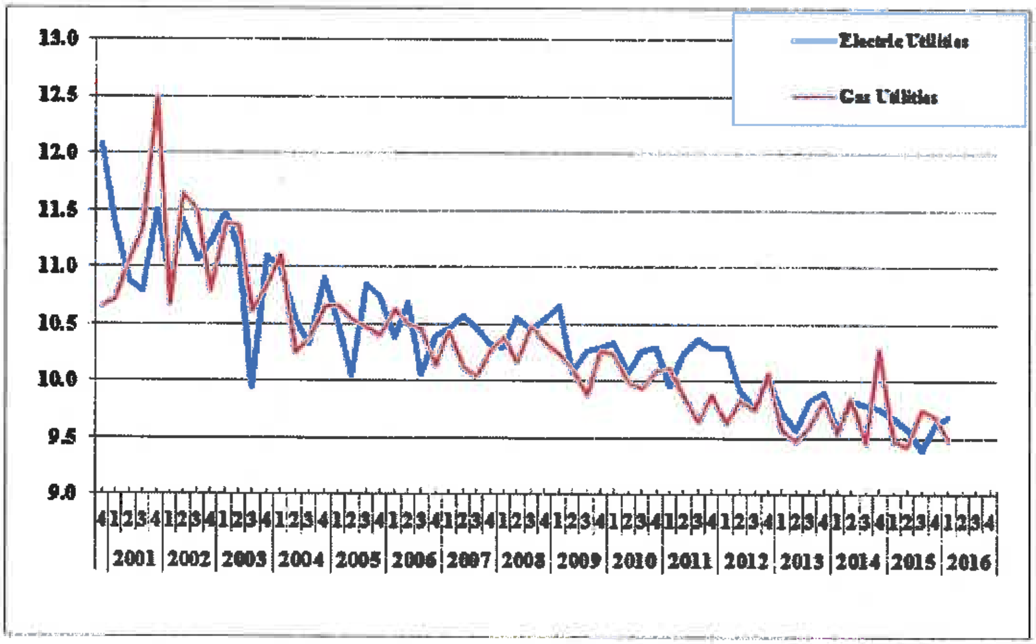
Figure 1
Thirty-Year Treasury Yield
2013-2016
Source: https://research.stlouisfed.org/fred2/series/DGS30

Q. HAVE THE AUTHORIZED ROEs FOR ELECTRIC UTILITIES AROUND THE NATION INCREASED OR DECREASED SINCE 2012?

A. Authorized ROEs for electric utilities throughout the United States have decreased since the Company's last rate case in 2012. As shown in Figure 2, these authorized ROEs have declined from 10.01% in 2012, to 9.80% in 2013, 9.76% in 2014, 9.58% in

2015, and 9.68% in the first quarter of 2016, according to Regulatory Research Associates.[3]

Figure 2
Authorized ROEs for Electric Utility and Gas Distribution Companies
2000-2016



Q. HAS FPL'S CREDIT RATING CHANGED SINCE 2012?

A. Yes. Moody's upgraded the long-term issuer credit rating for FPL in January 2014 from A2 to A1. This suggests that FPL's investment risk has declined. As discussed later in my testimony, electric utilities, on average, are rated Baa1 by Moody's. With a Company rating of A1 versus a Baa1 rating for other electric companies, FPL is rated three notches above other electric utilities.

Q. HOW HAS FPL PERFORMED SINCE THE COMPANY'S LAST RATE CASE?

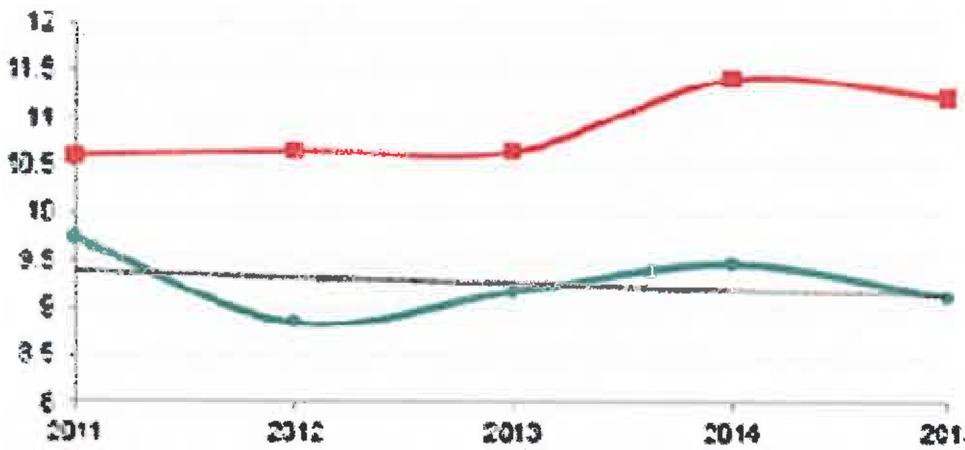
A. FPL has been one of the top performing electric utilities in the United States since its

[3] *Regulatory Focus*, Regulatory Research Associates, April 2016.

last rate case in terms of earned returns. Figure 3 shows the earned ROE for FPL versus the electric utility average from 2011-2015, as reported by Regulatory Research Associates ("RRA"). FPL's earned ROE has increased from 10.5% to about 11.5% since its last rate case.[4] On the other hand, the average earned ROE for RRA's electric utility universe has been about 9.0%.

Figure 3
Earned ROEs
FPL Versus Other Electric Utilities
2011-2015

Source: Regulatory Research Associates, "Florida Power & Light outperforms in RRA Quality Measures Subsidiaries study through year-end 2015", April 19, 2016.



Q. HAS FPL'S SUPERIOR PERFORMANCE BEEN REFLECTED IN THE STOCK PRICE OF ITS PARENT COMPANY – NEXTERA?

A. Definitely, NextEra Energy, Inc.'s ("NEE's") stock has significantly outperformed the stocks of other electric utilities, as well as the S&P 500. This is illustrated in Figure 4. Since 2013, NEE's stock price is up 74%, versus an increase of 48% for the Dow Jones Utilities Index ("DJU") and 41% for the S&P 500 ("GSPC").

[4] Regulatory Research Associates, "Florida Power & Light outperforms in RRA Quality Measures Subsidiaries study through year-end 2015", April 19, 2016.

Figure 4
Stock Performance of NEE, DJU, and S&P 500 (GSPC)
2013-2016
Source: https://finance.yahoo.com/

Furthermore, the authorized ROEs for distribution-only electric utilities have been about 20 basis points below those for vertically integrated electric utilities like FPL.

C. Summary of the Primary Rate of Return Issues in this Case

Q. PLEASE PROVIDE AN OVERVIEW OF THE ROE POSITIONS IN THIS PROCEEDING.

A. The primary issues related to the estimation of FPL's ROE include:

1. The Company's capital structure has much more equity and much less financial risk than other electric utilities, including those electric utilities used by Mr. Hevert in

estimating FPL's cost of equity capital. As noted above, OPC witness O'Donnell presents OPC's capital structure position;

2. Mr. Hevert's assessment of capital market conditions is flawed. In providing guidance on capital costs and in estimating FPL's ROE, he has relied upon economists' interest rate forecasts. Despite dire and unfounded predictions of rising interest rates over the past decade, long-term interest rates and capital costs are still at historically low levels. As I discuss below, there are strong indicators from my assessment study of global capital markets that long-term capital costs will remain low;

3. Mr. Hevert failed to recognize that FPL is less risky than other electric utilities and, therefore, investors require a lower, not a higher ROE;

4. Mr. Hevert has significantly changed his equity cost rate approach and testimony in this proceeding by erroneously giving primary weight to his CAPM and RP approaches and virtually no weight to his prior DCF-centered approach;

5. Beyond the changes in weight Mr. Hevert gives to his equity cost rate approaches in this proceeding, there are a number of errors in his DCF, CAPM, and RP approaches. These errors are addressed below; and

6. Mr. Hevert has included business risk considerations such as the Company's capital expenditure program, geography, and nuclear risk in assessing the relative riskiness of FPL in order to support his 11.0% ROE recommendation. All of these risk factors are already considered by rating agencies in determining the Company's credit ratings. Also, FPL's S&P and Moody's credit ratings of A- and A1 are above those of other electric utilities, including those companies in the two proxy groups.[5]

[5] It should be noted that whereas FPL and NextEra both are rated A- by S&P, Moody's has a higher credit rating for FPL (A1) than for NextEra (Baa1).

Q. PLEASE INITIALLY ADDRESS THE DIFFERENCES BETWEEN THE ALTERNATIVE ASSUMPTIONS REGARDING CAPITAL MARKET CONDITIONS BETWEEN YOUR EQUITY COST RATE ANALYSES AND MR. HEVERT'S.

A. Mr. Hevert and I have significantly different opinions regarding capital market conditions. Mr. Hevert's analyses and ROE results and recommendations reflect the assumption of higher interest rates and capital costs. These are the same assumptions and results that he has testified to in recent years. I review current market conditions and conclude that interest rates and capital costs are at historically low levels and are likely to remain low for some time. Moreover, I show that the interest rate forecasts used by Mr. Hevert have been wrong for a decade.

Q. TURNING TO THE ALTERNATIVE EQUITY COST RATE APPROACHES, WHAT ARE THE DIFFERENCES BETWEEN YOUR DCF MODEL AND MR. HEVERT'S DCF MODEL?

A. I have employed the traditional constant-growth DCF model. Mr. Hevert has also used this model, as well as a multi-stage growth version of the model. There are several issues with Mr. Hevert's DCF analyses: (1) in contrast to previous testimony in which Mr. Hevert gave primary weight to his DCF results, he has virtually ignored his constant-growth and multi-stage DCF results in arriving at his 11.0% ROE recommendation for FPL; (2) notwithstanding this change, there are errors with his constant-growth and multi-stage growth DCF analyses. These errors include: (a) he has relied exclusively on the overly optimistic and upwardly biased earnings per share

("EPS") growth rate forecasts of Wall Street analysts and *Value Line;* and (b) in his multi-stage DCF model, he has employed a terminal growth rate of 5.35%, which is excessive for a number of reasons, especially the fact that it is not reflective of prospective economic growth in the United States and is about 100 basis points above the projected long-term growth in U.S. Gross Domestic Product ("GDP"). On the other hand, when developing the DCF growth rate that I have used in my analysis, I have reviewed thirteen growth rate measures, including historical and projected growth rate measures, and have evaluated growth in dividends, book value, and earnings per share.

Q. PLEASE DISCUSS THE DIFFERENCES BETWEEN YOUR APPLICATION OF THE CAPM AND THAT OF MR. HEVERT.

A. The CAPM approach requires an estimate of the risk-free interest rate, beta, and the market or risk premium. There are two primary errors in Mr. Hevert's CAPM approach. First, Mr. Hevert has used a projected long-term Treasury yield that is more than 200 basis points above the current market rate. This forecast is extreme and significantly increases his CAPM and RP equity cost rates. However, the major area of disagreement involves the measurement and magnitude of the market risk premium. In short, Mr. Hevert's market risk premium is excessive and does not reflect current market fundamentals. As I highlight in my testimony, there are three methods for estimating a market or equity risk premium – historical returns, surveys, and expected return models. Mr. Hevert uses projected market risk premiums of 10.68% and 9.87%. Also, Mr. Hevert's projected market risk premiums use analysts' EPS growth rate projections to compute expected market returns and market risk premiums. These EPS growth rate projections and the resulting expected market returns and risk premiums include unrealistic assumptions regarding future economic and earnings growth and stock returns. I have used a market risk premium of 5.5%, which: (1) employs three different approaches to estimating a market premium; and (2) uses the results of many studies of the market risk premium. As I note, my market risk premium reflects the market risk premiums that were: (1) determined in recent academic studies by leading finance scholars; (2) employed by leading investment banks and management consulting firms; and (3) found in surveys of companies, financial forecasters, financial analysts, and corporate Chief Financial Officers ("CFOs").

Q. HAVE YOU EMPLOYED AN ALTERNATIVE RP MODEL?

A. No. The CAPM is a form of the RP model, so I believe that using another form of the RP model is unnecessary. Nevertheless, Mr. Hevert has employed an alternative RP model.

Q. PLEASE DISCUSS THE ERRORS WITH MR. HEVERT'S ALTERNATIVE RP MODEL.

A. Mr. Hevert estimates an equity cost rate using an alternative RP model. His risk premium is based on the historical relationship between the yields on long-term Treasury yields and authorized returns on equity for electric utility companies. There are several issues with this approach. First and foremost, this approach is a gauge of regulatory commission behavior and not investor behavior. Capital costs are determined in the marketplace through the financial decisions of investors and are reflected in such fundamental factors as dividend yields, expected growth rates, interest rates, and investors' assessment of the risk and expected return of different investments. Regulatory commissions evaluate not only capital market data in setting authorized ROEs, but also take into account other utility and rate case-specific information in setting ROEs. As such, Mr. Hevert's RP approach and results reflect other factors used by utility regulatory commissions in authorizing ROEs in addition to capital costs. This is especially true when the authorized ROE data includes the results of rate cases that were settled and not fully litigated. Second, Mr. Hevert's methodology produces an inflated measure of the risk premium because his approach uses historical authorized ROEs and Treasury yields, and the resulting risk premium is applied to projected Treasury yields. Finally, the risk premium is inflated as a measure of investors' required risk premium since electric utility companies have been selling at market-to-book ratios in excess of 1.0. This indicates that the authorized rates of return have been greater than the return that investors require.

Q. ARE THESE ERRORS REFLECTED IN THE DIFFERENCES BETWEEN MR. HEVERT'S RP RESULTS AND THE AVERAGE STATE-LEVEL AUTHORIZED ROEs FOR ELECTRIC UTILITY COMPANIES NATIONWIDE?

A. Yes, they are. Mr. Hevert's RP equity cost rate estimates for electric utility companies range from 10.04% to 10.53%. These figures overstate actual state-level authorized ROEs. As shown above in Figure 2, the average authorized ROEs for electric utilities have declined from 10.01% in 2012, to 9.80% in 2013, 9.76% in 2014, 9.58% in 2015, and 9.68% in the first quarter of 2016, according to Regulatory Research Associates.[6]

Q. WHAT ARE OTHER DIFFERENCES BETWEEN YOUR EQUITY COST RATE ANALYSES AND MR. HEVERT'S?

A. One other difference involves a flotation cost adjustment to reflect prospective equity issues. Mr. Hevert has made an explicit ROE adjustment for equity flotation costs of 0.12%. He has not cited any current or prospective equity issues by FPL or its parent company, NextEra. Thus, the Company should not be rewarded with a higher ROE that includes unnecessary flotation costs that the subsidiary FPL does not expect to incur.

II. CAPITAL COSTS IN TODAY'S MARKETS

Q. WHY ARE CAPITAL MARKET CONDITIONS AND THE OUTLOOK FOR INTEREST RATES AND CAPITAL COSTS IMPORTANT IN THIS CASE?[7]

A. As discussed above, a company's rate of return is its overall cost of capital. Capital costs, including the cost of debt and equity financing, are established in capital markets and reflect investors' return requirements on alternative investments based on risk and capital market conditions. These capital market conditions are a function of investors' expectations concerning many factors, including economic growth, inflation, government monetary and fiscal policies, and international developments, among

[6] *Regulatory Focus*, Regulatory Research Associates, July 2015. The electric utility authorized ROEs exclude the authorized ROEs in Virginia, which include generation adders.
[7] A historic perspective on interest rates and capital costs is provided in Appendix B.

others. In the wake of the financial crisis, much of the focus in the capital markets has been on the interaction of economic growth, interest rates, and the actions of the Federal Reserve. In addition, as illustrated in the United Kingdom's June 23, 2016 vote to leave the European Union ("BREXIT"), capital markets are global, and capital costs are impacted by global events.

Q. WHAT IS MR. HEVERT'S ASSESSMENT OF THE CAPITAL MARKETS ENVIRONMENT?

A. In pages 52-65 of his testimony, Mr. Hevert discusses the capital markets environment. Mr. Hevert argues that market data and economists' projections indicate that long-term interest rates are going to increase.

Q. PLEASE EXPLAIN YOUR CONCERNS REGARDING MR. HEVERT'S CONCLUSION OF HIGHER LONG-TERM INTEREST RATES.

A. In the last couple years, with the end of the Federal Reserve's QEIII program and its December 16, 2015 decision to raise the federal funds rate, there have been forecasts of higher long-term interest rates. However, these forecasts have proven to be wrong. For example, after the announcement of the end of the QEIII program, all the economists in Bloomberg's interest rate survey forecasted that interest rates would increase in 2014, and 100% of the economists were wrong. According to a *Market Watch* article:[8]

> The survey of economists' yield projections is generally skewed

[8] Ben Eisen, "Yes, 100% of economists were dead wrong about yields", *Market Watch*, October 22, 2014. http://www.marketwatch.com/story/yes-100-of-economists-were-dead-wrong-about-yields-2014-10-21.

> toward rising rates — only a few times since early 2009 have a majority of respondents to the Bloomberg survey thought rates would fall. But the unanimity of the rising rate forecasts in the spring was a stark reminder of how one-sided market views can become. It also teaches us that economists can be universally wrong.

Two other financial publications have produced studies on how economists consistently predict higher interest rates, yet the economists have been wrong. The first publication, entitled "How Interest Rates Keep Making People on Wall Street Look Like Fools," evaluated economists' forecasts of the yield on ten-year Treasury bonds at the beginning of the year for the last ten years.[9] The results demonstrated that economists consistently predict that interest rates will go higher, and interest rates have not fulfilled those predictions.

The second study tracked economists' forecasts of the yield on ten-year Treasury bonds on an ongoing basis from 2010 until 2015.[10] The results of this study, which was entitled "Interest Rate Forecasters are Shockingly Wrong Almost All of the Time," are shown in Figure 5 and demonstrate how economists continually forecast that interest rates are going up; however, they do not. Indeed, as Bloomberg has reported, economists' continued failure in forecasting increasing interest rates has caused the Federal Reserve Bank of New York to stop using the interest rate estimates of professional forecasters in the Bank's interest rate model due to the unreliability of those forecasters' interest rate forecasts.[11]

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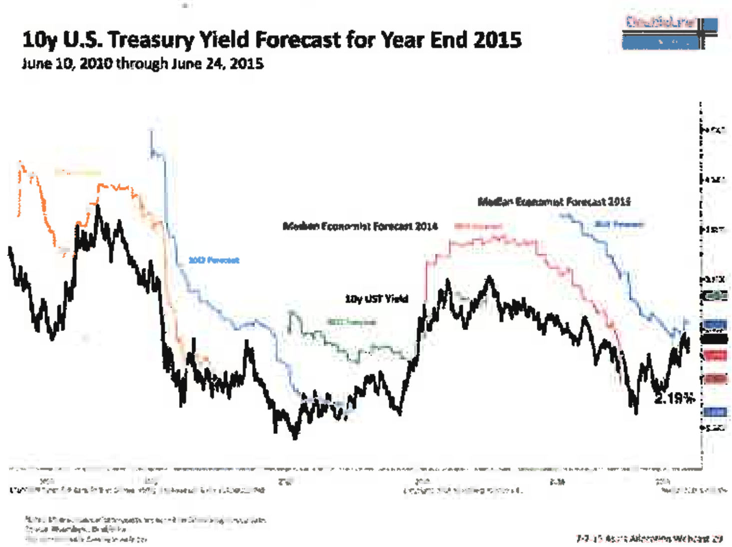
[9] Joe Weisenthal, "How Interest Rates Keep Making People on Wall Street Look Like Fools", Bloomberg.com, March 16, 2015. http://www.bloomberg.com/news/articles/2015-03-16/how-interest-rates-keep-making-people-on-wall-street-look-like-fools.

[10] Akin Oyedele, "Interest Rate Forecasters are Shockingly Wrong Almost All of the Time", *Business Insider*, July 8, 2015. http://www.businessinsider.com/interest-rate-forecasts-are-wrong-most-of-the-time-2015-7.

[11] Susanne Walker and Liz Capo McCormick, "Unstoppable $100 Trillion Bond Market Renders Models Useless", Bloomberg.com, June 2, 2014. http://www.bloomberg.com/news/articles/2014-06-01/the-unstoppable-100-trillion-bond-market-renders-models-useless

Figure 5
Economists' Forecasts of the Ten-Year Treasury Yield
2010-2015



Source: Akin Oyedele, "Interest Rate Forecasters are Shockingly Wrong Almost All of the Time", *Business Insider*, July 8, 2015. http://www.businessinsider.com/interest-rate-forecasts-are-wrong-most-of-the-time-2015-7.

Q. PLEASE REVIEW THE FEDERAL RESERVE'S DECISION TO RAISE THE FEDERAL FUNDS RATE IN DECEMBER 2015.

A. On December 16, 2015, the Federal Reserve decided to increase the target rate for Federal Funds to 0.25-0.50 percent. The federal funds rate is set by the Federal Reserve and is the borrowing rate generally only applicable to the most creditworthy financial institutions when they borrow and lend funds <u>overnight</u> to each other.[12] In the release, the FOMC included the following observations:[13]

> The Committee currently expects that, with gradual adjustments in the stance of monetary policy, economic activity will continue to expand at a moderate pace and labor market indicators will continue to strengthen. Overall, taking into account domestic and international developments, the Committee sees the risks to the outlook for both economic activity

[12] http://www.investopedia.com/terms/f/federalfundsrate.asp.

[13] Board of Governors of the Federal Reserve System, *FOMC Statement* (Dec. 16, 2015). https://www.federalreserve.gov/newsevents/press/monetary/20151216a.htm

> and the labor market as balanced. Inflation is expected to rise to 2 percent over the medium term as the transitory effects of declines in energy and import prices dissipate and the labor market strengthens further. The Committee continues to monitor inflation developments closely.

This increase comes after the range was kept in the 0.0 to 0.25 percent range for over five years in order to spur economic growth in the wake of the financial crisis. The move occurred almost two years after the end of QEIII program, the Federal Reserve's bond buying program. The Federal Reserve has been cautious in its approach to scaling its monetary intervention, and has paid close attention to a number of economic variables, including GDP growth, retail sales, consumer confidence, unemployment, the housing market, and inflation. While the Fed has cited improvements in many areas of the economy, it has also expressed concern with the low inflation rate, which is currently below the Fed's target of 2.0%.

Q. HOW DID LONG-TERM INTEREST RATES REACT TO THE FEDERAL RESERVE'S DECISION TO INCREASE THE FEDERAL FUNDS RATE?

A. The yields on long-term Treasury bonds decreased. The FOMC's decision to increase the federal funds rate range was highly anticipated in the markets. Nonetheless, as shown in the Figure 6, at the 2:00 p.m. announcement of the increase in the federal funds rate, the yield on 30-Year U.S. Treasury bonds actually decreased!

Figure 6
Intra-Day Thirty-Year Treasury Yields
December 16, 2015
Source: www.Yahoo.com

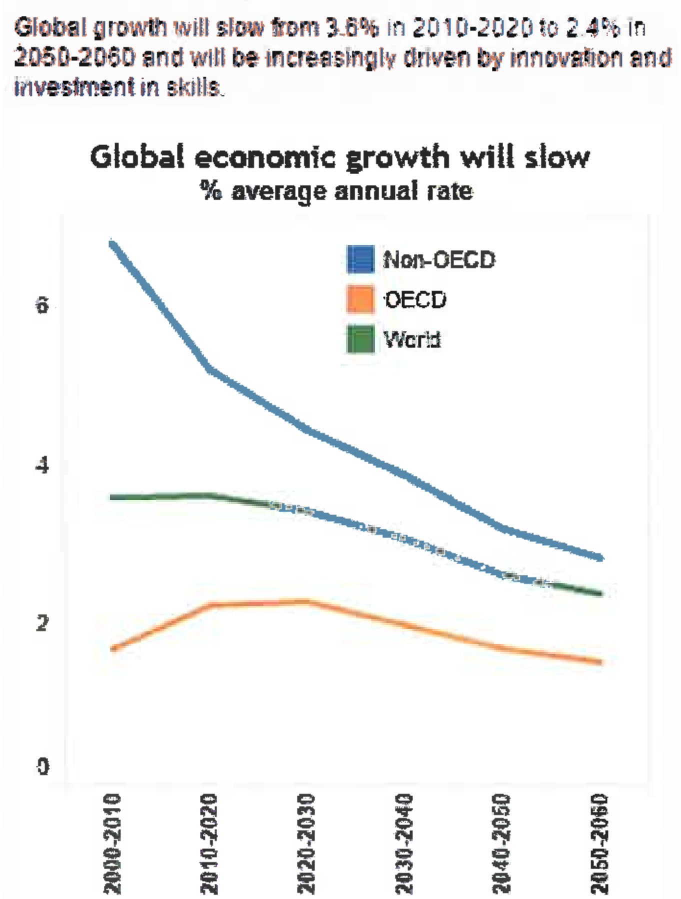
Q. WHAT HAS HAPPENED TO THE YIELD ON 30-YEAR U.S. TREASURY BONDS SINCE THAT DECEMBER 16, 2015 DECISION?

A. The yield on 30-year U.S. Treasury bonds continued to decline in 2016 and was below 2.50% in early June. It declined further on June 24th. with the United Kingdom's BREXIT referendum outcome. Such events illustrate that interest rates and capital costs are a function of global market developments and events. And while U.S. interest rates and capital costs are still at historically low levels, the fact that global investors bought U.S. Treasuries due to BREXIT indicates that U.S. Treasuries have favorable expected returns relative to the government securities of other major countries, such as Great Britain, Germany, and Japan. It should be noted that the stock prices of utility stocks increased following BREXIT while U.S. stocks declined. This again reflects the expected return and risk of utility stocks in the markets.

Q. HOW WILL INTEREST RATES AND COST OF CAPITAL BE AFFECTED BY ECONOMIC FACTORS IN THE LONG TERM?

A. In the long run, the key drivers of economic growth measured in nominal dollars are population growth, the advancement and diffusion of science and technology, and currency inflation. Although we experienced rapid economic growth during the "post-war" period (the 63 years that separated the end of World War II and the 2008 financial crisis), the post-war period is not necessarily reflective of expected future growth. It was marked by a near-trebling of global population, from under 2.5 billion to approximately 6.7 billion. Over the succeeding 63 years, according to United Nations projections, the global population will grow considerably more slowly, reaching approximately 10.3 billion in 2070. With population growth slowing, life expectancies lengthening, and post-war "baby boomers" reaching retirement age, median ages in developed-economy nations have risen and continue to rise. The postwar period was also marked by rapid catch-up growth as Europe, Japan, and China recovered from successive devastations, and regions such as India and China deployed have leapfrogged technologies that had been developed over a much longer period in earlier-industrialized nations. That period of rapid catch-up growth is coming to an end. For example, although China remains one of the world's fastest-growing regions, its growth is now widely expected to slow substantially. This convergence of projected growth in the former "second world" and "third world" towards the slower growth of the nations that have long been considered "first world" is illustrated in this "key findings" chart (Figure 7) published by the Organization for Economic Co-operation and Development:[14]

Figure 7
Projected Global Growth



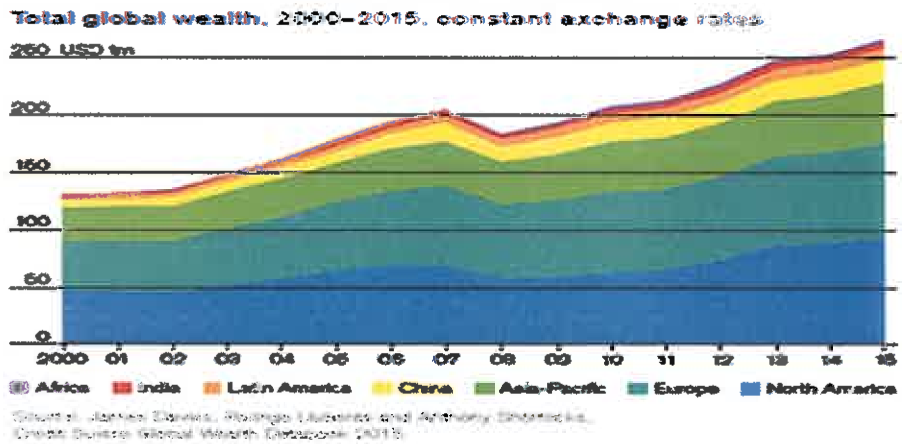
As to dollar inflation, it has declined to far below the level it reached in the 1970s. The Federal Reserve targets a 2.0% inflation rate, but its policies have been unable to achieve even that level of inflation. Indeed, inflation has been below the Federal Reserve's target rate for over four years due to a number of factors, including slow global economic growth, slack in the economy, and declining energy and commodity prices. The slow pace of inflation is also reflected in the decline in forecasts

[14] See http://www.oecd.org/eco/outlook/lookingto2060.htm.

of future inflation. The U.S. Energy Information Administration's ("EIA's") Annual Energy Outlook 2015 includes in its nominal GDP growth projection a long-term inflation component, which the EIA projects at only 1.8% per year for its forecast period through 2040.[15]

All of this translates into slowed growth in annual economic production and income, even when measured in nominal rather than real dollars. Meanwhile, the stored wealth that is available to fund investments has continued to rise. According to the most recent release of the Credit Suisse global wealth report (Figure 8), global wealth has more than doubled since the turn of this century, notwithstanding the temporary setback following the 2008 financial crisis:

Figure 8
Global Wealth – 2000-2015



These long-term trends mean that overall, and relative to what had been the post-war norm, the world now has more wealth chasing fewer opportunities for investment rewards. Ben Bernanke, the former Chairman of the Federal Reserve,

[15] See U.S. Energy Information Administration, *Annual Energy Outlook 2015*, Table 20 (available at http://www.eia.gov/forecasts/aeo/tables_ref.cfm).

called this phenomenon a "global savings glut."[16] Like any other liquid market, capital markets are subject to the law of supply and demand. With a large supply of capital available for investment and relatively scarce demand for investment capital, it should be no surprise to see the cost of investment capital decline and, therefore, interest rates remaining low.

Q. ON THE ISSUE OF THE FEDERAL RESERVE AND LONG-TERM INTEREST RATES, PLEASE HIGHLIGHT FORMER FEDERAL RESERVE CHAIRMAN BEN BERNANKE'S RECENT TAKE ON THE LOW INTEREST RATES IN THE U.S.

A. Mr. Bernanke addressed the issue of the continuing low interest rates in his weekly Brookings Blog. Mr. Bernanke indicated that the focus should be on real and not nominal interest rates and noted that, in the long term, these rates are not determined by the Federal Reserve:[17]

> If you asked the person in the street, "Why are interest rates so low?", he or she would likely answer that the Fed is keeping them low. That's true only in a very narrow sense. The Fed does, of course, set the benchmark nominal short-term interest rate. The Fed's policies are also the primary determinant of inflation and inflation expectations over the longer term, and inflation trends affect interest rates, as the figure above [below] shows. But what matters most for the economy is the real, or inflation-adjusted, interest rate (the market, or nominal, interest rate minus the inflation rate). The real interest rate is most relevant for capital investment decisions, for example. The Fed's ability to affect real rates of return, especially longer-term real rates, is transitory and limited. Except in the short

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[16] Ben S. Bernanke, *The Global Saving Glut and the U.S. Current Account Deficit*, March 10, 2005, available at http://www.federalreserve.gov/boarddocs/speeches/2005/200503102/.

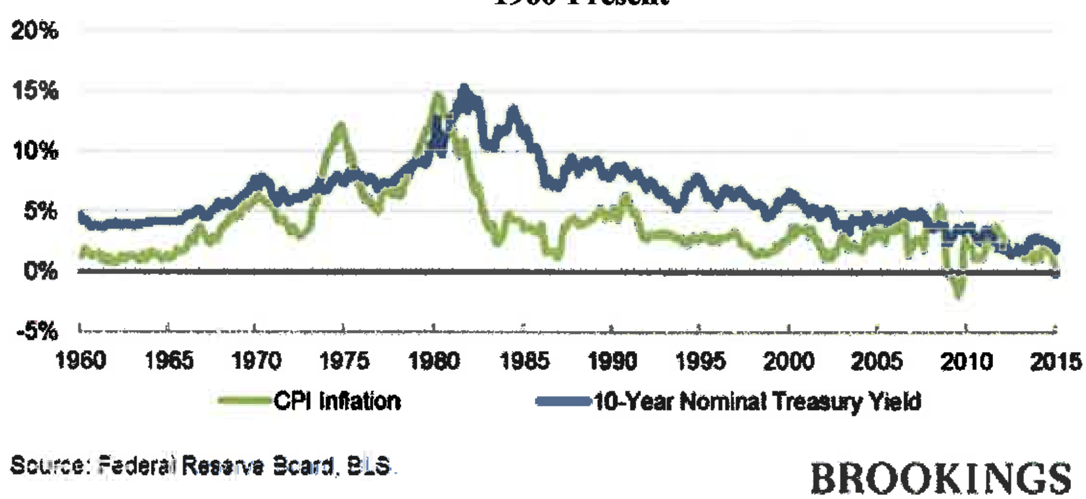
[17] Ben S. Bernanke, "Why are Interest Rates So Low?", Weekly Blog, Brookings, March 30, 2015. http://www.brookings.edu/blogs/ben-bernanke/posts/2015/03/30-why-interest-rates-so-low.

> run, real interest rates are determined by a wide range of economic factors, including prospects for economic growth—not by the Fed.

Mr. Bernanke also addressed the issue about whether low-interest rates are a short-term aberration or a long-term trend (see Figure 9):[18]

> Low interest rates are not a short-term aberration, but part of a long-term trend. As the figure below shows, ten-year government bond yields in the United States were relatively low in the 1960s, rose to a peak above 15 percent in 1981, and have been declining ever since. That pattern is partly explained by the rise and fall of inflation, also shown in the figure. All else equal, investors demand higher yields when inflation is high to compensate them for the declining purchasing power of the dollars with which they expect to be repaid. But yields on inflation-protected bonds are also very low today; the real or inflation-adjusted return on lending to the U.S. government for five years is currently about *minus* 0.1 percent.

Figure 9
Interest Rates and Inflation
1960-Present



[18] Ben S. Bernanke, "Why are Interest Rates So Low," Weekly Blog, Brookings, March 30, 2015. http://www.brookings.edu/blogs/ben-bernanke/posts/2015/03/30-why-interest-rates-so-low.

Q. CAN YOU PLEASE PROVIDE THE COMMISSION WITH YOUR OPINION REGARDING THE FUTURE OUTLOOK FOR INTEREST RATES AND CAPITAL COSTS?

A. I believe that U.S. Treasuries offer an attractive yield, relative to those of other major governments around the world, which will attract capital to the United States and keep U.S. interest rates down. There are several factors driving this conclusion.

First, the economy has been growing for over five years and, as noted above, the Federal Reserve sees continuing strength in the economy. The labor market has improved, with the May 2016 U.S. unemployment now down to 4.7%.[19]

Second, interest rates remain at historically low levels and are likely to remain low. There are two factors driving the continued lower interest rates: (1) inflationary expectations in the U.S. remain low and remain below the FOMC's target of 2.0%; and (2) global economic growth – including Europe (where growth is stagnant) and China (where growth is slowing significantly). As a result, while the yields on long-term U.S. Treasury bonds are low by historical standards, these yields are well above the government bond yields in Germany, Japan, and the United Kingdom. Thus, U.S. Treasuries offer an attractive yield relative to those of other major governments around the world, thereby attracting capital to the United States and keeping U.S. interest rates down.

Q. WHAT DO YOU RECOMMEND THE COMMISSION DO REGARDING THE FORECASTS OF HIGHER INTEREST RATES AND CAPITAL COSTS?

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[19] Bureau of Labor Statistics, available at http://www.bls.gov/news.release/laus.nr0.htm, last checked on June 23, 2016.

A. I suggest that the Commission set an equity cost rate based on current market cost rate indicators and not speculate on the future direction of interest rates. As the above studies indicate, economists are always predicting that interest rates are going up, and yet they are almost always wrong. Obviously, investors are well aware of the consistently wrong forecasts of higher interest rates and, therefore, place little weight on such forecasts. Investors would not be buying long-term Treasury bonds or utility stocks at their current yields if they expected interest rates to suddenly increase, thereby producing higher yields and negative returns. For example, consider a utility that pays a dividend of $2.00 with a stock price of $50.00. The current dividend yield is 4.0%. If, as Mr. Hevert suggests, interest rates and required utility yields increase, the price of the utility's stock would decline. In the example above, if higher return requirements led the dividend yield to increase from 4.0% to 5.0% in the next year, the stock price would have to decline to $40.00, which would be a -20% return on the stock. Obviously, investors would not buy the utility's stock with an expected return of -20% due to higher dividend yield requirements.

In sum, forecasting prices and rates that are determined in the financial markets, such as interest rates, the stock market, and gold prices, appears to be impossible to do accurately. For interest rates, I have never seen a study that suggests one forecasting service is consistently better than others or that interest rate forecasts are consistently better than just assuming that the current interest rate will be the rate in the future. As discussed above, investors would not be buying long-term Treasury bonds or utility stocks at their current yields if they expected interest rates to suddenly increase, thereby producing higher yields and negative returns.

III. PROXY GROUP SELECTION

Q. PLEASE DESCRIBE YOUR APPROACH TO DEVELOPING A FAIR RATE OF RETURN RECOMMENDATION FOR FPL.

A. To develop a fair rate of return recommendation for the Company, I have evaluated the return requirements of investors on the common stock of a proxy group of publicly held electric utility companies.

Q. PLEASE DESCRIBE YOUR PROXY GROUP OF ELECTRIC COMPANIES.

A. The selection criteria for my Electric Proxy Group include the following:

1. At least 50% of revenues from regulated electric operations as reported by *AUS Utilities Report*;
2. Listed as an Electric Utility by *Value Line Investment Survey* and listed as an Electric Utility or Combination Electric & Gas Utility in *AUS Utilities Report*;
3. An investment grade issuer credit rating by Moody's and S&P;
4. Has paid a cash dividend in the past six months, with no cuts or omissions;
5. Not involved in an acquisition of another utility, the target of an acquisition, or in the sale or spin-off of utility assets, in the past six months; and
6. Analysts' long-term EPS growth rate forecasts available from Yahoo, Reuters, and/or Zacks.

My Electric Proxy Group includes twenty-nine companies. Summary financial statistics for the proxy group are listed in Panel A of page 1 of Exhibit JRW-4.[20] The

[20] In my testimony, I present financial results using both means and medians as measures of central tendency.

median operating revenues and net plant among members of the Electric Proxy Group are $5,926.1 million and $14,705.0 million, respectively. The group receives 80% of its revenues from regulated electric operations, has BBB+/Baa1 issuer credit ratings from S&P and Moody's respectively, has a current common equity ratio of 46.7%, and has an earned return on common equity of 9.5%.

Q. PLEASE DESCRIBE MR. HEVERT'S PROXY GROUP OF ELECTRIC UTILITY COMPANIES.

A. The Hevert Proxy Group consists of seventeen electric utility companies.[21] Summary financial statistics for the proxy group are listed on Panel B of page 1 of Exhibit JRW-4. The median operating revenues and net plant among members of the Hevert Proxy Group are $3,317.6 million and $9,366.5 million, respectively. The group receives 78% of revenues from regulated electric operations, has an average BBB+ issuer credit rating from S&P and an average Baa1 long-term rating from Moody's, has a current common equity ratio of 48.6%, and has an earned return on common equity of 9.5%.

Q. HOW DOES THE INVESTMENT RISK OF THE COMPANY COMPARE TO THAT OF THE TWO PROXY GROUPS?

A. I believe that bond ratings provide a good assessment of the investment risk of a company. Exhibit JRW-4 also shows S&P and Moody's issuer credit ratings for the companies in the two groups. FPL's issuer credit rating is A- according to S&P and

However, due to outliers among means, I have used the median as the measure of central tendency.

[21] Great Plains Energy and Westar Energy are excluded from my analysis due to their pending merger.

A1 according to Moody's. These ratings are above the mean and median S&P and Moody's issuer credit ratings for the Electric Proxy Group (BBB+ and Baa1). Therefore, I believe that FPL's investment risk is below the investment risk of the Electric and Hevert Proxy Groups.

Q. HOW DOES THE INVESTMENT RISK OF THE TWO PROXY GROUPS COMPARE BASED ON THE VARIOUS RISK METRICS PUBLISHED BY *VALUE LINE*?

A. In Exhibit JRW-5, I have assessed the riskiness of the two proxy groups using five different risk measures from *Value Line*. These measures include Beta, Financial Strength, Safety, Earnings Predictability, and Stock Price Stability.[22] These risk measures suggest that the two proxy groups are similar in risk. The comparisons of the risk measures for the Electric and Hevert Proxy Groups, respectively, include Beta (0.72 vs. 0.75), Financial Strength (A vs. A), Safety (2.0 vs. 2.0), Earnings Predictability (78 vs. 81), and Stock Price Stability (95 vs. 96). On balance, these measures suggest that the two proxy groups are similar.

Q. HOW DOES THE INVESTMENT RISK OF THE TWO PROXY GROUPS COMPARE TO FPL'S PARENT, NEXTERA, BASED ON THE VARIOUS RISK METRICS PUBLISHED BY *VALUE LINE*?

A. The investment risk is similar. NextEra's risk metrics include Beta (0.70), Financial Strength (A), Safety (2), Earnings Predictability (75), and Stock Price Stability (100), which are all similar to the two proxy groups.

[22] These metrics are defined on page 2 of Exhibit JRW-5.

IV. <u>CAPITAL STRUCTURE RATIOS AND DEBT COST RATES</u>

Q. PLEASE DESCRIBE FPL'S PROPOSED CAPITAL STRUCTURE AND SENIOR CAPITAL COST RATES.

A. The Company has proposed a capital structure from investor-provided capital of 40.40% long-term debt and 59.60% common equity.

Q. WHAT ARE THE COMMON EQUITY RATIOS IN THE CAPITALIZATIONS OF THE TWO PROXY GROUPS?

A. As shown in Exhibit JRW-4, the median common equity ratios of the Electric and Hevert Proxy Groups are 46.7% and 48.6%, respectively. As such, FPL's proposed capitalization from investor-provided capital and as proposed for ratesetting purposes has much more equity and much less financial risk than the average current capitalizations of the electric utility companies in the proxy groups.

Q. WHAT ARE THE COMMON EQUITY RATIOS OF FPL'S PARENT, NEXTERA?

A. As shown in Exhibit JRW-4, the common equity ratio for NextEra is 42.8%. Hence, FPL's proposed capitalization also has much more equity and much less financial risk than the average current capitalizations of the electric utility companies in the two proxy groups.

V. THE COST OF COMMON EQUITY CAPITAL

A. Overview

Q. WHY MUST AN OVERALL COST OF CAPITAL OR FAIR RATE OF RETURN BE ESTABLISHED FOR A PUBLIC UTILITY?

A. In a competitive industry, the return on a firm's common equity capital is determined through the competitive market for its goods and services. Due to the capital requirements needed to provide utility services and the economic benefit to society from avoiding duplication of these services, some public utilities are monopolies. Because of the lack of competition and the essential nature of their services, it is not appropriate to permit monopoly utilities to set their own prices. Thus, regulation seeks to establish prices that are fair to consumers and, at the same time, sufficient to meet the operating and capital costs of the utility (i.e., provide an adequate return on capital to attract investors).

Q. PLEASE PROVIDE AN OVERVIEW OF THE COST OF CAPITAL IN THE CONTEXT OF THE THEORY OF THE FIRM.

A. The total cost of operating a business includes the cost of capital. The cost of common equity capital is the expected return on a firm's common stock that the marginal investor would deem sufficient to compensate for risk and the time value of money. In equilibrium, the expected and required rates of return on a company's common stock are equal.

Normative economic models of a company or firm, developed under very restrictive assumptions, provide insight into the relationship between firm performance or profitability, capital costs, and the value of the firm. Under the economist's ideal model of perfect competition, where entry and exit are costless, products are undifferentiated, and there are increasing marginal costs of production, firms produce up to the point where price equals marginal cost. Over time, a long-run equilibrium is established where price equals average cost, including the firm's capital costs. In equilibrium, total revenues equal total costs, and because capital costs represent investors' required return on the firm's capital, actual returns equal required returns, and the market value must equal the book value of the firm's securities.

In the real world, however, firms can achieve competitive advantage due to product market imperfections. Most notably, companies can gain competitive advantage through product differentiation (adding real or perceived value to products) and by achieving economies of scale (decreasing marginal costs of production). Competitive advantage allows firms to price products above average cost and, thereby, earn accounting profits greater than those required to cover capital costs. When these profits are in excess of that required by investors, or when a firm earns a return on equity in excess of its cost of equity, investors respond by valuing the firm's equity in excess of its book value.

James M. McTaggart, founder of the international management consulting firm Marakon Associates, described this essential relationship between the return on equity, the cost of equity, and the market-to-book ratio in the following manner:[23]

[23] James M. McTaggart, "The Ultimate Poison Pill: Closing the Value Gap", *Commentary* (Spring 1986), p. 3.

> Fundamentally, the value of a company is determined by the cash flow it generates over time for its owners, and the minimum acceptable rate of return required by capital investors. This "cost of equity capital" is used to discount the expected equity cash flow, converting it to a present value. The cash flow is, in turn, produced by the interaction of a company's return on equity and the annual rate of equity growth. High return on equity (ROE) companies in low-growth markets, such as Kellogg, are prodigious generators of cash flow, while low ROE companies in high-growth markets, such as Texas Instruments, barely generate enough cash flow to finance growth.
>
> A company's ROE over time, relative to its cost of equity, also determines whether it is worth more or less than its book value. If its ROE is consistently greater than the cost of equity capital (the investor's minimum acceptable return), the business is economically profitable and its market value will exceed book value. If, however, the business earns an ROE consistently less than its cost of equity, it is economically unprofitable and its market value will be less than book value.

As such, the relationship between a firm's return on equity, cost of equity, and market-to-book ratio is relatively straightforward. A firm that earns a return on equity above its cost of equity will see its common stock sell at a price above its book value. Conversely, a firm that earns a return on equity below its cost of equity will see its common stock sell at a price below its book value.

Q. PLEASE PROVIDE ADDITIONAL INSIGHTS INTO THE RELATIONSHIP BETWEEN ROE AND MARKET-TO-BOOK RATIOS.

A. This relationship is discussed in a classic Harvard Business School case study entitled "Note on Value Drivers." On page 2 of that case study, the author describes the relationship between the cost of equity ("K") and the market-to-book ratio:[24]

> For a given industry, more profitable firms – those able to generate higher returns per dollar of equity – should have higher market-to-

[24] Benjamin Esty, "Note on Value Drivers", Harvard Business School, Case Study No. 9-297-082, April 7, 1997.

book ratios. Conversely, firms which are unable to generate returns in excess of their cost of equity should sell for less than book value.

Profitability	*Value*
If ROE > K	*then Market/Book > 1*
If ROE = K	*then Market/Book =1*
If ROE < K	*then Market/Book < 1*

To assess the relationship by industry, as suggested above, I performed a regression study between estimated ROE and market-to-book ratios using electric utility, natural gas distribution, and water utility companies. I used all companies in these three industries that are covered by *Value Line* and that have estimated ROE and market-to-book ratio data. The results are presented in Panels A-C of Exhibit JRW-6. The average R-squares for the electric, gas, and water companies are 0.77, 0.56, and 0.75, respectively.[25] This demonstrates the strong positive relationship between ROEs and market-to-book ratios for public utilities.

Q. WHAT ECONOMIC FACTORS HAVE AFFECTED THE COST OF EQUITY CAPITAL FOR PUBLIC UTILITIES?

A. Exhibit JRW-7 provides indicators of public utility equity cost rates over the past decade.

Page 1 shows the yields on long-term A-rated public utility bonds. These yields decreased from 2000 until 2003, and then hovered in the 5.50%-6.50% range from mid-2003 until mid-2008. These yields spiked up to the 7.75% range with the onset of the Great Recession financial crisis, and remained high and volatile until early 2009. These

[25] R-square measures the percent of variation in one variable (e.g., market-to-book ratios) that is explained by another variable (e.g., expected ROE). R-squares vary between zero and 1.0, with values closer to 1.0 indicating a higher relationship between two variables.

yields declined to below 4.0% in mid-2013, and then increased with interest rates in general to the 4.85% range as of late 2013. Subsequently, these yields declined to below 4.0% in the first quarter of 2015, increased with interest rates in general in 2015, and have since dropped back to the 4.0% range.

Page 2 provides the dividend yields for electric utilities over the past decade. The dividend yields for this electric group have declined from the year 2000 to 2007, increased to 5.2% in 2009, and declined to about 3.75% in 2014 and 2015.

Average earned returns on common equity and market-to-book ratios for electric utilities are on page 3 of Exhibit JRW-7. For the electric group, earned returns on common equity have declined gradually since the year 2000 and have been in the 9.0% range in recent years. The average market-to-book ratios for this group peaked at 1.68X in 2007, declined to 1.07X in 2009, and have increased since that time. As of 2015, the average market-to-book for the group was 1.55X. This means that, for at least the last decade, returns on common equity have been greater than the cost of capital, or more than necessary to meet investors' required returns. This also means that customers have been paying more than they need to support an artificially elevated profit level for regulated utilities beyond what investors require.

Q. WHAT FACTORS DETERMINE INVESTORS' EXPECTED OR REQUIRED RATE OF RETURN ON EQUITY?

A. The expected or required rate of return on common stock is a function of market-wide as well as company-specific factors. The most important market factor is the time value of money as indicated by the level of interest rates in the economy. Common stock investor requirements generally increase and decrease with like changes in interest rates. The perceived risk of a firm is the predominant factor that influences investor return requirements on a company-specific basis. A firm's investment risk is often separated into business and financial risk. Business risk encompasses all factors that affect a firm's operating revenues and expenses. Financial risk results from incurring fixed obligations in the form of debt in financing its assets.

Q. HOW DOES THE INVESTMENT RISK OF UTILITIES COMPARE WITH THAT OF OTHER INDUSTRIES?

A. Due to the essential nature of their service, as well as their regulated status, public utilities are exposed to a lesser degree of business risk than other, non-regulated businesses. The relatively low level of business risk allows public utilities to meet much of their capital requirements through borrowing in the financial markets, thereby incurring greater than average financial risk. Nonetheless, the overall investment risk of public utilities is below that for most other industries.

Exhibit JRW-8 provides an assessment of investment risk for 97 industries as measured by beta, which according to modern capital market theory, is the only relevant measure of investment risk. These betas come from the *Value Line Investment Survey* and range from a high of 1.62 for the petroleum (producing) industry to a low of 0.68 for electric utilities (Eastern U.S.). The study shows that the investment risk of utilities is very low. In fact, the lowest betas are for electric utilities (Eastern U.S., Central U.S., and Western U.S.), natural gas utility, and water utility. The average betas for electric, natural gas, and water utility companies are 0.72, 0.74, and 0.71, respectively. As such, the cost of equity for utilities is among the lowest of all industries in the U.S.

Q. WHAT IS THE COST OF COMMON EQUITY CAPITAL?

A. The costs of debt and preferred stock are normally based on historical or book values and can be determined with a great degree of accuracy. The cost of common equity capital, however, cannot be determined precisely and must instead be estimated from market data and informed judgment. This return requirement of the stockholder should be commensurate with the return requirement on investments in other enterprises having comparable risks.

According to valuation principles, the present value of an asset equals the discounted value of its expected future cash flows. Investors discount these expected cash flows at their required rate of return that, as noted above, reflects the time value of money and the perceived riskiness of the expected future cash flows. As such, the cost of common equity is the rate at which investors discount expected cash flows associated with common stock ownership.

Q. HOW CAN THE EXPECTED OR REQUIRED RATE OF RETURN ON COMMON EQUITY CAPITAL BE DETERMINED?

A. Models have been developed to ascertain the cost of common equity capital for a firm. Each model, however, has been developed using restrictive economic assumptions. Consequently, judgment is required in selecting appropriate financial valuation models to estimate a firm's cost of common equity capital, in determining the data inputs for these models, and in interpreting the models' results. All of these decisions must take into consideration the firm involved as well as current conditions in the economy and the financial markets.

Q. **HOW DO YOU PLAN TO ESTIMATE THE COST OF EQUITY CAPITAL FOR FPL?**

A. I rely primarily on the discounted cash flow ("DCF") model to estimate the cost of equity capital. Given the investment valuation process and the relative stability of the utility business, I believe that the DCF model provides the best measure of equity cost rates for public utilities. I have also performed a capital asset pricing model ("CAPM") study; however, I give these results less weight because I believe that risk premium studies, of which the CAPM is one form, provide a less reliable indication of equity cost rates for public utilities.

B. DCF Analysis

Q. **PLEASE DESCRIBE THE THEORY BEHIND THE TRADITIONAL DCF MODEL.**

A. According to the DCF model, the current stock price is equal to the discounted value of all future dividends that investors expect to receive from investment in the firm. As such, stockholders' returns ultimately result from current as well as future dividends. As owners of a corporation, common stockholders are entitled to a *pro rata* share of the firm's earnings. The DCF model presumes that earnings that are not paid out in the form of dividends are reinvested in the firm to provide for future growth in earnings and dividends. The rate at which investors discount future dividends, which reflects the timing and riskiness of the expected cash flows, is interpreted as the market's expected or required return on the common stock. Therefore, this discount rate represents the cost of common equity. Algebraically, the DCF model can be expressed as:

$$P = \frac{D_1}{(1+k)^1} + \frac{D_2}{(1+k)^2} + \ldots \frac{D_n}{(1+k)^n}$$

where P is the current stock price, D_n is the dividend in year n, and k is the cost of common equity.

Q. IS THE DCF MODEL CONSISTENT WITH VALUATION TECHNIQUES EMPLOYED BY INVESTMENT FIRMS?

A. Yes. Virtually all investment firms use some form of the DCF model as a valuation technique. One common application for investment firms is called the three-stage DCF or dividend discount model ("DDM"). The stages in a three-stage DCF model are presented in Exhibit JRW-9, Page 1 of 2. This model presumes that a company's dividend payout progresses initially through a growth stage, then proceeds through a transition stage, and finally assumes a maturity (or steady-state) stage. The dividend-payment stage of a firm depends on the profitability of its internal investments which, in turn, is largely a function of the life cycle of the product or service.

1. Growth stage: characterized by rapidly expanding sales, high profit margins, and an abnormally high growth in earnings per share. Because of highly profitable expected investment opportunities, the payout ratio is low.

Competitors are attracted by the unusually high earnings, leading to a decline in the growth rate.

2. Transition stage: in later years, increased competition reduces profit margins and earnings growth slows. With fewer new investment opportunities, the company begins to pay out a larger percentage of earnings.

3. Maturity (steady-state) stage: eventually, the company reaches a position where its new investment opportunities offer, on average, only slightly attractive ROEs. At that time, its earnings growth rate, payout ratio, and ROE stabilize for the remainder of its life. The constant-growth DCF model is appropriate when a firm is in the maturity stage of the life cycle.

In using this model to estimate a firm's cost of equity capital, dividends are projected into the future using the different growth rates in the alternative stages, and then the equity cost rate is the discount rate that equates the present value of the future dividends to the current stock price.

Q. HOW DO YOU ESTIMATE STOCKHOLDERS' EXPECTED OR REQUIRED RATE OF RETURN USING THE DCF MODEL?

A. Under certain assumptions, including a constant and infinite expected growth rate, and constant dividend/earnings and price/earnings ratios, the DCF model can be simplified to the following:

$$P = \frac{D_1}{k - g}$$

where P is the current stock price, D_1 represents the expected dividend over the coming year, and g is the expected growth rate of dividends. This is known as the constant-growth version of the DCF model. To use the constant-growth DCF model to estimate a firm's cost of equity, one solves for "k" in the above expression to obtain the following:

$$k = \frac{D_1}{P} + g$$

Q. IN YOUR OPINION, IS THE CONSTANT-GROWTH VERSION OF THE DCF MODEL APPROPRIATE FOR PUBLIC UTILITIES?

A. Yes. The economics of the public utility business indicate that the industry is in the maturity or constant-growth stage of a three-stage DCF. The economics include the relative stability of the utility business, the maturity of the demand for public utility services, and the regulated status of public utilities (especially the fact that their returns on investment are effectively set through the ratemaking process). The appropriate DCF valuation procedure for companies in the maturity stage is the constant-growth DCF. In the constant-growth version of the DCF model, the current dividend payment and stock price are directly observable. However, the primary problem and controversy in applying the DCF model to estimate equity cost rates entails estimating investors' expected dividend growth rates.

Q. WHAT FACTORS SHOULD ONE CONSIDER WHEN APPLYING THE DCF METHODOLOGY?

A. One should be sensitive to several factors when using the DCF model to estimate a firm's cost of equity capital. In general, one must recognize the assumptions under which the DCF model was developed in estimating its components (the dividend yield and the expected growth rate). The dividend yield can be measured precisely at any point in time; however, it tends to vary somewhat over time. Estimation of expected growth is considerably more difficult. One must consider recent firm performance, in conjunction with current economic developments and other information available to investors, to accurately estimate investors' expectations.

Q. WHAT DIVIDEND YIELDS HAVE YOU REVIEWED?

A. I have calculated the dividend yields for the companies in the two proxy groups using the current annual dividend and the 30-day, 90-day, and 180-day average stock prices. These dividend yields, as derived from the 30-day, 90-day, and 180-day average stock prices, are provided in Panel A of page 2 of Exhibit JRW-10. For the Electric Proxy Group, the median dividend yields using the 30-day, 90-day, and 180-day average stock prices range from 3.4% to 3.7%. I am using the average of the medians - 3.50% - as the dividend yield for the Electric Proxy Group. The dividend yields for the Hevert Proxy Group are shown in Panel B of page 2 of Exhibit JRW-10. The median dividend yields range from 3.4% to 3.7% using the 30-day, 90-day, and 180-day average stock prices. I am using the average of the medians - 3.50% - as the dividend yield for the Hevert Proxy Group.

Q. PLEASE DISCUSS THE APPROPRIATE ADJUSTMENT TO THE SPOT DIVIDEND YIELD.

A. According to the traditional DCF model, the dividend yield term relates to the dividend yield over the coming period. As indicated by Professor Myron Gordon, who is commonly associated with the development of the DCF model for popular use, this is obtained by: (1) multiplying the expected dividend over the coming quarter by 4, and (2) dividing this dividend by the current stock price to determine the appropriate dividend yield for a firm that pays dividends on a quarterly basis.[26]

In applying the DCF model, some analysts adjust the current dividend for growth over the coming year as opposed to the coming quarter. This can be complicated because firms tend to announce changes in dividends at different times during the year. As such, the dividend yield computed based on presumed growth over the coming quarter as opposed to the coming year can be quite different. Consequently, it is common for analysts to adjust the dividend yield by some fraction of the long-term expected growth rate.

Q. GIVEN THIS DISCUSSION, WHAT ADJUSTMENT FACTOR DO YOU USE FOR YOUR DIVIDEND YIELD?

A. I adjust the dividend yield by one-half (1/2) of the expected growth to reflect growth over the coming year. The DCF equity cost rate ("K") is computed as:

$$K = [\,(D/P) * (1 + 0.5g)\,] + g$$

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[26] *Petition for Modification of Prescribed Rate of Return*, Federal Communications Commission, Docket No. 79-05, Direct Testimony of Myron J. Gordon and Lawrence I. Gould at 62 (April 1980).

Q. PLEASE DISCUSS THE GROWTH RATE COMPONENT OF THE DCF MODEL.

A. There is debate about the proper methodology to employ in estimating the growth component of the DCF model. By definition, this component is investors' expectation of the long-term dividend growth rate. Presumably, investors use some combination of historical and/or projected growth rates for earnings and dividends per share and for internal or book-value growth to assess long-term potential.

Q. WHAT GROWTH DATA HAVE YOU REVIEWED FOR THE PROXY GROUPS?

A. I have analyzed a number of measures of growth for companies in the proxy groups. I reviewed *Value Line's* historical and projected growth rate estimates for earnings per share ("EPS"), dividends per share ("DPS"), and book value per share ("BVPS"). In addition, I utilized the average EPS growth rate forecasts of Wall Street analysts as provided by Yahoo, Reuters and Zacks. These services solicit five-year earnings growth rate projections from securities analysts and compile and publish the means and medians of these forecasts. Finally, I also assessed prospective growth as measured by prospective earnings retention rates and earned returns on common equity.

Q. PLEASE DISCUSS HISTORICAL GROWTH IN EARNINGS AND DIVIDENDS AS WELL AS INTERNAL GROWTH.

A. Historical growth rates for EPS, DPS, and BVPS are readily available to investors and are presumably an important ingredient in forming expectations concerning future growth. However, one must use historical growth numbers as measures of investors' expectations with caution. In some cases, past growth may not reflect future growth potential. Also, employing a single growth rate number (for example, for five or ten years) is unlikely to accurately measure investors' expectations, due to the sensitivity of a single growth rate figure to fluctuations in individual firm performance and overall economic fluctuations (i.e., business cycles). However, one must appraise the context in which the growth rate is being employed. According to the conventional DCF model, the expected return on a security is equal to the sum of the dividend yield and the expected long-term growth in dividends. Therefore, to best estimate the cost of common equity capital using the conventional DCF model, one must look to long-term growth rate expectations.

Internally generated growth is a function of the percentage of earnings retained within the firm (the earnings retention rate) and the rate of return earned on those earnings (the return on equity). The internal growth rate is computed as the retention rate times the return on equity. Internal growth is significant in determining long-term earnings and, therefore, dividends. Investors recognize the importance of internally generated growth and pay premiums for stocks of companies that retain earnings and earn high returns on internal investments.

Q. PLEASE DISCUSS THE SERVICES THAT PROVIDE ANALYSTS' EPS FORECASTS.

A. Analysts' EPS forecasts for companies are collected and published by a number of different investment information services, including Institutional Brokers Estimate

System ("I/B/E/S"), Bloomberg, FactSet, Zacks, First Call and Reuters, among others. Thompson Reuters publishes analysts' EPS forecasts under different product names, including I/B/E/S, First Call, and Reuters. Bloomberg, FactSet, and Zacks publish their own sets of analysts' EPS forecasts for companies. These services do not reveal: (1) the analysts who are solicited for forecasts; or (2) the identity of the analysts who actually provide the EPS forecasts that are used in the compilations published by the services. I/B/E/S, Bloomberg, FactSet, and First Call are fee-based services. These services usually provide detailed reports and other data in addition to analysts' EPS forecasts. Thompson Reuters and Zacks provide limited EPS forecast data free-of-charge on the internet. Yahoo finance (http://finance.yahoo.com) lists Thompson Reuters as the source of its summary EPS forecasts. The Reuters website (www.reuters.com) also publishes EPS forecasts from Thompson Reuters, but with more detail. Zacks (www.zacks.com) publishes its summary forecasts on its website. Zacks estimates are also available on other websites, such as msn.money (http://money.msn.com).

Q. PLEASE PROVIDE AN EXAMPLE OF THESE EPS FORECASTS.

A. The following example provides the EPS forecasts compiled by Reuters for Alliant Energy Corp. (stock symbol "LNT"). The figures are provided on page 2 of Exhibit JRW-9. Line one shows two analysts' EPS estimates for the quarter ending June 30, 2016. The mean, high, and low estimates are $0.33, $0.38, and $0.28, respectively. The second line shows two analysts' quarterly EPS estimates for the quarter ending September 30, 2016 of $0.92 (mean), $0.98 (high), and $0.86 (low). Line three shows eight analysts' annual EPS estimates for the fiscal year ending December 2016: $1.89

(mean), $1.92 (high), and $1.88 (low). Line four shows nine analysts' annual EPS estimates for the fiscal year ending December 2017: $2.01 (mean), $2.12 (high), and $1.97 (low). The quarterly and annual EPS forecasts in lines 1-4 are expressed in dollars and cents. As in the LNT case shown here, it is common for more analysts to provide estimates of annual EPS as opposed to quarterly EPS. The bottom line shows the projected long-term EPS growth rate, which is expressed as a percentage. For LNT, two analysts have provided a long-term EPS growth rate forecast, with mean, high, and low growth rates of 6.60%, 7.20%, and 6.00%, respectively.

Q. WHICH OF THESE EPS FORECASTS IS USED IN DEVELOPING A DCF GROWTH RATE?

A. The DCF growth rate is the long-term projected growth rate in EPS, DPS, and BVPS. Therefore, in developing an equity cost rate using the DCF model, the projected long-term growth rate is the projection used in the DCF model.

Q. WHY DO YOU NOT RELY EXCLUSIVELY ON THE EPS FORECASTS OF WALL STREET ANALYSTS IN ARRIVING AT A DCF GROWTH RATE FOR THE PROXY GROUP?

A. There are several issues with using the EPS growth rate forecasts of Wall Street analysts as DCF growth rates. First, the appropriate growth rate in the DCF model is the dividend growth rate, not the earnings growth rate. Nonetheless, over the very long term, dividends and earnings will have to grow at a similar growth rate. Therefore, consideration must be given to other indicators of growth, including prospective dividend growth, internal growth, as well as projected earnings growth. Second, a 2011 study by Lacina, Lee, and Xu has shown that analysts' long-term earnings growth rate forecasts are no more accurate at forecasting future earnings than naïve random walk forecasts of future earnings.[27] Employing data over a twenty-year period, these authors demonstrate that using the most recent year's EPS figure to forecast EPS in the next 3-5 years proved to be just as accurate as using the EPS estimates from analysts' long-term earnings growth rate forecasts. In the authors' opinion, these results indicate that analysts' long-term earnings growth rate forecasts should be used with caution as inputs for valuation and cost of capital purposes. Finally, and most significantly, it is well known that the long-term EPS growth rate forecasts of Wall Street securities analysts are overly optimistic and upwardly biased. This has been demonstrated in a number of academic studies over the years.[28] Hence, using these growth rates as a DCF growth rate will provide an overstated equity cost rate. On this issue, a study by Easton and Sommers (2007) found that optimism in analysts' growth rate forecasts leads to an upward bias in estimates of the cost of equity capital of almost 3.0 percentage points.[29]

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[27] M. Lacina, B. Lee & Z. Xu, *Advances in Business and Management Forecasting (Vol. 8),* Kenneth D. Lawrence, Ronald K. Klimberg (ed.), Emerald Group Publishing Limited, pp.77-101 (2011).

[28] The studies that demonstrate analysts' long-term EPS forecasts are overly-optimistic and upwardly biased include: R.D. Harris, "The Accuracy, Bias, and Efficiency of Analysts' Long Run Earnings Growth Forecasts", *Journal of Business Finance & Accounting*, pp. 725-55 (June/July 1999); P. DeChow, A. Hutton, and R. Sloan, "The Relation Between Analysts' Forecasts of Long-Term Earnings Growth and Stock Price Performance Following Equity Offerings", *Contemporary Accounting Research* (2000); K. Chan, L., Karceski, J., & Lakonishok, J., "The Level and Persistence of Growth Rates," *Journal of Finance* pp. 643–684, (2003); M. Lacina, B. Lee and Z. Xu, *Advances in Business and Management Forecasting (Vol. 8),* Kenneth D. Lawrence, Ronald K. Klimberg (ed.), Emerald Group Publishing Limited, pp.77-101 (2011); and Marc H. Goedhart, Rishi Raj, and Abhishek Saxena, "Equity Analysts, Still Too Bullish," *McKinsey on Finance,* pp. 14-17 (Spring 2010).

[29] Easton, P., & Sommers, G., *Effect of Analysts' Optimism on Estimates of the Expected Rate of Return Implied by Earnings Forecasts, Journal of Accounting Research,* 45(5), pp. 983–1015 (2007).

Q. IS IT YOUR OPINION THAT STOCK PRICES REFLECT THE UPWARD BIAS IN THE EPS GROWTH RATE FORECASTS?

A. Yes, I do believe that investors are well aware of the bias in analysts' EPS growth rate forecasts and, therefore, stock prices reflect the upward bias.

Q. HOW DOES THAT AFFECT THE USE OF THESE FORECASTS IN A DCF EQUITY COST RATE STUDY?

A. According to the DCF model, the equity cost rate is a function of the dividend yield and expected growth rate. Because stock prices reflect the bias, it would affect the dividend yield. In addition, the DCF growth rate needs to be adjusted downward from the projected EPS growth rate to reflect the upward bias.

Q. PLEASE DISCUSS THE HISTORICAL GROWTH OF THE COMPANIES IN THE PROXY GROUPS, AS PROVIDED BY *VALUE LINE*.

A. Page 3 of Exhibit JRW-10 provides the 5- and 10-year historical growth rates for EPS, DPS, and BVPS for the companies in the two proxy groups, as published in the *Value Line Investment Survey*. The median historical growth measures for EPS, DPS, and BVPS for the Electric Proxy Group, as provided in Panel A, range from 3.5% to 5.0%, with an average of the medians of 4.3%. For the Hevert Proxy Group, as shown in Panel B of page 3 of Exhibit JRW-10, the historical growth measures for EPS, DPS, and BVPS, as measured by the medians, range from 3.5% to 6.5%, with an average of the medians of 4.5%.

Q. PLEASE SUMMARIZE *VALUE LINE'S* PROJECTED GROWTH RATES FOR THE COMPANIES IN THE PROXY GROUPS.

A. *Value Line's* projections of EPS, DPS, and BVPS growth for the companies in the proxy groups are shown on page 4 of Exhibit JRW-10. As stated above, due to the presence of outliers, the medians are used in the analysis. For the Electric Proxy Group, as shown in Panel A of page 4 of Exhibit JRW-10, the medians range from 4.0% to 5.5%, with an average of the medians of 4.8%. The range of the medians for the Hevert Proxy Group, shown in Panel B of page 4 of Exhibit JRW-10, is from 4.0 % to 5.5%, with an average of the medians of 5.0%.

Also provided on page 4 of Exhibit JRW-10 are the prospective sustainable growth rates for the companies in the two proxy groups as measured by *Value Line*'s average projected return on shareholders' equity and retention rates. As noted above, sustainable growth is a significant and a primary driver of long-run earnings growth. For the Electric and Hevert Proxy Groups, the median prospective sustainable growth rates are 3.9% and 3.9%, respectively.

Q. PLEASE ASSESS GROWTH FOR THE PROXY GROUPS AS MEASURED BY ANALYSTS' FORECASTS OF EXPECTED 5-YEAR EPS GROWTH.

A. Yahoo, Zacks, and Reuters collect, summarize, and publish Wall Street analysts' long-term EPS growth rate forecasts for the companies in the proxy groups. These forecasts are provided for the companies in the proxy groups on page 5 of Exhibit JRW-10. I have reported both the mean and median growth rates for the groups. Since there is considerable overlap in analyst coverage between the three services, and not all of the companies have forecasts from the different services, I have averaged the expected five-year EPS growth rates from the three services for each company to arrive at an expected EPS growth rate for each company. The mean/median of analysts' projected EPS growth rates for the Electric and Hevert Proxy Groups are 4.8%/5.0% and 5.4%/5.3%, respectively.[30]

Q. PLEASE SUMMARIZE YOUR ANALYSIS OF THE HISTORICAL AND PROSPECTIVE GROWTH OF THE PROXY GROUPS.

A. Page 6 of Exhibit JRW-10 shows the summary DCF growth rate indicators for the proxy groups.

The historical growth rate indicators for my Electric Proxy Group imply a baseline growth rate of 4.3%. The average of the projected EPS, DPS, and BVPS growth rates from *Value Line* is 4.8%, and *Value Line*'s projected sustainable growth rate is 3.9%. The projected EPS growth rates of Wall Street analysts for the Electric Proxy Group are 4.8% and 5.0%, as measured by the mean and median growth rates. The overall range for the projected growth rate indicators (ignoring historical growth) is 3.9% to 5.0%. Giving primary weight to the projected EPS growth rate of Wall Street analysts, I believe that the appropriate range of growth rates is 4.75% to 5.0%. I will use the midpoint of this range - 4.875% - as the DCF growth rate for the Electric Proxy Group. This growth rate figure is clearly in the upper end of the range of historic and projected growth rates for the Electric Proxy Group.

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[30] Given the variation in the measures of central tendency of analysts' projected EPS growth rates for the proxy groups, I have considered both the means and medians in the growth rate analysis.

For the Hevert Proxy Group, the historical growth rate indicators indicate a growth rate of 4.5%. The average of the projected EPS, DPS, and BVPS growth rates from *Value Line* is 5.0%, and *Value Line*'s projected sustainable growth rate is 3.9%. The projected EPS growth rates of Wall Street analysts are 5.4% and 5.3%, as measured by the mean and median growth rates. The overall range for the projected growth rate indicators is 3.9% to 5.4%. Again, giving primary weight to the projected EPS growth rate of Wall Street analysts, I believe that the appropriate growth rate is 5.25% for the Hevert Proxy Group. Similar to the Electric Proxy Group, this growth rate figure is clearly in the upper end of the range of historic and projected growth rates for the Hevert Proxy Group.

Q. **BASED ON THE ABOVE ANALYSIS, WHAT ARE YOUR INDICATED COMMON EQUITY COST RATES FROM THE DCF MODEL FOR THE PROXY GROUPS?**

A. My DCF-derived equity cost rates for the groups are summarized on page 1 of Exhibit JRW-10 and in Table 1 below.

Table 1
DCF-derived Equity Cost Rate/ROE

	Dividend Yield	1 + ½ Growth Adjustment	DCF Growth Rate	Equity Cost Rate
Electric Proxy Group	**3.50%**	**1.024375**	**4.875%**	**8.45%**
Hevert Proxy Group	**3.50%**	**1.026250**	**5.250%**	**8.85%**

The result for my Electric Proxy Group is the 3.50% dividend yield, times the one and one-half growth adjustment of 1.024375, and a DCF growth rate of 4.875%, which results in an equity cost rate of 8.45%. The result for the Hevert Proxy Group is 8.85%, which includes a dividend yield of 3.50%, an adjustment factor of 1.02625, and a DCF growth rate of 5.25%.

C. Capital Asset Pricing Model

Q. PLEASE DISCUSS THE CAPITAL ASSET PRICING MODEL ("CAPM").

A. The CAPM is a risk premium approach to gauging a firm's cost of equity capital. According to the risk premium approach, the cost of equity is the sum of the interest rate on a risk-free bond (R_f) and a risk premium (RP), as in the following:

$$k = R_f + RP$$

The yield on long-term U.S. Treasury securities is normally used as R_f. Risk premiums are measured in different ways. The CAPM is a theory of the risk and expected returns of common stocks. In the CAPM, two types of risk are associated with a stock: firm-specific risk or unsystematic risk, and market or systematic risk, which is measured by a firm's beta. The only risk that investors receive a return for bearing is systematic risk.

According to the CAPM, the expected return on a company's stock, which is also the equity cost rate (K), is equal to:

$$K = (R_f) + \beta * [E(R_m) - (R_f)]$$

Where:

- K represents the estimated rate of return on the stock;
- $E(R_m)$ represents the expected return on the overall stock market. Frequently, the 'market' refers to the S&P 500;
- (R_f) represents the risk-free rate of interest;
- $[E(R_m) - (R_f)]$ represents the expected equity or market risk premium—the

excess return that an investor expects to receive above the risk-free rate for investing in risky stocks; and

- *Beta*—(ß) is a measure of the systematic risk of an asset.

To estimate the required return or cost of equity using the CAPM requires three inputs: the risk-free rate of interest (R_f), the beta (ß), and the expected equity or market risk premium $[E(R_m) - (R_f)]$. R_f is the easiest of the inputs to measure – it is represented by the yield on long-term U.S. Treasury bonds. ß, the measure of systematic risk, is a little more difficult to measure because there are different opinions about what adjustments, if any, should be made to historical betas due to their tendency to regress to 1.0 over time. And finally, an even more difficult input to measure is the expected equity or market risk premium $[E(R_m) - (R_f)]$. I will discuss each of these inputs below.

Q. PLEASE DISCUSS EXHIBIT JRW-11.

A. Exhibit JRW-11 provides the summary results for my CAPM study. Page 1 shows the results, and the following pages contain the supporting data.

Q. PLEASE DISCUSS THE RISK-FREE INTEREST RATE.

A. The yield on long-term U.S. Treasury bonds has routinely been viewed as the risk-free rate of interest in the CAPM. The yield on long-term U.S. Treasury bonds, in turn, has been considered to be the yield on U.S. Treasury bonds with 30-year maturities.

Q. WHAT RISK-FREE INTEREST RATE ARE YOU USING IN YOUR CAPM?

A. As shown on page 2 of Exhibit JRW-11, the yield on 30-year U.S. Treasury bonds has been in the 2.5% to 4.0% range over the 2013–2016 time period. The 30-year Treasury yield is currently at the bottom of this range. Given the recent range of yields and the possibility of higher interest rates, I use 4.0% as the risk-free rate, or R_f, in my CAPM.

Q. WHAT BETAS ARE YOU EMPLOYING IN YOUR CAPM?

A. Beta (ß) is a measure of the systematic risk of a stock. The market, usually taken to be the S&P 500, has a beta of 1.0. The beta of a stock with the same price movement as the market also has a beta of 1.0. A stock whose price movement is greater than that of the market, such as a technology stock, is riskier than the market and has a beta greater than 1.0. A stock with below-average price movement, such as that of a regulated public utility, is less risky than the market and has a beta less than 1.0. Estimating a stock's beta involves running a linear regression of a stock's return on the market return.

As shown on page 3 of Exhibit JRW-11, the slope of the regression line is the stock's ß. A steeper line indicates that the stock is more sensitive to the return on the overall market. This means that the stock has a higher ß and greater-than-average market risk. A less steep line indicates a lower ß and less market risk.

Several online investment information services, such as Yahoo and Reuters, provide estimates of stock betas. Usually, these services report different betas for the same stock. The differences are usually due to: (1) the time period over which ß is measured; and (2) any adjustments that are made to reflect the fact that betas tend to regress to 1.0 over time. In estimating an equity cost rate for the proxy groups, I am using the betas for the companies as provided in the *Value Line Investment Survey*. As shown on page 3 of Exhibit JRW-11, the median betas for the companies in the Electric and Hevert Proxy Groups are 0.70 and 0.75, respectively.

Q. PLEASE DISCUSS THE MARKET RISK PREMIUM ("MRP").

A. The MRP is equal to the expected return on the stock market (e.g., the expected return on the S&P 500, $E(R_m)$ minus the risk-free rate of interest (R_f)). The MRP is the difference in the expected total return between investing in equities and investing in "safe" fixed-income assets, such as long-term government bonds. However, while the MRP is easy to define conceptually, it is difficult to measure because it requires an estimate of the expected return on the market - $E(R_m)$. As discussed below, there are different ways to measure $E(R_m)$, and various studies have come up with significantly different magnitudes for $E(R_m)$. As Merton Miller, the 1990 Nobel Prize winner in Economics indicated, $E(R_m)$ is very difficult to measure and is one of the great mysteries in finance.[31]

Q. PLEASE DISCUSS THE ALTERNATIVE APPROACHES TO ESTIMATING THE MRP.

A. Page 4 of Exhibit JRW-11 highlights the primary approaches to, and issues in, estimating the expected MRP. The traditional way to measure the MRP was to use the difference between historical average stock and bond returns. In this case, historical stock and bond returns, also called *ex post* or backward-looking returns, were used as

[31] Merton Miller, "The History of Finance: An Eyewitness Account," *Journal of Applied Corporate Finance*, 2000, p. 3.

the measures of the market's expected return, also known as the *ex ante* or forward-looking expected return. This type of historical evaluation of stock and bond returns is often called the "Ibbotson approach" after Professor Roger Ibbotson, who popularized this method of using historical financial market returns as measures of expected returns. Most historical assessments of the equity risk premium suggest an equity risk premium range of 5% to 7% above the rate on long-term U.S. Treasury bonds. However, this can be a problem because: (1) *ex post* returns are not the same as *ex ante* expectations; (2) market risk premiums can change over time, increasing when investors become more risk-averse and decreasing when investors become less risk-averse; and (3) market conditions can change such that *ex post* historical returns are poor estimates of *ex ante* expectations.

The use of historical returns as market expectations has been criticized in numerous academic studies, as discussed later in my testimony. The general theme of these studies is that the large equity risk premium discovered in historical stock and bond returns cannot be justified by the fundamental data. These studies, which fall under the category "Ex Ante Models and Market Data," compute *ex ante* expected returns using market data to arrive at an expected equity risk premium. These studies have also been called "Puzzle Research" after the famous study by Mehra and Prescott, in which the authors first questioned the magnitude of historical equity risk premiums relative to fundamentals.[32]

[32] Rajnish Mehra & Edward C. Prescott, "The Equity Premium: A Puzzle," *Journal of Monetary Economics,* p. 145 (1985).

In addition, there are a number of surveys of financial professionals regarding the MRP. There have also been several published surveys of academics on the equity risk premium. *CFO Magazine* conducts a quarterly survey of CFOs, which includes questions regarding their views on the current expected returns on stocks and bonds. Over 500 CFOs normally participate in the survey.[33] Questions regarding expected stock and bond returns are also included in the Federal Reserve Bank of Philadelphia's annual survey of financial forecasters, which is published as the *Survey of Professional Forecasters*.[34] This survey of professional economists has been published for almost 50 years. In addition, Pablo Fernandez conducts annual surveys of financial analysts and companies regarding the equity risk premiums they use in their investment and financial decision-making.[35]

Q. PLEASE PROVIDE A SUMMARY OF THE MARKET RISK PREMIUM STUDIES.

A. Derrig and Orr (2003), Fernandez (2007), and Song (2007) have completed the most comprehensive reviews to date of the research on the MRP.[36] Derrig and Orr's study

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[33] *See* Duke/CFO Magazine Global Business Outlook Survey, www.cfosurvey.org.

[34] Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters* (Feb, 2016). The Survey of Professional Forecasters was formerly conducted by the American Statistical Association ("ASA") and the National Bureau of Economic Research ("NBER") and was known as the ASA/NBER survey. The survey, which began in 1968, is conducted each quarter. The Federal Reserve Bank of Philadelphia, in cooperation with the NBER, assumed responsibility for the survey in June 1990.

[35] Pablo Fernandez, Alberto Ortiz and Isabel Fernandez Acín, "Market Risk Premium used in 71 countries in 2016: A survey with 6,932 answers", May 9, 2016.

[36] *See* Richard Derrig & Elisha Orr, "Equity Risk Premium: Expectations Great and Small", Working Paper (version 3.0), Automobile Insurers Bureau of Massachusetts (August 28, 2003); Pablo Fernandez, "Equity Premium: Historical, Expected, Required, and Implied", IESE Business School Working Paper (2007); Zhiyi Song, "The Equity Risk Premium: An Annotated Bibliography", CFA Institute (2007).

evaluated the various approaches to estimating MRPs, as well as the issues with the alternative approaches and summarized the findings of the published research on the MRP. Fernandez examined four alternative measures of the MRP – historical, expected, required, and implied. He also reviewed the major studies of the MRP and presented the summary MRP results. Song provides an annotated bibliography and highlights the alternative approaches to estimating the MRP.

Page 5 of Exhibit JRW-11 provides a summary of the results of the primary risk premium studies reviewed by Derrig and Orr, Fernandez, and Song, as well as other more recent studies of the MRP. In developing page 5 of Exhibit JRW-11, I have categorized the studies as discussed on page 4 of Exhibit JRW-11. I have also included the results of studies of the "Building Blocks" approach to estimating the equity risk premium. The Building Blocks approach is a hybrid approach employing elements of both historical and *ex ante* models.

Q. PLEASE DISCUSS PAGE 5 OF EXHIBIT JRW-11.

A. Page 5 of JRW-11 provides a summary of the results of the MRP studies that I have reviewed. These include the results of: (1) the various studies of the historical risk premium; (2) *ex ante* MRP studies; (3) MRP surveys of CFOs, financial forecasters, analysts, companies and academics; and (4) the Building Blocks approach to the MRP. There are results reported for over 30 studies, and the median MRP is 4.63%.

Q. PLEASE HIGHLIGHT THE RESULTS OF THE MORE RECENT RISK PREMIUM STUDIES AND SURVEYS.

A. The studies cited on page 5 of Exhibit JRW-11 include every MRP study and survey I could identify that was published over the past decade and that provided an MRP estimate. Most of these studies were published prior to the financial crisis. In addition, some of these studies were published in the early 2000s at the market peak. It should be noted that many of these studies (as indicated) used data over long periods of time (as long as 50 years of data) and were not estimating an MRP as of a specific point in time (e.g., the year 2001). To assess the effect of the earlier studies on the MRP, I have reconstructed page 5 of Exhibit JRW-11 on page 6 of Exhibit JRW-11; however, I have eliminated all studies dated before January 2, 2010. The median for this subset of studies is 5.03%.

Q. GIVEN THESE RESULTS, WHAT MRP ARE YOU USING IN YOUR CAPM?

A. Much of the data indicates that the market risk premium is in the 4.0% to 6.0% range. Several recent studies (such as Damodaran, American Appraisers, Duff & Phelps, Duarte and Rosa, and the CFO Survey) have suggested an increase in the market risk premium. Therefore, I will use 5.5%, which is in the upper end of the range, as the market risk premium, or MRP.

Q. IS YOUR *EX ANTE* MRP CONSISTENT WITH THE MRPs USED BY CFOs?

A. Yes. In the June 2016 CFO survey conducted by *CFO Magazine* and Duke University, which included approximately 450 responses, the expected 10-year MRP was 4.55%.[37]

[37] Duke/CFO Magazine Global Business Outlook Survey, www.cfosurvey.org, June 2016.

Q. IS YOUR *EX ANTE* MRP CONSISTENT WITH THE MRPs OF PROFESSIONAL FORECASTERS?

A. The financial forecasters in the previously referenced Federal Reserve Bank of Philadelphia survey projected both stock and bond returns. In the February 2016 survey, the median long-term expected stock and bond returns were 5.34% and 3.44%, respectively. This provides an *ex ante* MRP of 1.90% (5.34% minus 3.44%). As such, my MRP is larger than that forecasted by the professional forecasters.

Q. IS YOUR *EX ANTE* MRP CONSISTENT WITH THE MRPs OF FINANCIAL ADVISORS?

A. Yes. Duff & Phelps is a well-known valuation and corporate finance advisor that publishes extensively on the cost of capital. As of 2016, Duff & Phelps recommended using a 5.5% MRP for the U.S.[38]

Q. WHAT EQUITY COST RATE IS INDICATED BY YOUR CAPM ANALYSIS?

A. The results of my CAPM study for the proxy groups are summarized on page 1 of Exhibit JRW-11 and in Table 2 below.

Table 2

CAPM-derived Equity Cost Rate/ROE

$$K = (R_f) + \beta * [E(R_m) - (R_f)]$$

	Risk-Free Rate	Beta	Equity Risk Premium	Equity Cost Rate
Electric Proxy Group	4.0%	0.70	5.5%	7.9%
Hevert Proxy Group	4.0%	0.75	5.5%	8.1%

[38] http://www.duffandphelps.com/insights/publications/cost-of-capital/index.

For the Electric Proxy Group, the risk-free rate of 4.0% plus the product of the beta of 0.70 times the equity risk premium of 5.5% results in a 7.9% equity cost rate. For the Hevert Proxy Group, the risk-free rate of 4.0% plus the product of the beta of 0.75 times the equity risk premium of 5.5% results in an 8.1% equity cost rate.

D. Equity Cost Rate Summary

Q. **PLEASE SUMMARIZE THE RESULTS OF YOUR EQUITY COST RATE STUDIES.**

A. My DCF analyses for the Electric and Hevert Proxy Groups indicate equity cost rates of 8.45% and 8.85%, respectively. The CAPM equity cost rates for the Electric and Hevert Proxy Groups are 7.9% and 8.1%, respectively.

Table 3
ROEs Derived from DCF and CAPM Models

	DCF	CAPM
Electric Proxy Group	**8.45%**	**7.90%**
Hevert Proxy Group	**8.85%**	**8.10%**

Q. **GIVEN THESE RESULTS, WHAT IS YOUR ESTIMATED EQUITY COST RATE FOR THE GROUPS?**

A. Given these results, I conclude that the appropriate equity cost rate for companies in the Electric and Hevert Proxy Groups is in the 7.90% to 8.85% range. However, since I rely primarily on the DCF model, I am using the upper end of the range as the equity cost rate. Therefore, I conclude that the appropriate equity cost rate for the groups is 8.75%. This recommendation gives primary weight to the DCF results for the two proxy groups.

Q. WHAT IS YOUR RECOMMENDED EQUITY COST RATE AND RANGE FOR FPL?

A. Based upon my analysis, the appropriate equity cost rate (or return on equity) for FPL is 8.75%, with a range from 7.90% to 8.85%.

Q. PLEASE INDICATE WHY AN EQUITY COST RATE OF 8.75% IS APPROPRIATE FOR FPL.

A. There are a number of reasons why an equity cost rate of 8.75% is appropriate, reasonable, and fair for the Company in this case:

1. As shown in Exhibits JRW-2 and JRW-3, capital costs for utilities, as indicated by long-term bond yields, are still at historically low levels. In addition, given low inflationary expectations and slow global economic growth, interest rates are likely to remain at low levels for some time.

2. As shown in Exhibit JRW-8, the electric utility industry is among the lowest risk industries in the U.S., as measured by beta. As such, the cost of equity capital for this industry is among the lowest in the U.S., according to the CAPM.

3. The investment risk of FPL, as indicated by the Company's S&P and Moody's issuer credit ratings of A- and A1, respectively, are better than the average issuer credit ratings of the Electric and Hevert Proxy Groups. I have not made an adjustment to account for FPL's lower risk since I have employed Mr. O'Donnell's capital structure.

4. The authorized ROEs for electric utilities have declined from 10.01% in 2012, to 9.80% in 2013, 9.76% in 2014, 9.58% in 2015, and 9.68% in the first quarter

of 2016, according to Regulatory Research Associates.[39] In my opinion, authorized ROEs have lagged behind capital market cost rates or, in other words, authorized ROEs have been slow to reflect low capital market cost rates. This has been especially true in recent years, as some state commissions have been reluctant to authorize ROEs below 10%. However, the trend has been towards lower ROEs, and the norm now is below 10%. Hence, I believe that my recommended ROE reflects our present historically low capital cost rates, and these low capital cost rates are finally being recognized as the norm by state utility regulatory commissions.

Q. PLEASE DISCUSS YOUR RECOMMENDATION IN LIGHT OF A RECENT MOODY'S PUBLICATION.

A. In 2015, Moody's published an article on utility ROEs and credit quality. In the article, Moody's recognizes that authorized ROEs for electric and gas companies are declining due to lower interest rates.[40]

> The credit profiles of US regulated utilities will remain intact over the next few years despite our expectation that regulators will continue to trim the sector's profitability by lowering its authorized returns on equity (ROE). Persistently low interest rates and a comprehensive suite of cost recovery mechanisms ensure a low business risk profile for utilities, prompting regulators to scrutinize their profitability, which is defined as the ratio of net income to book equity. We view cash flow measures as a more important rating driver than authorized ROEs, and we note that regulators can lower authorized ROEs without hurting cash flow, for instance by targeting depreciation, or through special rate structures.

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[39] *Regulatory Focus*, Regulatory Research Associates, April, 2016. The electric utility authorized ROEs exclude the authorized ROEs in Virginia, which include generation adders.

[40] Moody's Investors Service, "Lower Authorized Equity Returns Will Not Hurt Near-Term Credit Profiles", March 10, 2015, p. 1.

Moody's indicates that even with the lower authorized ROEs, electric and gas companies are earning ROEs of 9.0% to 10.0%; however, these lower authorized ROEs are not impairing their credit profiles and are not deterring them from raising record amounts of capital. With respect to authorized ROEs, Moody's recognizes that utilities and regulatory commissions are having trouble justifying higher ROEs in the face of lower interest rates and cost recovery mechanisms.[41]

> Robust cost recovery mechanisms will help ensure that US regulated utilities' credit quality remains intact over the next few years. As a result, falling authorized ROEs are not a material credit driver at this time, but rather reflect regulators' struggle to justify the cost of capital gap between the industry's authorized ROEs and persistently low interest rates. We also see utilities struggling to defend this gap, while at the same time recovering the vast majority of their costs and investments through a variety of rate mechanisms.

Overall, this article further supports the prevailing/emerging belief that lower authorized ROEs are unlikely to hurt the financial integrity of utilities or their ability to attract capital.

Q. DO YOU BELIEVE THAT YOUR 8.75% ROE RECOMMENDATION MEETS *HOPE* AND *BLUEFIELD* STANDARDS?

A. Yes. As previously noted, according to the *Hope* and *Bluefield* decisions, returns on capital should be: (1) comparable to returns investors expect to earn on investments with similar risk; (2) sufficient to assure confidence in the company's financial integrity; and (3) adequate to maintain the company's credit and to attract capital.

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[41] Moody's Investors Service, "Lower Authorized Equity Returns Will Not Hurt Near-Term Credit Profiles", March 10, 2015, p. 2.

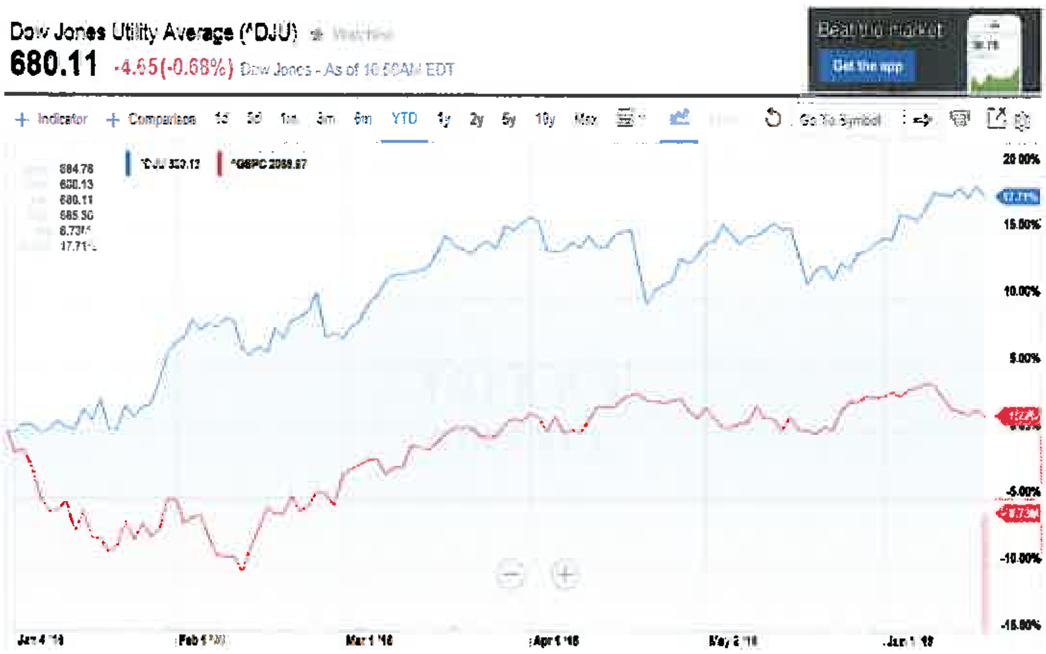
FPL's S&P and Moody's credit ratings are better than the average of the Electric and Hevert Proxy Groups. While my recommendation is below the average authorized ROEs for electric utility companies, it reflects the downward trend in authorized and earned ROEs of electric utility companies. As highlighted in the Moody's publication cited above, despite authorized and earned ROEs below 10%, the credit quality of electric and gas companies has not been impaired and, in fact, has improved because utilities are raising approximately $50 billion per year in capital. Major positive factors in the improved credit quality of utilities are regulatory ratemaking mechanisms. Therefore, I do believe that my ROE recommendation meets the criteria established in the *Hope* and *Bluefield* decisions.

Q. CAN YOU PRESENT MARKET-BASED EVIDENCE THAT YOUR 8.75% ROE RECOMMENDATION MEETS *HOPE* AND *BLUEFIELD* STANDARDS?

A. Yes. The current earned ROE's for electric utilities has been in the 9.0% to 9.5% range in the first half of 2016, according to the *AUS Utilities Report*. Figure 10 provides the year-to-date stock performance of the Dow Jones Utilities Index ("DJU") and the S&P 500 ("GSPC"). While the S&P 500 is up 1.22%, the DJU is up 17.71%. This provides very direct evidence that a ROE of 9.0% to 9.5% is clearly more than enough to meet investor return requirements. Therefore, this demonstrates that my 8.75% recommendation meets the *Hope* and *Bluefield* standards of providing a comparable return to investors that is sufficient to assure the company's financial integrity and adequate to maintain credit quality and attract capital.

Figure 10

Stock Performance of DJU and S&P 500
2016
Source: https://finance.yahoo.com/



Q. DO YOU HAVE AN OPINION ABOUT FPL'S REQUESTED CAPITAL STRUCTURE OR ROE ADDER?

A. None other than the Commission should carefully consider the testimony of OPC witnesses Kevin O'Donnell on FPL's requested capital structure and Daniel Lawton on FPL's requested ROE adder/surplus ROE inflator, which is not needed to maintain credit quality or attract capital.

VI. CRITIQUE OF FPL'S RATE OF RETURN TESTIMONY

Q. PLEASE SUMMARIZE WITNESS HEVERT'S RATE OF RETURN RECOMMENDATION FOR FPL.

A. The Company has proposed a capital structure from investor-provided capital of 40.40% long-term debt and 59.60% common equity. FPL witness Hevert has recommended a common equity cost rate of 11.0% for FPL.

Q. WHAT ISSUES DO YOU HAVE WITH THE COMPANY'S COST OF CAPITAL POSITION?

I have the following issues with the Company's cost of capital position:

1. The Company's capital structure has much more equity and much less financial risk than other electric utilities, including those electric utilities used by Mr. Hevert in estimating FPL's cost of equity capital. This issue is addressed by OPC witness O'Donnell;

2. Mr. Hevert's assessment of capital market conditions is flawed. He has relied on upwardly biased economists' interest rate forecasts in assessing capital costs and in estimating FPL's ROE. However, economists have been forecasting higher interest rates for a decade and, as I have already demonstrated in my testimony, they have been proven wrong. The fact is that long-term interest rates and capital costs are still at historic lows. As previously discussed, there are strong indicators from my assessment of global capital markets that long-term capital costs will remain low;

3. Mr. Hevert has not recognized that FPL is less risky than other electric utilities and, therefore, investors require a lower, not a higher, ROE;

4. Mr. Hevert has significantly changed his equity cost rate approach and testimony in this proceeding by erroneously giving primary weight to his CAPM and RP approaches and virtually no weight to his DCF approach;

5. Beyond the changes in weight he gives his equity cost rate approaches in this proceeding, there are a number of errors in his DCF, CAPM, and RP approaches. These errors include:

DCF Approach: (1) in contrast to previous testimony in which Mr. Hevert gave primary weight to his DCF results, he has virtually ignored his constant-growth and multi-stage DCF results in arriving at his 11.0% ROE recommendation for FPL; (2) notwithstanding this change, there are errors with his constant-growth and multi-stage growth DCF analyses. These errors include: (a) his exclusive reliance on the overly optimistic and upwardly biased EPS growth rate forecasts of Wall Street analysts and *Value Line;* and (b) in his multi-stage DCF model, he has employed a terminal growth rate of 5.35%, which is excessive for a number of reasons, especially the fact that it is not reflective of prospective economic growth in the U.S. and is about 100 basis points above the projected long-term growth in U.S. GDP;

CAPM approach: (1) Mr. Hevert has used a projected long-term Treasury yield of 4.85%, which is more than 200 basis points above the current market rate; (2) Mr. Hevert's MRP is excessive and does not reflect current market fundamentals. The primary reason is because Mr. Hevert's projected MRPs use analysts' EPS growth rate projections to compute an expected market return and market risk premium. These EPS growth rate projections and the resulting expected market returns and MRPs include unrealistic assumptions regarding future economic and earnings growth and stock returns;

Alternative RP Model: Mr. Hevert's alternative RP model is based on the historical relationship between the yields on long-term Treasury yields and authorized ROEs for electric utility companies. The errors for this model include: (1) his Alternative RP Model approach is a gauge of commission behavior and not investor behavior. Capital costs are determined in the capital markets. Regulatory commissions take into account other utility- and rate case-specific information in setting ROEs; (2) Mr. Hevert's methodology produces an inflated measure of the risk premium because his approach uses historical authorized ROEs and Treasury yields, and the resulting risk premium is applied to projected Treasury yields; (3) the risk premium in his Alternative RP Model is inflated as a measure of investors' required risk premium, since electric utility companies have been selling at market-to-book ratios in excess of 1.0. This indicates that the authorized rates of return have been greater than the return that investors require; and (4) reflective of these errors, Mr. Hevert's RP equity cost rate estimates of 10.04% to 10.53% are well above current authorized ROEs for electric utility companies;

6. Mr. Hevert has included business risk considerations such as the Company's capital expenditure program, geography, and nuclear risk in assessing the relative riskiness of FPL in supporting his 11.0% ROE recommendation. However, Mr.

Hevert ignores the fact that all of these factors are already considered by rating agencies in determining the Company's credit ratings. Moreover, FPL's S&P and Moody's credit ratings of A- and A1, respectively, are above those of other electric utilities, including those companies in the proxy groups; and

7. Mr. Hevert includes an explicit ROE adjustment for equity flotation costs of 0.12%. However, he has not identified any current or prospective equity issues by FPL or its parent company, NextEra, to justify any adjustment.

Q. **PLEASE OUTLINE YOUR REBUTTAL ANALYSES.**

A. I have already discussed the capital market conditions and the Company's capital structure and relative risk. I will now address Mr. Hevert's new equity cost rate methodology, the equity cost rate approaches (DCF, CAPM, alternative RP models), as well as flotation costs.

A. Mr. Hevert's New Equity Cost Rate Approach and Testimony

Q. **WHAT DO YOU MEAN BY MR. HEVERT'S NEW EQUITY COST RATE APPROACH AND METHODOLOGY?**

A. In this proceeding, Mr. Hevert has significantly changed his equity cost rate approach and testimony from what he previously filed in other jurisdictions. This change directly leads to his inflated ROE recommendation of 11.0% for FPL. Specifically, in this case, Mr. Hevert gives primary weight to his seriously flawed CAPM and RP approaches and virtually ignores his DCF results. This change is further exemplified in Table 4, which is a summary of his equity cost results in a rate case involving NSTAR Gas Company.[42] In that proceeding, he presents his "Summary of Analytical Results," which are from the DCF model, and he presents "Supporting Methodologies," which are his CAPM and Alternative RP approaches. In this case, Mr. Hevert has virtually abandoned his DCF model results, and relied exclusively on his former "Supporting Methodologies." As discussed below, this grossly inflates his ROE recommendation for FPL. The CAPM and alternative RP results are overstated due to his reliance on interest rate forecasts that are more than <u>200 basis points</u> above current market interest rates, and risk premiums that do not reflect capital market conditions and economic reality.

Table 4
Hevert Summary of Equity Cost Rate Results
Source: Testimony of Robert Hevert, p. 50, December 17, 2014
Commonwealth of Massachusetts, Department of Public Utilities
D.P.U. 14-150

Table 8: Summary of Analytical Results

Discounted Cash Flow	*Mean Low*	*Mean*	*Mean High*
30-Day Constant Growth DCF	7.96%	9.26%	10.85%
90-Day Constant Growth DCF	7.94%	9.24%	10.84%
180-Day Constant Growth DCF	7.99%	9.29%	10.88%
30-Day Multi-Stage DCF	9.33%	9.65%	10.07%
90-Day Multi-Stage DCF	9.32%	9.63%	10.05%
180-Day Multi-Stage DCF	9.35%	9.67%	10.10%
Supporting Methodologies			
CAPM Results		*Bloomberg Derived Market Risk Premium*	*Value Line Derived Market Risk Premium*
Average Bloomberg Beta Coefficient			
Current 30-Year Treasury (3.09%)		11.18%	10.67%
Near-Term Projected 30-Year Treasury (3.88%)		11.98%	11.47%
Average Value Line Beta Coefficient			
Current 30-Year Treasury (3.09%)		11.21%	10.69%
Near Term Projected 30-Year Treasury (3.88%)		12.00%	11.49%
	Low	*Mid*	*High*
Bond Yield Risk Premium	10.03%	10.17%	10.76%
Flotation Costs		0.12%	

[42] Testimony of Robert B. Hevert in Support of NSTAR Gas Company, December 17, 2014, Commonwealth of Massachusetts, Department of Public Utilities, D.P.U. 14-150, p. 50.

B. Mr. Hevert's DCF Approach

Q. PLEASE SUMMARIZE MR. HEVERT'S DCF ESTIMATES.

A. On pages 27-36 of his testimony and in Exhibits RBH-4 and RBH-5, Mr. Hevert develops an equity cost rate by applying the DCF model to the Hevert Proxy Group. Mr. Hevert's DCF results are summarized in Panel A of Exhibit JRW-12. He uses constant-growth and multi-stage growth DCF models. He also uses three dividend yield measures (30, 90, and 180 days) in his DCF models. In his constant-growth DCF models, Mr. Hevert has relied on the forecasted EPS growth rates of Zacks, First Call, and *Value Line*. His multi-stage DCF model uses analysts' EPS growth rate forecasts as a short-term growth rate, and his projection of GDP growth as the long-term growth rate. For all three models, he reports Mean Low, Mean, and Mean High results.

Q. WHAT ARE THE ERRORS IN MR. HEVERT'S DCF ANALYSES?

A. The primary errors in Mr. Hevert's DCF analyses are: (1) the lack of weight he gives to his constant-growth DCF results; (2) his exclusive use of the overly optimistic and upwardly biased EPS growth rate forecasts of Wall Street analysts and *Value Line*; and (3) the use of an inflated terminal growth rate of 5.35% in his multi-stage DCF model, which is not reflective of prospective economic growth in the U.S. and is more than 100 basis points above the projected long-term GDP growth.

1. The Low Weight Given to the Constant-Growth DCF Results

Q. HOW MUCH WEIGHT HAS MR. HEVERT GIVEN TO HIS DCF RESULTS IN ARRIVING AT AN EQUITY COST RATE FOR THE COMPANY?

A. Apparently, very little, if any at all. The average of his mean constant-growth stage DCF equity cost rates is only 9.4%.[43] Had he given these results more weight, or even any weight, he would have arrived at a much lower equity cost rate recommendation.

Q. AT PAGE 68 OF HIS TESTIMONY, MR. HEVERT SUGGESTS THAT EQUITY COST RATE RESULTS FROM THE CONSTANT-GROWTH DCF MODEL ARE SUSPECT DUE TO THE RELATIVELY HIGH VALUATION LEVELS OF UTILITY COMPANIES. PLEASE RESPOND.

A. Mr. Hevert expresses concerns with the constant-growth DCF model results because utility Price/Earnings ("P/E") ratios have increased and are high on both an absolute and relative levels. Mr. Hevert is correct - the P/E ratios of utility stocks have increased. However, as discussed in the previously cited Moody's article, the higher valuation of utilities is justified because cost recovery mechanisms have reduced utility industry risk, which has led to higher P/E multiples. Moody's states:[44]

> As utilities increasingly secure more up-front assurance for cost recovery in their rate proceedings, we think regulators will increasingly view the sector as less risky. The combination of low capital costs, high equity market valuation multiples (which are better than or on par with the broader market despite the regulated utilities' low risk profile), and a transparent assurance of cost recovery tend to support the case for lower authorized returns, although because utilities will argue they should rise, or at least stay unchanged.

Therefore, Mr. Hevert's suggestion that the constant-growth DCF results may provide low results due to the relatively high P/E multiples of utilities is incorrect. On the

[43] The 9.4% represents the average of the "Mean" column for the constant-growth DCF results shown in Panel A of Exhibit JRW-12.
[44] Moody's Investors Service, "Lower Authorized Equity Returns Will Not Hurt Near-Term Credit Profiles", March 10, 2015, p. 3.

contrary, as indicated by Moody's, the lower risk of utilities has led to higher valuation levels and P/E multiples.

2. Reliance of Wall Street Analysts' EPS Growth Rate Forecasts

Q. PLEASE DISCUSS MR. HEVERT'S EXCLUSIVE RELIANCE ON THE PROJECTED GROWTH RATES OF WALL STREET ANALYSTS AND *VALUE LINE*.

A. It seems highly unlikely that investors today would rely exclusively on the EPS growth rate forecasts of Wall Street analysts and ignore other growth rate measures in arriving at their expected growth rates for equity investments. As I previously indicated, the appropriate growth rate in the DCF model is the dividend growth rate, not the earnings growth rate. Hence, consideration must be given to other indicators of growth, including historical prospective dividend growth, internal growth, as well as projected earnings growth. In addition, the previously cited 2011 study by Lacina, Lee, and Xu has shown that analysts' long-term earnings growth rate forecasts are no more accurate at forecasting future earnings than naïve random walk forecasts of future earnings.[45] As such, the weight given to Wall Street analysts' projected EPS growth rates should be limited. And finally, and most significantly, it is well-known that the long-term EPS growth rate forecasts of Wall Street securities analysts are overly optimistic and

[45] M. Lacina, B. Lee and Z. Xu, *Advances in Business and Management Forecasting (Vol. 8),* Kenneth D. Lawrence, Ronald K. Klimberg (ed.), Emerald Group Publishing Limited, pp.77-101.

upwardly biased.[46] A 2007 study by Easton and Sommers found that optimism in analysts' earnings growth rate forecasts leads to an upward bias in estimates of the cost of equity capital of almost 3.0 percentage points.[47] Hence, using these EPS growth rates as a DCF growth rate produces an overstated equity cost rate.

Q. WHY IS WITNESS HEVERT'S EXCLUSIVE RELIANCE ON THE PROJECTED GROWTH RATES OF WALL STREET ANALYSTS AND *VALUE LINE* PROBLEMATIC?

A. As discussed earlier in my testimony, this is because the long-term EPS growth rate estimates of Wall Street analysts have been shown to be upwardly biased and overly optimistic. Therefore, exclusive reliance on these forecasts for a DCF growth rate injects upwardly skewed bias into one of the basic inputs in the DCF model.

3. Multi-Stage DCF Analysis

Q. PLEASE DISCUSS MR. HEVERT'S MULTI-STAGE DCF ANALYSIS.

A. Mr. Hevert has employed a multi-stage growth DCF model that includes: (1) the first stage is the average projected analyst growth rate of Wall Street analysts as published by First Call, Zacks, and *Value Line*; and (2) the second stage is a long-term expected earnings growth rate equal to his measure of long-term GDP growth. The long-term nominal GDP growth rate of 5.35% is based on: (a) a real GDP growth rate of 3.25%,

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[46] See footnote No. 28.

[47] Easton, P., & Sommers, G., *Effect of Analysts' Optimism on Estimates of the Expected Rate of Return Implied by Earnings Forecasts*, *Journal of Accounting Research*, 45(5), pp. 983–1015 (2007).

which is calculated over the 1929-2014 time period; and (b) an inflation rate of 2.10%.

Q. WHAT ARE THE PRIMARY ERRORS WITH MR. HEVERT'S MULTI-STAGE DCF ANALYSIS?

A There are two primary errors with Mr. Hevert's multi-stage DCF analysis: (1) the first-stage DCF growth rate is the average projected EPS growth rate from Wall Street analysts which, as discussed above, are overly optimistic and upwardly biased; and (2) the long-term GDP growth rate is based on historical GDP growth and is about 100 basis points above long-term projections of GDP growth.

Q. PLEASE IDENTIFY THE ERRORS IN MR. HEVERT'S PROJECTED LONG-TERM GDP GROWTH RATE OF 5.35%.

A. There are two major errors in this analysis. First, Mr. Hevert has not provided any theoretical or empirical support that long-term GDP growth is a reasonable proxy for the expected growth rate of the companies in his proxy group. Five-year and ten-year historic measures of growth for earnings and dividends for electric utility companies, as shown on page 3 of Exhibit JRW-10, suggest growth that is more than 100 basis points below Mr. Hevert's 5.35% long-term GDP growth rate. Mr. Hevert has provided no evidence as to why investors would rely on his overly optimistic estimate of long-term GDP growth as the appropriate growth rate for electric utility companies.

The second error is the magnitude of Mr. Hevert's long-term GDP growth rate estimate of 5.35%. On page 1 of Exhibit JRW-13 of my testimony, I provide an analysis of GDP growth since 1960. Since 1960, nominal GDP has grown at a compounded rate of 6.58%, but economic growth in the U.S. has slowed considerably in recent decades. Page 2 of Exhibit JRW-13 provides the nominal annual GDP growth rates over the 1961-2015 time period. Nominal GDP growth grew from 6.0% to over 12.0% from the 1960s to the early 1980s, due in large part to inflation and higher prices. With the exception of an uptick during the mid-2000s, annual nominal GDP growth rates have declined to the 3.5% to 4.0% range during the most recent five-year period.

The components of nominal GDP growth are real GDP growth and inflation. Page 3 of Exhibit JRW-13 shows the annual real GDP growth rate over the 1961-2015 time period. Real GDP growth has gradually declined from the 5.0% to 6.0% range in the 1960s to the 2.0% to 3.0% range during the most recent five-year period. The second component of nominal GDP growth is inflation. Page 4 of Exhibit JRW-13 shows inflation as measured by the annual growth rate in the Consumer Price Index ("CPI") over the 1961-2015 time period. The large increase in prices from the late 1960s to the early 1980s is readily evident. Equally evident is the rapid decline in inflation during the 1980s, as inflation declined from above 10% to about 4%. Since that time, inflation has gradually declined and has been in the 2.0% range or below during the most recent five-year period.

The graphs on pages 2, 3, and 4 of Exhibit JRW-13 provide very clear evidence of the decline in nominal GDP as well as its components (real GDP and inflation) in recent decades. To gauge the magnitude of the decline in nominal GDP growth, Table 5 provides the compounded GDP growth rates for 10, 20, 30, 40 and 50 years. While the 50-year compounded GDP growth rate is 6.65%, there has been a significant decline in nominal GDP growth over subsequent 10-year intervals. These figures clearly suggest that nominal GDP growth in recent decades has slowed, becoming increasingly monotonic, and that a figure in the range of 4.0% to 5.0% is more appropriate today for the U.S. economy. Therefore, Mr. Hevert's long-term GDP growth rate of 5.35% is clearly inflated, and he provides no valid justification for this rate.

Table 5
Historic GDP Growth Rates

10-Year Average - 2006-2015	**3.28%**
20-Year Average - 1996-2015	**4.36%**
30-Year Average - 1986-2015	**4.87%**
40-Year Average - 1976-2015	**6.19%**
50-Year Average - 1966-2015	**6.65%**

Q. ARE THE LOWER GDP GROWTH RATES OF RECENT DECADES CONSISTENT WITH THE FORECASTS OF GDP GROWTH?

A. Yes, and a lower range is also consistent with long-term GDP forecasts. There are several forecasts of annual GDP growth that are available from economists and government agencies. These are listed on page 5 of Exhibit JRW-13. Economists, in the February 2016 *Survey of Professional Forecasters,* forecasted the mean 10-year nominal GDP growth rate to be 4.4%.[48] The EIA, in its projections used in preparing *Annual Energy Outlook 2015,* forecasted long-term GDP growth of 4.2% for the period 2015-2040.[49] The Congressional Budget Office ("CBO"), in its forecasts for the period 2015-2040,

[48] Federal Reserve Bank of Philadelphia, *Survey of Professional Forecasters* (Feb., 2016).

[49] U.S. Energy Information Administration, *Annual Energy Outlook 2015*. http://www.eia.gov/forecasts/aeo/.

projected a nominal GDP growth rate of 4.3%.[50] Finally, the Social Security Administration ("SSA"), in its Annual Old-Age, Survivors, And Disability Insurance ("OASDI") Report, projected a nominal GDP growth rate of 4.5% for the period 2015-2090.[51] These four forecasts and projections of GDP growth from economists and government agencies range from 4.2% to 4.5%. Overall, these projections of nominal GDP growth over extended future time periods provide very direct evidence that Mr. Hevert's long-term GDP growth rate of 5.35% is grossly overstated by almost 100 basis points.

Q. DOES MR. HEVERT PROVIDE ANY REASONS WHY HE HAS IGNORED THE WELL-KNOWN LONG-TERM REAL GDP FORECASTS OF THE CBO, SSA, AND EIA?

A. No.

Q. IN YOUR OPINION, WHAT IS WRONG WITH MR. HEVERT'S REAL GDP FORECAST BASED ON HISTORIC DATA AND IGNORING THE WELL-KNOWN LONG-TERM GDP FORECASTS OF THE CBO, SSA, AND EIA?

A. In developing a DCF growth rate for his constant-growth DCF analysis, Mr. Hevert has totally ignored <u>historic</u> EPS, DPS, and BVPS data and relied solely on the long-term EPS growth rate <u>projections</u> of Wall Street analysts and *Value Line*. In contrast, in developing

[50] Congressional Budget Office, The *2015 Long-term Budget Outlook,* July 2015. https://www.cbo.gov/publication/50250.

[51] Social Security Administration, *2015 Annual Report of the Board of Trustees of the Old-Age, Survivors, and Disability Insurance (OASDI) Program*. http://www.ssa.gov/oact/tr/2015/X1_trLOT.html.

a terminal DCF growth rate for his multi-stage growth DCF analysis, Mr. Hevert has also totally ignored the well-known long-term real GDP growth rate forecasts of the CBO, SSA, and EIA, and relied solely on historic data going back to 1929. Simply put, he is inconsistent with his methodology.

C. Mr. Hevert's CAPM Approach

Q. PLEASE DISCUSS MR. HEVERT'S CAPM APPROACH.

A. On pages 19-23 of his testimony and in Exhibit RBH-2, Mr. Hevert estimates an equity cost rate by applying a CAPM model to his proxy group. As I discussed earlier, the CAPM approach requires an estimate of the risk-free interest rate, beta, and the equity risk premium. Mr. Hevert uses three different measures of the 30-Year Treasury bond yield: (a) a current yield of 2.96% and a near-term projected yield of 4.00%, and a long-term projected yield of 4.80%; (b) two different betas (an average Bloomberg Beta of 0.608 and an average *Value Line* Beta of 0.776); and (c) two market risk premium measures - a Bloomberg, DCF-derived market risk premium of 10.68% and a *Value Line*-derived market risk premium of 9.87%. Based on these figures, he finds a CAPM equity cost rate range from 8.96% to 13.09%. Mr. Hevert's CAPM results are summarized in Panel B of Exhibit JRW-12.

Q. WHAT ARE THE ERRORS IN MR. HEVERT'S CAPM ANALYSIS?

A. The primary errors with Mr. Hevert's CAPM analysis are: (1) the projected risk-free interest rate of 4.80%; and (2) the expected market return used to compute the MRPs.

1. Projected Risk-Free Interest Rate

Q. PLEASE DISCUSS THE BASE YIELD IN MR. HEVERT'S CAPM ANALYSIS.

A. Mr. Hevert uses a projected long-term Treasury yield of 4.80% in his CAPM analyses. This figure is more than 200 basis points above the current yield on long-term Treasury bonds of 2.50%.

2. Market Risk Premium

Q. WHAT ARE THE ERRORS IN MR. HEVERT'S CAPM ANALYSES?

A. The primary errors in Mr. Hevert's CAPM analyses are the market premiums of 10.68% and 9.87%, which are based on the upwardly biased long-term EPS growth rate estimates of Wall Street analysts.

Q. PLEASE ASSESS MR. HEVERT'S MARKET RISK PREMIUMS DERIVED FROM APPLYING THE DCF MODEL TO THE S&P 500 AND *VALUE LINE INVESTMENT SURVEY*.

A. For his Bloomberg and *Value Line* market risk premiums, Mr. Hevert computes market risk premiums of 10.68% and 9.87% by: (1) calculating an expected market return by applying the DCF model to the S&P 500; and, then (2) subtracting the current 30-year Treasury bond yield from the calculation. Mr. Hevert's estimated expected market returns from these are 13.63% (using Bloomberg's three- to five-year EPS growth rate estimates)[52] and 12.82% (using *Value Line's* three- to five-year EPS growth rate

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[52] Testimony of Robert B. Hevert, Exhibit RBH-6, pp. 1-6.

estimates).[53] As discussed below, these results are not realistic. He uses: (1) a dividend yield of 2.39% and an expected DCF growth rate of 11.24% for Bloomberg; and (2) a dividend yield of 2.24% and an expected DCF growth rate of 10.58% for *Value Line.*

Q. HOW DID MR. HEVERT ERR WHEN ANALYZING MARKET PREMIUMS?

A. The primary error is that the expected DCF growth rate is the projected five-year EPS growth rate from Wall Street analysts as reported by these two services. As explained below, this produces an overstated expected market return and equity risk premium.

Q. WHAT EVIDENCE CAN YOU PROVIDE THAT MR. HEVERT'S GROWTH RATES ARE ERRONEOUS OR NOT REALISTIC?

A. Mr. Hevert's expected long-term EPS growth rates of 11.24% for Bloomberg and 10.58% for *Value Line* represent the forecasted five-year EPS growth rates of Wall Street analysts. As I have explained earlier, the error with this approach is that the EPS growth rate forecasts of Wall Street securities analysts are overly optimistic and upwardly biased, thus his results are not realistic. As discussed below, these projected EPS growth rates are not consistent with historic or projected growth in earnings and the economy.

Q. ARE EPS GROWTH RATES OF 11.24% and 10.58% CONSISTENT WITH THE HISTORIC AND PROJECTED GROWTH IN EARNINGS AND THE ECONOMY?

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[53] Testimony of Robert B. Hevert, Exhibit RBH-6, pp. 7-12.

A. No. Long-term EPS growth rates of 11.24% and 10.58% are not consistent with historic or projected economic and earnings growth in the U.S. for several reasons: (1) long-term growth in EPS is far below Mr. Hevert's projected EPS growth rates; (2) more recent trends in GDP growth, as well as projections of GDP growth, suggest slower long-term economic and earnings growth in the future; and (3) over time, EPS growth tends to lag behind GDP growth.

The long-term economic, earnings, and dividend growth rates in the U.S. have only been in the 5% to 7% range. I performed an analysis of the growth in nominal GDP, S&P 500 stock price appreciation, and S&P 500 EPS and DPS growth since 1960. The results are provided on page 1 of Exhibit JRW-13, and a summary is provided in Table 6 below.

Table 6
GDP, S&P 500 Stock Price, EPS, and DPS Growth
1960-Present

Nominal GDP	**6.58%**
S&P 500 Stock Price	**6.69%**
S&P 500 EPS	**6.64%**
S&P 500 DPS	**5.76%**
Average	**6.42%**

The long-term growth results of GDP, S&P 500, S&P EPS, and S&P DPS from 1960-2015 are presented graphically on page 6 of Exhibit JRW-13. In sum, the historical long-term growth rates for GDP, S&P 500, S&P EPS, and S&P DPS have been in the 5% to 7% range.

Q. DOES MORE RECENT DATA SUGGEST THAT U.S. ECONOMIC GROWTH IS HIGHER OR LOWER THAN THE LONG-TERM DATA?

A. As previously discussed and presented in Table 5, the more recent trend suggests lower future economic growth than the long-term historic GDP growth. The historical GDP growth rates for 10, 20, 30, 40 and 50 years clearly suggest that nominal GDP growth in recent decades has slowed to the 4.0% to 5.0% area. By comparison, Mr. Hevert's long-term growth rate projections of 11.24% and 10.58% are vastly overstated. His estimates suggest that companies in the U.S. would be expected to: (1) increase their growth rate of EPS by almost 100% in the future; and (2) maintain that growth indefinitely in an economy that is expected to grow at about one-half of his projected growth rates, as forecasted by economists and various government agencies. Thus, Mr. Hevert's projections are unrealistic.

Q. WHAT LEVEL OF GDP GROWTH IS FORECASTED BY ECONOMISTS AND VARIOUS GOVERNMENT AGENCIES?

A. As previously discussed, there are several forecasts of annual GDP growth that are available from economists and government agencies. These are listed in page 5 of Exhibit JRW-13. These forecasts suggest long-term GDP growth rates in the 4.2% to 4.5% range.

Q. WHY IS GDP GROWTH RELEVANT IN YOUR DISCUSSION OF MR. HEVERT'S USE OF THE LONG-TERM EPS GROWTH RATES IN DEVELOPING A MARKET RISK PREMIUM FOR HIS CAPM?

A. As indicated in recent research, the long-term earnings growth rates of companies are, on average, limited to the growth rate in GDP.

Q. PLEASE EXPLAIN THE LINK BETWEEN ECONOMIC AND EARNINGS GROWTH AND EQUITY RETURNS.

A. Brad Cornell of the California Institute of Technology recently published a study on GDP growth, earnings growth, and equity returns. He finds that long-term EPS growth in the U.S. is directly related to GDP growth, with GDP growth providing an upward limit on EPS growth. In addition, he finds that long-term stock returns are determined by long-term earnings growth. He concludes with the following observations:[54]

> The long-run performance of equity investments is fundamentally linked to growth in earnings. Earnings growth, in turn, depends on growth in real GDP. This article demonstrates that both theoretical research and empirical research in development economics suggest relatively strict limits on future growth. In particular, real GDP growth in excess of 3 percent in the long run is highly unlikely in the developed world. In light of ongoing dilution in earnings per share, this finding implies that investors should anticipate real returns on U.S. common stocks to average no more than about 4–5 percent in real terms.

Given current inflation in the 2% to 3% range and real returns in the 4% to 5% range, the results imply nominal expected stock market returns in the 6% to 8% range. As such, Mr. Hevert's projected earnings growth rates and implied expected stock market returns and equity risk premiums are not indicative of the realities of the U.S. economy and stock market. As such, his expected CAPM equity cost rate is significantly overstated.

[54] Bradford Cornell, "Economic Growth and Equity Investing", *Financial Analysts Journal* (January-February 2010), p. 63.

Q. PLEASE PROVIDE A SUMMARY ASSESSMENT OF MR. HEVERT'S PROJECTED EQUITY RISK PREMIUM DERIVED FROM EXPECTED MARKET RETURNS.

A. Mr. Hevert's market risk premium derived from his DCF application to the S&P 500 is inflated due to errors and bias in his study. Investment banks, consulting firms, and CFOs use the equity risk premium concept every day in making financing, investment, and valuation decisions. Thus, the opinions of CFOs and financial forecasters are especially relevant. CFOs deal with capital markets on an ongoing basis since they must continually assess and evaluate capital costs for their companies. They are also well aware of the historical stock and bond return studies of Ibbotson. Duke University's Survey of approximately 500 CFOs, in the June 2016 *CFO Magazine,* shows an expected return on the S&P 500 of 6.3% over the next ten years. In addition, the financial forecasters in the February 2016 Federal Reserve Bank of Philadelphia survey expect an annual nominal market return of 5.34% over the next ten years. As such, with a more realistic equity or market risk premium, the appropriate equity cost rate for a public utility should be in the 8.0% to 9.0% range, and not in the 10.0% to 11.0% range.

D. Mr. Hevert's Risk Premium Approach

Q. PLEASE REVIEW MR. HEVERT'S RP ANALYSIS.

A. On pages 23-26 of his testimony and in Exhibit RBH-3, Mr. Hevert estimates an equity cost rate using a RP model. Mr. Hevert develops an equity cost rate by: (1) regressing the commission-authorized returns on equity for electric utility companies from the

January 1, 1980 to September 2015 time period on the thirty-year Treasury Yield; and (2) then adding the risk premium established in (1) to three different thirty-year Treasury yields: (a) a current yield of 2.96% and a near-term projected yield of 4.00%; and (b) a long-term projected yield of 4.80%. Mr. Hevert's RP results are provided in Panel C of Exhibit JRW-12. He reports RP equity cost rates ranging from 10.04% to 10.53%.

Q. WHAT ARE THE ERRORS IN MR. HEVERT'S RP ANALYSIS?

A. The two errors are: (1) the long-term projected 30-Year Treasury yield of 4.80%; and (2) primarily, the excessive risk premium.

1. Base Yield

Q. WHAT IS THE ISSUE WITH THE PROJECTED LONG-TERM TREASURY RATE OF 4.80%?

A. This figure is more than <u>200 basis points</u> above the current 30-year Treasury rate. This figure is simply not reasonable. Thirty-year Treasury bonds are currently yielding about 2.50%. Institutional investors would not be buying bonds at this yield if they expected interest rates to increase so dramatically in the coming years. Moreover, an increase of yields of 200 basis points on 30-year Treasury bonds in the next couple of years would result in significant capital losses for investors buying bonds today at current market yields.

2 Risk Premium

Q. WHAT ARE THE ISSUES WITH MR. HEVERT'S RISK PREMIUM?

A. There are several problems with this approach. His methodology produces an inflated measure of the risk premium because the approach uses historic commission-authorized ROEs and historic Treasury yields, and the resulting risk premium is applied to projected Treasury Yields. And since Treasury yields are always forecasted to increase, the resulting risk premium would be smaller if done correctly, and would require the use of projected Treasury yields in the analysis rather than historic Treasury yields.[55] This mismatch, use of historic Treasury yields then applied to projected Treasury yields, results in a higher measure of the risk premium.

In addition, Mr. Hevert's RP approach is a gauge of *utility regulatory commission* behavior and not *investor* behavior. Capital costs are determined in the marketplace through the financial decisions of investors and are reflected in such fundamental factors as dividend yields, expected growth rates, interest rates, investors' assessment of the risk, and the expected return of different investments. Regulatory commissions evaluate capital market data in setting authorized ROEs, but also take into account other utility- and rate case-specific information in setting ROEs. As such, Mr. Hevert's approach and results reflect other factors such as: capital structure, credit ratings and other risk measures, service territory, capital expenditures, energy supply

[55] For example, on Exhibit RBH-3, page 19, Mr. Hevert reports a commission-authorized ROE of 9.50% on December 30, 2015. On that day, the 30-year Treasury yield was 2.93%. Hence, Mr. Hevert reports a risk premium of 6.57% (9.50% minus 2.93%). However, projected interest rates are always higher than current rates. If the projected long-term Treasury rate was 4.80% at the time, as Mr. Hevert uses in this case, the risk premium would only be 4.70% (9.50% minus 4.80%).

issues, rate design, investment and expense trackers, and other factors used by utility commissions in determining an appropriate ROE, in addition to capital costs. This is especially true when the authorized ROE data includes the results of rate cases that are settled and not fully litigated.

Finally, Mr. Hevert's methodology produces an inflated required rate of return since electric utilities have been selling at market-to-book ratios in excess of 1.0 for many years. This indicates that the authorized rates of return have been greater than the return that investors require. The relationship between ROE, the equity cost rate, and market-to-book ratios was explained earlier in this testimony. In short, a market-to-book ratio above 1.0 indicates that a company's ROE is above its equity cost rate. Therefore, the risk premium produced from Mr. Hevert's study is overstated as a measure of investor return requirements and produces an inflated equity cost rate.

E. Flotation Costs

Q. PLEASE DISCUSS MR. HEVERT'S ADJUSTMENT FOR FLOTATION COSTS.

A. Mr. Hevert includes an explicit ROE adjustment for equity flotation costs of 0.12%. This adjustment is erroneous for several reasons. First, he has not identified any current or prospective equity issues by FPL or its parent company, NextEra, to justify this adjustment. As such, the Company is requesting higher revenues in the form of a ROE adjusted for flotation costs, even though the Company has not identified any such costs.

Beyond this issue, it is commonly argued that a flotation cost adjustment is necessary to prevent the dilution of the existing shareholders. However, this is incorrect for several reasons:

(1) If an equity flotation cost adjustment is similar to a debt flotation cost adjustment, the fact that the market-to-book ratios for electric utility companies are over 1.5X (as shown on page 3 of Exhibit JRW-7) actually suggests that there should be a flotation cost *reduction* (and not an increase) to the equity cost rate. This is because when (a) a bond is issued at a price in excess of face or book value; and (b) the difference between its market price and the book value is greater than the flotation or issuance costs, the cost of that debt is lower than the coupon rate of the debt. As a result, the amount by which market values of electric utility companies are in excess of book values is much greater than flotation costs. Hence, if common stock flotation costs were exactly like bond flotation costs, and one was making an explicit flotation cost adjustment to the cost of common equity, the adjustment would be downward;

(2) If a flotation cost adjustment is needed to prevent dilution of existing stockholders' investment, then the reduction of the book value of stockholder investment associated with flotation costs can occur only when a company's stock is selling at a market price at or below its book value. As noted above, electric utility companies are selling at market prices well in excess of book value. Hence, when new shares are sold, existing shareholders realize an increase in the book value per share of their investment, not a decrease;

(3) Flotation costs consist primarily of the underwriting spread (or fee) rather than out-of-pocket expenses. On a per-share basis, the underwriting spread is

the difference between the price the investment banker receives from investors and the price the investment banker pays to the company. Therefore, these are not expenses that must be recovered through the regulatory process. Furthermore, the underwriting spread is known to the investors who are buying the new issue of stock, and who are well aware of the difference between the price they are paying to buy the stock and the price that the company is receiving. The offering price which they pay is what matters when investors decide to buy a stock based on its expected return and risk prospects. Therefore, the Company is not entitled to an adjustment to the allowed return to account for those costs; and

(4) Flotation costs, in the form of the underwriting spread, are a form of a transaction cost in the market. They represent the difference between the price paid by investors and the amount received by the issuing company. Whereas FPL believes that it should be compensated for these transaction costs, it has not accounted for *other* market transaction costs in determining its cost of equity. Most notably, brokerage fees that investors pay when they buy shares in the open market are another market transaction cost. Brokerage fees increase the effective stock price paid by investors to buy shares. If the Company had included these brokerage fees or transaction costs in its DCF analysis, the higher effective stock prices paid for stocks would lead to lower dividend yields and equity cost rates. This would result in a downward adjustment to their DCF equity cost rate.

Q DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes, it does.

BY MR. SAYLER:

Q And, Dr. Woolridge, do you have exhibits that were identified as JRW-1 through JRW-13 attached to your direct testimony it?

A Yes.

Q All right. And is it correct that on August 5th, 2016, OPC filed a revised JRW-1 on your behalf?

A Yes.

Q And on also on August 15th, Office of Public Counsel revised -- filed a revised JRW-4, is that correct?

A Yes.

Q All right.

MR. SAYLER: And Madam Chair, OPC would note for the record that Exhibit 169 identified on staff's comprehensive exhibit list --

CHAIRMAN BROWN: Yes. It.

MR. SAYLER: -- should be updated to the reflect that JRW-4 was revised.

CHAIRMAN BROWN: Okay. Noted.

BY MR. SAYLER:

Q And were these exhibits and revisions prepared under your direction and supervision?

A Yes.

Q All right.
MR. SAYLER: And again all of Dr. Woolridge's exhibits are No. 166 through 178. And I believe this is --
CHAIRMAN BROWN: Staff does not have any.
MR. SAYLER: Okay.
BY MR. SAYLER:
Q And these exhibits, are they true and correct to the best of your knowledge and belief?
A Yes.
Q And if you were asked the same questions -- sorry, skipping ahead. Now, I am ready.
Dr. Woolridge, did you prepare a five-minute summary for your testimony?
A Yes.
Q All right. Would you please provide that?
A Okay. Good afternoon Commissioners. My summary focuses on the appropriate return on equity for FPL, and identifies and discusses the those most significant ROE issues in this case.
In my opinion, under the current market conditions, the appropriate ROE for an electric utility with a risk profile such as FPL is 8.75 percent. My ROE recommendation is tied to the capital structured recommended by OPC witness O'Donnell, which includes a

common equity ratio of 50 percent.

My relatively low ROE recommendation reflects current capital market conditions. With interest rates low, and stock prices high, capital costs are historically low levels. In contrast to my recommendation, FPL witness Mr. Hevert has proposed a common equity cost rate of 11 percent. His recommendation is based on FPL's recommended capital structure with a 59 percent common equity ratio.

Initially in my testimony, I highlight three changes have occurred since FPL's last rate case in 2012. First of all, interest rates, as indicated by the 30-year treasury rate, have declined from about three percent or so at the time of the decision to 2.25 percent.

Second, the average authorized ROE for electric utilities has declined from about 10 percent in 2012 to the 9.5 percent range in 2016.

And third, Moody's credit rating for FPL was increased from A2 to A1 in January of 2014. This would suggest that FPL's investment risk has gone down.

Also since the last rate case, FPL's earned return on equity has increased from about 10.5 percent to about 11.5 percent. Now, this average compares to the average for electric utilities in general, which has been about nine-and-a-half percent.

In part, because of FPL's high return on equity, the common stock of FPL's parent, NextEra, has out-performed the electric utilities as well as the S&P 500 since the last rate case.

Now, turning to the issues in this case. Both FPL's Mr. Hevert and myself a have applied the discounted cash flow in capital asset pricing models to the proxy groups of electric utility companies. Mr. Hevert has also used a bond rate -- bond prem -- bond yield risk premium approach.

Now, my DCF and CAPM studies suggest a range of 7.9 percent to 8.85 percent. I use the -- I use 8.75 percent within that range. Mr. Hevert's equity cost rate range from 861 percent -- 8.61 to 13.09 percent, and he uses 11 percent for FPL.

There are several major issues, I believe, when we look at the differences of opinion in this case. The first major differences are different capital market assumptions. In his capital markets, Mr. Hevert presumes interest rates are going up based on forecast of interest rates from economists. I show that these forecast of higher interest rates have been around about 10 years, and interest rates have simply gone down since that type.

Second of all, Mr. Hevert has significantly changed his equity cost rate approaches in this case. In previous cases over the years, he has primarily relied on the DCF approach. However, in this case, he has used a risk premium and CAPM approaches, and given his DCF results very little weight.

The third major issue is the riskiness of FPL. Mr. Hevert has failed to recognize that FPL is less risky than other electric utilities, as majored by Moody's and Standard & Poor's credit ratings. Mr. Hevert has cited risk considerations such as the company's expenditures, their geography and their nuclear risk in assessing the relative risk of FPL, and in order to support his 11 percent recommendation.

All all of these risk factors are, indeed, examined by Moddy's Moodies and Standard & Poor's when put together credit ratings, and they have concluded FPL has better credit ratings than the average of the two proxy groups of electric utilities.

My prefiled testimony deals with other issues in the case, and that concludes my summary.

CHAIRMAN BROWN: Thank you.

MR. SAYLER: Madam Chair, we would tender this witness for cross-examination at this time.

CHAIRMAN BROWN: Thank you.

And again, welcome, Dr. Woolridge.

THE WITNESS: Thank you.

CHAIRMAN BROWN: You flew down from State College?

THE WITNESS: Yes, I did. It's not easy to get in here. It's not easy to get in here.

CHAIRMAN BROWN: That is the truth. My parents live up there, so -- all right.

We will start with FIPUG. Again, a reminder, no friendly cross.

MR. MOYLE: Sometimes it's harder to get out of here. We will do our best to accommodate you today. And thank you.

EXAMINATION

BY MR. MOYLE:

Q I am going to ask you the line of questions that I also asked the witness who just took the stand with respect to equity ratio of 10 percent or less as compared to your 8.5 percent.

What have other commissions around the country done recently with respect to ROEs?

MR. GUYTON: Objection. Asked and answered.

MR. MOYLE: It's my second question.

MR. GUYTON: It's already been asked and answered. It's established in the record. It's just simply redundant.

CHAIRMAN BROWN: Mr. Moyle?

MR. MOYLE: Well, he had a different, I think, range or answer. So, I want to see whether he has considered all the ROEs and recently been determined how he got to his information. He put some different numbers out there, said the average was 9.5.

CHAIRMAN BROWN: Okay. Objection overruled.

THE WITNESS: Yeah, I said it's in the range of 9.5 percent. If you look through June of this year, it's lower than it was in the first quarter. So, if you take all of the ROEs as of June, it's around 9.5 percent. I don't know the -- I don't remember the exact number.

BY MR. MOYLE:

Q Okay. And I know you do CAPEX and DCF and these other models, but -- but a lot of the witnesses in this case have said, look, here's what other commissions are doing. You would -- you would agree that that's a relative factual benchmark for consideration, correct?

MR. GUYTON: Objection. It's friendly cross.

CHAIRMAN BROWN: It is.

MR. GUYTON: Either that or he's trying to adopt this witness as his own.

CHAIRMAN BROWN: Mr. Moyle, it is friendly cross. Can you rephrase the question?

MR. MOYLE: Yeah, I will rephrase it.

BY MR. MOYLE:

Q Do -- commissions around the country, when they are making ROE decisions, do they typically consider the same set of parameters?

A I mean, I have testified in 30 different states. And generally, the approach is -- whether it's Mr. Hevert or somebody else or Mr. Baudino -- I mean, they use the same general models usually. And so, they -- they're evaluating the same market data.

They may come to different conclusions about what the appropriate -- they feel the appropriate allowed return is, but generally, the testimony -- I mean, obviously Mr. Hevert and I disagree on some things, but the -- the approaches are the same, looking at interest rates and that sort of thing, the economy. Pretty much the same thing.

Q Okay. And then last question -- assume there is an exhibit in evidence that has some information about recent commission decisions and the average is closer to 10 than 8.75. Why should the Commission go to 8.75, given that exhibit?

A Well, I -- as I say in my testimony, I address that issue. And there were a couple of things I address in my testimony. No. 1 is a number of commissions around the country have been slow to authorize returns below 10 percent and -- Wisconsin is being one of them, and a couple others.

And No. 2, I say that the issue we are addressing is whether a return meets Hope and Bluefield standards. And I give evidence in my testimony about the earned returns of electric utilities; the fact, year-to-date, they're earning 9, 9.2 percent. And their stock prices are up 17 percent.

That's the evidence I present in support of the idea of 8.75 is adequate to meet investors' return requirements.

Q Okay. And your point about a sticking point -- is that kind of like a glass ceiling or something? I mean, don't understand the sticking point 10.

A Well, I mean, if you look at the data over time, their have been -- many commissions have been slow to go below 10. I mean, if you look over the last, say, three years, 85 percent of the authorized returns are below 10 percent. As it turns out, there are states that just refuse to go below 10.

Q Okay. And you think it's time for this

commission to go below 10.

MR. GUYTON: Objections. We have indulged about as much friendly cross as we can indulge.

CHAIRMAN BROWN: Objection sustained.

Mr. Moyle, is that it?

MR. MOYLE: That's it. Thank you.

CHAIRMAN BROWN: All right.

Hospitals.

MR. SIQVELAND: We have nothing for this witness. Thank you.

CHAIRMAN BROWN: Thank you.

Retail federation.

MR. LAVIA: No questions. Thank you.

CHAIRMAN BROWN: Thank you.

FEA.

MR. JERNIGAN: No questions, Madam.

CHAIRMAN BROWN: Thank you.

Sierra Club.

MS. CSANK: No questions.

CHAIRMAN BROWN: Thank you.

AARP.

MR. COFFMAN: No questions?

CHAIRMAN BROWN: FPL Florida Power & Light.

MR. GUYTON: I have a few.

EXAMINATION

BY MR. GUYTON:
Q Dr. Woolridge, welcome back to Florida.
A Thank you.
Q My name is Charlie Guyton. I have a few questions for you today. And I want to start with what I think may be an error in your testimony, but I -- I want to run it by you. Would you turn to page nine?
A I need a copy of my testimony.
Yes.
Q And if you would, look at lines eight and nine on page nine that follow your Figure 4.
A Yes.
Q And would you look back at the question that is posed on page seven that those lines are supposed to be in response to.
A Yes.
Q Shouldn't lines eight and nine on page nine really have been lines eight and nine on page seven? Shouldn't they follow Figure 2 and the question that Figure 2 responds to?
A Yes, they should have.
Q Now, you've testified on a number of occasions before the Florida Public Service Commission, correct?
A I have.
Q And I've gone back and I've found at least

nine cases where you've testified on behalf of the Office of Public Counsel regarding investor-owned electric utility cases. Does that sound about the right number?

A That -- that probably is. I don't know if it's the exact, but that sounds about right.

Q All right. And by my count, it's twice for Florida Public Utilities, twice in Gulf cases, twice in TECO cases, and once in a Progress Energy case; is that fair enough?

A I will accept that, subject to check.

Q Okay. Now, your analytical approach in this case doesn't differ markedly from your analytical approach in those prior cases, does it?

A That's correct.

Q Okay. Now, I went back to take a look at what you recommended in those cases and what the Commission found. And you haven't had a very good track record in terms of convincing the Commission that your specific ROE is correct, have you?

A I do not know those exact numbers. I think they are coming my way, but I do not know the numbers.

Q Okay. Do you know generally that not once has the Commission adopted your specific ROE recommendation?

A Oh, I -- I do. And I agree with you there. I don't know if they've ever adopted FPL's witnesses' ROE recommendation either. But no, you're right. I have -- I have been below where the Commission has authorized returns.

Q Okay. And I am going to ask you about a couple of those cases. I have some documents we can use to refresh your recollection, but I am going to see if we can avoid having to pass that out and take the time.

Is that fine to proceed that --

A That's okay.

Q All right. The first case that I found was a 2009 case where you testified on behalf of OPC in a Florida Public Utilities case. And you recommended a return on equity of 9.15. And the Commission found a return on equity of 11 percent. Do you recall that case?

A I do not --

MR. MOYLE: I'm going to object to this line on relevancy.

CHAIRMAN BROWN: Mr. Guyton?

MR. GUYTON: I think it goes to the weight that the Commission should give this witness. I mean, he has testified here before. You've had the benefit of reviewing his testimony. And you've not -- you've yet to accept it. And I just think it goes to the weight it should be given the witness' testimony.

MR. MOYLE: I mean, every case has its own facts and make a decision, this is the case. And what -- what, commissions have done here or there and other jurisdictions, we don't -- we don't think is relevant.

CHAIRMAN BROWN: Objection overruled. I will allow it, but -- but cautiously.

MR. GUYTON: Certainly.

BY MR. GUYTON:

Q I think the question was: Do you recall that specific case?

A I do not recall that specific case. I -- so, no, I don't recall.

Q Okay. Do you recall testifying in FPL's 2009 rate case?

A I do. And Dr. Hevert was the FPL witness.

Q And there, in the 2009 case, the Commission approved a return on equity that was only 50 basis points higher than your recommended return on equity, correct?

A I do -- I do recall that. I think I was at 9-and-a-half percent and the Commission adopted a 10-percent.

Q And that finding by the Commission was the lowest return on equity authorized by this commission in over 30 years, wasn't it, for an electric IOU?

A I -- I will accept that, subject to check.

Q And shortly after that finding, two rating agencies downgraded Florida Power & Light Company, correct?

A I don't recall that. I -- I do -- I do know that there were some short-term ramifications. I don't recall all the details.

Q Okay. Do you recall the most recent case in which you testified before the Commission, another Florida Public Utilities case?

A Yes. I believe that was two years ago.

Q All right. And there, your recommended ROE was 125 to 150 basis points lower than what the Commission ultimately set the ROE, was it not?

A I don't remember the exact details. I -- so, I don't remember. But I will accept your numbers, subject to check, if you have them.

Q In the -- in the nine cases where you've previously testified or filed testimony on behalf of OPC in electric IOU cases, some of those cases were fully litigated and some were settled, were they not?

A Yeah. Well, at least the most recent FPL case was settled, yes.

Q Okay. Would you accept, subject to check, that, out of the nine cases, five were settled and OPC agreed in a settlement to a return on equity higher than what you recommended in your testimony?

A I do not recall the details. I will accept that, subject to check.

MR. GUYTON: Okay. That's all we have. Thank you.

CHAIRMAN BROWN: Thank you.

Staff.

EXAMINATION

BY MS. BROWNLESS:

Q Good afternoon, Dr. Woolridge. How are you today?

A Okay. Thank you.

Q In preparing your testimony in this proceeding, did you review the testimony of FP&L's direct witnesses?

A Excuse me?

Q When you were preparing your testimony today -- in the process of preparing it, did you review the testimony of Florida Power & Light's direct witnesses?

A I did. I, obviously, focused on Mr. Hevert and Mr. Dewhurst.

Q Thank you.

A But I think I really responded to Mr. Hevert.

Q Thanks.

And in this case, staff has filed 42 sets of interrogatories and 21 sets of production of documents during the five-month course of this proceeding. Were you provided the responses to staff's interrogatories and POD request associated with your subject area as they became available?

A I was.

Q Were you also provided responses associated with your subject area of FIPUG's discovery, FEA's discovery, South Florida's discovery, AARP's discovery?

A I was, but I really focused on the questions I asked because those are the ones I was interested in. But some of them refer to other parties' data requests. So, I looked at those.

Q Okay. And I think you just answered this, but I will ask it. During the course of your engagement, did you prepare discovery questions for the Office of Public Counsel?

A Yes.

Q And I note OPC filed 20 sets of interrogatories in this case and 18 POD requests. And

how many of those did you prepare, sir?
A I don't recall.
Q Okay. Was it more than 10?
A Probably more than 10, less -- no, probably about 20 or so.
Q Okay.
MR. MOYLE: Madam Chair, I think -- this seems to be getting into attorney work product if you are asking an expert witness what he talked to a lawyer about --
MS. BROWNLESS: We're asking him --
MR. MOYLE: -- helped prepared questions.
CHAIRMAN BROWN: Hold on.
MS. BROWNLESS: -- if he reviewed the responses to the discovery that he asked. And he has answered our question, Mr. Moyle.
And finally, you had an --
CHAIRMAN BROWN: Suzanne -- Suzanne, one second, please.
Mr. Moyle?
MR. MOYLE: I thought they were asking, did you help the lawyers or did you prepare questions that were served as discovery. If I misheard that, that's okay, but it seems that's encroaching upon, you know, attorney-client work product.

CHAIRMAN BROWN: Ms. Brownless?

MS. BROWNLESS: Well, first of all, we did ask that question. We are not attempting to impinge upon attorney-client work product. We're just asking if he prepared discovery and if he reviewed -- was allowed to review the responses to the discovery that he prepared.

CHAIRMAN BROWN: Can you restate the question that you're going to ask him?

BY MS. BROWNLESS:

Q Were you -- did you -- were you provided the responses to your discovery?

A Yes.

Q Thank you.

I am going to turn to the substance of your testimony. In your analysis of the appropriate return on equity for FP&L, did you make an adjustment to the -- to include flotation cost in your recommended return on equity of 8.75 percent?

A No.

Q Okay. And do you agree that the electric companies in your proxy group and that NextEra Energy periodically issue stock to raise equity capital?

A Yes.

Q And do you also agree that, when a company

sells stock, it incurs a cost for that transaction?

A When a company sells stock to the market, it incurs a -- a cost.

Q Okay. Do the transaction costs reduce the amount of the proceeds that an electric company receives from the sale of the stock?

A It -- it will. And -- and again, this is what marker -- the investors -- when they price the stock, they understand this. And so when we use the stock price in a DCF model, we fully account for it.

Q Okay. If I am -- and correct me if I'm wrong -- in your testimony, do you use credit ratings to compare the investment risk of FPL to that of your electric-company proxy group?

A I do. And I use credit ratings because we don't have any other -- any risk measures for FPL. You don't have stock ratings. You don't have betas. You don't have things like that.

So for FPL specifically, credit ratings are the only real risk measure you have.

Q And that's because FP&L doesn't issue its own stock, correct?

A That's correct.

Q And with regard to the credit ratings, when you analyze those, did you reach the conclusion that

FP&L is less-risky than other electric utilities?

A Yes.

Q Now, FP&L is an electric operating company. And the electric companies in your proxy group are holding companies; is that correct?

A Yes. That's correct.

Q Is the purpose of Moody's and Standard & Poor's credit ratings to assess a utility's creditworthiness and its ability to pay its debts obligations?

A It is. Now, they are assessing the credit. But again, we don't have any other risk measure for -- for FPL. And, you know, there's different -- you know, you use beta. I have used some other Value Line risk metrics. There's different measures risk. And none of them are perfect.

It's just credit ratings are one that you have for the operating companies and you have for the holding companies. So I am not saying there is a perfect measure risk. I -- I prefer credit ratings. They are universally applied. People understand them. That sort of thing.

And so they are going to consider everything about the operating characteristics of FPL and the other utilities as well. So that all goes into the evaluation process. So I agree with you; it is for there debt, but you know, it's -- it's a risk measure that we actually have something for for FPL.

MS. BROWNLESS: Thank you so much. That concludes our questions.

CHAIRMAN BROWN: Thank you, Ms. Brownless.

Commissioners, any questions?

Redirect, Mr. Sayler?

MR. SAYLER: Yes, ma'am.

FURTHER EXAMINATION

BY MR. SAYLER:

Q Dr. Woolridge, do you remember being asked a few questions by the counsel for FIPUG?

A Yes.

Q I believe he used the term "CAPEX." When you do these analyses, do you use a CAPEX analysis or --

A CAPM, the capital asset pricing model.

Q Okay. You recall being a few -- or asked a few questions about that -- by FPL's counsel about your participation in several cases with the Office of Public Counsel?

A Yes.

Q And in 2009, do you recall being asked about the ROE that you recommended?

A Yes.

Q And do you recall the ultimate ROE being 11.25, subject to check?

A I -- I do not recall. I mean, 2009, I thought the reference was to the FPL case.

Q Okay.

A I am not sure what --

Q Okay.

A -- 11.25 was.

Q Now, the Florida FPUC case -- do you know if that was resolved by Commission decision or was that a settlement?

A I don't remember.

Q Okay. And now, for the 2009 FPL rate case, do you recall being asked a question that, following the Commission's decision for a -- to adopt a 10.0 ROE, there was assertions that two rating agencies downgraded FP&L?

A Yeah, I -- I don't recall the specific -- I do remember there were some short-term issues, but --

Q All right. Do you recall if that was limited just to FPL or involved some of the operating companies?

A I don't remember.

Q Okay. But subsequent to that downgrading, where is FPL's rating today?

A Well, I mean, it -- subsequent, you know --

FPL is rated A-1 by Moody's. And Moody's actually -- they -- they look at the individual company, whereas S&P looks at the whole family. So S&P looks at NextEra and everything else.

And they're -- and they are at A-minus with S&P. But that's the overall credit rating. And they have been upgraded, that sort of thing.

Q All right.

A Of course, another element since 2009 is authorized ROEs that are a lot lower now than they were in 2009.

Q All right. Dr. Woolridge, in some of the cases you were involved with and provided testimony, the cases were ultimately settled for an ROE above what you recommended; is that correct?

A Yeah. I mean, sometimes settlements -- they -- they stipulate and include an ROE. And sometimes they don't. I don't remember all the different cases in Florida.

Q Now, when it comes to the settlements, are there many issues settled besides just the ROE?

A Oh, yeah. I think all of us understand, who have been involved in rate cases, when there is a settlement, there is a give-and-take on different issues.

Q All right.

A I mean, if you go back -- in fact, if you go back and look at RRA, they specifically note cases that are settled. And in many -- in many states, the Commission will say that there is no precedence set here by the ROE because it's a settlement.

But not all states have that -- that stipulation when there is a settlement and there is a stated ROE.

Q Okay. And when the Commission accepts a settlement that has a -- an identified ROE, is that ROE set -- is that ROE adjudicated like in a regular rate case?

MR. GUYTON: Objection. Goes beyond the scope of the direct as well as the cross. I just simply asked if OPC agreed to a number higher than Mr. -- Dr. Woolridge recommended.

CHAIRMAN BROWN: Mr. Sayler?

MR. SAYLER: Yes. I understand he used the word "set," and he opened -- I believe he opened the door in the sense to explain or to explore why that particular ROE was agreed to in a settlement because there are multiple issues resolved in settlements and as part of the give and take.

CHAIRMAN BROWN: Objection overruled.

MR. SAYLER: All right.

CHAIRMAN BROWN: Rephrase the question or restate the question to the witness.

MR. SAYLER: Yes, ma'am.

BY MR. SAYLER:

Q Does -- when accepting a settlement, does the Commission set the ROE or is that agreed to by the parties?

A Well, it's agreed to the parties. Sometimes it's, then, subject to review by commissions. I have seen commissions who, then, lower the ROE that was in the settlement. And then both parties still have to sign on to it or the different parties.

But no, I mean, eventually -- in some cases, there is a -- an ROE, which is part of the settlement and then approved by the Commission. Sometimes the Commission won't accept the settlement because they don't like ROE or something like that. And sometimes they adjust the ROE and give it back to the parties and say, if you want to agree, this is the number.

So, I mean, they are all a little bit different.

Q Do you recall being asked a question by Commission staff about flotation costs?

A Yes.

Q Who is the issuer of the stock?
A Well, in -- in the case, it's NextEra. It's the parent. It's not FPL.
Q And who decides how much of the funds obtained from the stock issuance go to the various operating companies?
A Well, the parent company and the board of directors of the parent company are the ones that allocate the capital --
Q All right.
A -- to the subsidiary or the various subsidiaries.
Q All right. And then, who absorbs that, for lack of a better word, flotation costs or the cost of equity issues?
A Well, I mean, there's different -- when you talk about flotation costs, you have out-of-pocket costs where you pay the attorneys, you pay the printing, that sort of thing, versus the underwriting spread, which goes to the underwriters. And it's -- it's spread among the selling group of investment firm, that sort of thing.
So there's two different components; out-of-pocket as well as the underwriting spread. And effectively, when you talk about underwriting spread --

I mean, it's not just all stockholders; it's only people who are buying it at the new price. They are the ones out there effectively paying it. So it's different than what it sounds like.

Q All right.

MR. SAYLER: Thank you, Madam Chair. No further questions on redirect.

And at the appropriate time, we would like to ask that you excuse this witness. And we have some -- also exhibits to move into the record.

CHAIRMAN BROWN: Let's not excuse him just yet.

MR. SAYLER: Okay.

CHAIRMAN BROWN: Let's -- we have got Exhibit 166 through 178 --

MR. SAYLER: Yes, ma'am.

CHAIRMAN BROWN: -- with the updated exhibit listed as 169.

MR. SAYLER: Yes.

CHAIRMAN BROWN: Would you like to move those in?

MR. SAYLER: I would like to move those records -- exhibits into the record, Madam Chair.

CHAIRMAN BROWN: Any objection?

MR. GUYTON: No objection.

CHAIRMAN BROWN: Okay. We will move in 166 through 178 with the revised 169.

(Whereupon, Exhibit Nos. 166 through 179 were received into evidence.)

CHAIRMAN BROWN: And now's a good time for you to be excused, Dr. Woolridge.

THE WITNESS: Thank you.

MR. SAYLER: And Madam Chair, thank you to all the parties. Thank you for accommodating Dr. Woolridge's schedules. And save travels back home.

THE WITNESS: My students probably won't be happy.

CHAIRMAN BROWN: It's hard to get back there. Thank you so much.

All right. We are going to be moving on to Dismukes, Witness Dismukes, but let's take about a five-minute break before that.

MR. SAYLER: And during the break, I will pass out the exhibit from Hevert's testimony.

(Brief recess.)

MR. SAYLER: Yes, ma'am. Erik Sayler, Public Counsel. During the break, I passed out a CD along with a roadmap sheet that just identifies all the places in the comprehensive exhibit list where these testimonies were already moved into the record. And the CD contains complete copies of all those testimonies that this commission moved in last week.

CHAIRMAN BROWN: Okay. You have Woolridge's errata provided as 711. Would you like to have that moved into the record?

MR. SAYLER: We are still assembling that errata sheet as we speak.

CHAIRMAN BROWN: Okay. We'll just hold off. You just have to remind me, though.

MR. SAYLER: I will certainly do so.

CHAIRMAN BROWN: Okay.

FPL. Mr. Butler, 710?

MR. BUTLER: Yes. We would move that into the record.

CHAIRMAN BROWN: Any objections?

Seeing none --

MR. MOYLE: Which one?

CHAIRMAN BROWN: 710.

MR. MOYLE: 710, the admissions -- request for admission?

CHAIRMAN BROWN: Yes.

MR. BUTLER: It is.

MR. MOYLE: Yes. So we have objections to that.

CHAIRMAN BROWN: Okay.

MR. MOYLE: So -- so the -- the objections are hearsay based. And probably, just so we have clarity, I will just go through them.

CHAIR BROWN: Can everybody just kind of keep it down so I can hear Mr. Moyle, please? Thanks -- we can hear Mr. Moyle.

MR. MOYLE: So the first one is the -- is the -- the request: FPL has been recognized with awards for the reliability and service it provides to its customers awards.

And the answer says that they have reviewed FPL's website, which indicates that FPL has reported they have received some awards. So somebody is looking at a website, which is hearsay, because no one here is from the website and can talk about that. So that is objected to on hearsay grounds.

The same with respect to No. 8, hearsay grounds. Mr. Kelly is not a witness in this case. And they are trying to put in some information that Mr. Kelly -- is attributed to Mr. Kelly, but clearly, it's hearsay, an out-of-court statement made by a declarant who is unavailable.

Same with No. 9.

Same with No. 10.

Same with -- actually, 15 is a little bit different. And we would object on the grounds there to the extent it calls for a legal conclusion because it's asking the Commission about the Bluefield Supreme Court case and the Hope case. And it goes on and comments on those cases. So, that's inappropriate. We would object on that ground.

And that would be it.

CHAIRMAN BROWN: Okay. I get the basis for objecting on those issues.

MR. BUTLER: May I be heard?

CHAIRMAN BROWN: Yes.

MR. BUTLER: To be clear, we are asking that these be admitted as admissions against the interest of OPC. They apply to OPC. And there is a clear, well-established exception to the hearsay rule on -- for admissions against a party's interest. That is the basis for our request that they be admitted into the record.

MR. MOYLE: They don't apply against me, though. I am not OPC.

CHAIRMAN BROWN: Mr. Hetrick.

MR. HETRICK: Yes. Thank you, Madam Chair.

We agree with counsel for FPL in this regard. There is Section 90.803(18), which acknowledges what he just stated.

CHAIRMAN BROWN: Okay. We are going to go ahead and move that into the record. So, we are moving 710 into the record at this time.

Your objections are noted, Mr. Moyle, for the record.

(Whereupon, Exhibit No. 710 was admitted into the record.)

CHAIRMAN BROWN: All right. Mr. Sayler or OPC, we will hold off on 711 -- 711 until you let us know. Thanks.

All right. Mr. -- Mr. -- Dr. Dismukes, have you been sworn in?

THE WITNESS: Yes, ma'am, I have.

CHAIRMAN BROWN: Thank you.

Ms. Christensen, please proceed.

EXAMINATION

BY MS. CHRISTENSEN:

Q Yes, can I ask the witness, can you please tell us your name and business address for the record, please.

A David E Dismukes, 5800 One Park Insurance

Drive, Suite 5F, Baton Rouge Louisiana.
Q Thank you, Dr. Dismukes.
Can you tell me, did you cause to be prefiled in this cause direct testimonies on June 17th, 2016, regarding the incentive mechanism, and July 7, 2016, for the base-rate case issues in this docket?
A Yes, I did.
Q And did you have any corrections to your testimony?
A I did have some errata, yes, ma'am.
Q Okay. And have you reviewed the errata sheet that has been passed out regarding the changes to your testimony? I believe it was the July 7th testimony.
A Yes, ma'am.
Q And do you have any corrections to that errata sheet?
A No, ma'am, I do not.
Q Okay. Great.
Okay. And if I were to ask you the same questions today with corrections that you have made here today, would your answers and your testimonies be the same today as they were at the time you filed your prefiled testimonies?
A Yes, they would.
Q Okay. Now, on your prefiled testimony for

June 7th -- or, sorry -- June 17th --

A Yes, ma'am.

Q -- did you attach an exhibit labeled DED-1, which I believe was your resume?

A Yes, I did.

Q Okay. And did you have any corrections or changes to that exhibit?

A No, ma'am, I do not.

Q Okay. And then did you also, to your prefiled testimony, have exhibits attached labeled DED-1 through DED-13 attached to your July 7th prefiled testimony?

A Yes, I did.

Q And do you have any corrections to those exhibits?

A No, ma'am, I didn't.

MS. CHRISTENSEN: Thank you.

Can I ask that the witness' prefiled testimonies dated June 17th, 2016, and July 7th, 2016, be entered into the record as though read?

CHAIRMAN BROWN: We will insert Dr. Dismukes' June 17th and July 7th testimony into the record as though read.

(Prefiled direct testimony inserted into the record as though read.)

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is David E. Dismukes. My business address is 5800 One Perkins Place Drive, Suite 5-F, Baton Rouge, Louisiana 70808.

Q. WOULD YOU PLEASE STATE YOUR OCCUPATION AND CURRENT PLACE OF EMPLOYMENT?

A. I am a Consulting Economist with the Acadian Consulting Group ("ACG"), a research and consulting firm that specializes in the analysis of regulatory, economic, financial, accounting, statistical, and public policy issues associated with regulated and energy industries. ACG is a Louisiana-registered partnership, formed in 1995, and is located in Baton Rouge, Louisiana.

Q. DO YOU HOLD ANY ACADEMIC POSITIONS?

A. Yes. I am a full Professor, Executive Director, and Director of Policy Analysis at the Center for Energy Studies, Louisiana State University ("LSU"). I am also a full Professor in the Department of Environmental Sciences and the Director of the Coastal Marine Institute in the School of the Coast and Environment at LSU. I also serve as an Adjunct Professor in the E. J. Ourso College of Business Administration (Department of Economics), and I am a member of the graduate research faculty at LSU. Attached is Exhibit DED-1, which provides my academic vitae, and also includes a list all of my publications, presentations, pre-filed expert witness testimony, expert reports, expert legislative testimony, and affidavits.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have been retained by the Florida Office of Public Counsel ("OPC"), on behalf of the Citizens of the State of Florida ("Citizens"), to provide an expert opinion to the Florida Public Service Commission (the "Commission" or "FPSC") on the application filed by Florida Power & Light Company ("FPL" or the "Company") to recalibrate and continue its asset optimization activities which I will also refer to as its "modified incentive program." This incentive program is "modified" in the sense that it differs from the Commission's long-standing off-system sales incentive policies first approved in Docket No. 830001-EU-B and later modified in Docket No, 991779-EI.[1] The Commission's long-standing incentive policies current apply to all other Florida investor-owned utilities ("IOUs") with the exception of FPL.

Q. IS THE COMPANY PROPOSING TO MAKE ANY CHANGES TO ITS MODIFIED INCENTIVE PROGRAM?

A Yes. The Company is proposing to "recalibrate" many of the terms and conditions of its modified incentive program. In summary, these changes include:

1) Reducing the annual sharing threshold from $46 million to $36 million.

2) Instead of charging ratepayers for variable power plant O&M costs for wholesale economy energy sales greater than 514,000 MWh annually, FPL would net wholesale economy energy purchases against wholesale economy energy sales and charge (or credit) ratepayers for the corresponding variable power plant O&M costs through the Fuel Clause.

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[1] Order No. PSC-00-1744-PAA-EI, , issued September 26, 2000, in Docket No. 991779-EI, at p 14.

3) The rate at which FPL would charge (or credit) variable power plant O&M costs to the ratepayers through the Fuel Clause would decrease from $1.51/MWh to $0.97/MWh.

4) Extend the Incentive Program as modified until December 31, 2020.

Q. HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?

A. The remainder of my testimony is organized into the following sections:

- Summary of recommendations
- Incentive program historic overview
- Modified incentive program performance
- Overcapacity incentives
- Competitive market implications
- Jurisdictional policy issues
- Incentives for off-system purchases
- Conclusions and recommendations

II. SUMMARY OF RECOMMENDATIONS

Q. PLEASE SUMMARIZE YOU RECOMMENDATIONS.

A. I recommend that the Commission reject the Company's request to extend and recalibrate its modified incentive program for two primary reasons. First and foremost, FPL has simply not met its burden of proof nor shown that extension and proposed recalibration of its modified incentive program is in the public interest. The Company has provided a dearth of information on the modified incentive program and whether it has led to verifiable and positive changes in the Company's actions, and how, if at all, those changes have resulted in net public benefits. In addition, the Company has provided no information, nor attempted to quantify, how the proposed changes to its modified incentive program will lead to future ratepayer benefits over and beyond what would otherwise occur under the Commission's long-standing off-system sales incentive policies. Therefore, the Commission must reject the proposal given the lack of compelling information supporting a public interest finding. This rejection will ultimately result in the Company's modified incentive program expiring at the same time as its rate case settlement agreement.

Second, the current proceeding has not afforded parties enough time to review the broad policy implications of this proposal, particularly as it relates to the state's other electric utilities. If the Commission is hesitant to discontinue the program, it should hold FPL's request in abeyance until the matter can be explored in greater detail in a separate proceeding where all of these incentive issues can be thoroughly and fully vetted for not only the Company, but also for all Florida utilities. In past proceedings involving these types of incentive programs, the Commission recognized that its incentive policy decisions would have ramifications extending well beyond simple ratemaking, including those impacting existing and emerging markets and resource efficiency. FPL's current proposals will have the same important market and efficiency implications and should be examined within the context of a comparable proceeding.

Q. SUMMARIZE THE MAJOR CONCERNS YOU HAVE WITH THE COMPANY'S MODIFIED INCENTIVE PROGRAM PROPOSAL.

A. I have a number of concerns about the Company's proposal that I will discuss in greater detail in my testimony that include:

- The Company has provided no substantive evidence on the extent to which its physical assets have been meaningfully and significantly optimized as a result of the modified incentive program.

- No compelling information has been provided by the Company on the extent to which ratepayers will benefit from a continuation and recalibration of its modified incentive program.
- The Company has provided no compelling evidence examining the extent to which its modified incentive program represents a considerable improvement over the Commission's long-standing incentive programs.
- The Company's modified incentive program can lead to inappropriate incentives for the over-development of capacity resources and, as a result, over-capitalization or inefficient capacity-related expenses.
- The Company's modified incentive program has anti-competitive market implications that include the potential to, but are likely not limited to:
    - The use of regulated assets and vertical market power to create an unfair competitive advantage in competitive wholesale energy market transactions.
    - The creation of an unequal playing field between FPL and the state's other IOUs.
    - The creation of an unequal playing field between FPL and other competitive energy marketers.
- It is not clear, from a policy perspective, that the FPSC has the regulatory authority to incent utilities to become active competitive energy marketers, particularly in competitive natural gas markets. The Company's modified incentive program has less to do with asset optimization than it does with creating new and expanded market opportunities and incentive financial returns for the Company and its shareholders outside the traditional utility business model of generation, transmission, and distribution as defined by Florida law. For instance, there are no explicit legislative policies or statutes that encourage the Commission to offer financial incentives to electric utilities in return for utilities successfully entering into transactions that generate profits off natural gas commodity sales; neither inside, nor outside, the State of Florida.
- Giving utilities an incentive return for purchasing electricity that is lower-cost than a utility's own self-generation is simply antithetical to the philosophical underpinnings of utility regulation. Part of a utility's obligation to serve is to provide least-cost service and failure to do so should represent grounds for imprudence, not the provision of incentive financial returns.

III. INCENTIVE PROGRAM OVERVIEW

Q. PLEASE DISCUSS THE ORIGINS OF THE COMMISSION'S OFF-SYSTEM SALES INCENTIVES POLICIES.

A. The Commission's original off-system sales incentive policies date back several decades to the time of the energy crisis of the early 1980s. During this time period, energy costs were high, and there were emerging questions about generator availability, generator efficiency, and the various primary fuels used to generate electricity. This was the period in which Florida began adopting policies encouraging both demand- and supply-side efficiencies, as well as fuel diversity. In 1984, the Commission established an incentive program to encourage electric IOUs to participate more actively in what was known as the Florida Energy Broker Network ("broker network"). Under the broker system, utility generators would "trade" excess generation on a cost basis, where the "gains" on sale would be determined as the relative differences of the cost of generation being displaced by the broker sales.

Q. WHY DID THE COMMISSION NEED TO ADOPT INCENTIVES TO ENCOURAGE UTILITIES TO PARTICIPATE IN THIS PROGRAM?

A. At the time, incentives were thought to be needed for a variety of reasons. First, off-system sales, as a general matter, arose very infrequently. Wholesale markets, as we know them today, did not exist. To the extent that a wholesale "market" could be said to exist, this market was limited to longer-term, multi-year transactions between utilities, not short term-type commodity transactions which occur on a regular basis in today's wholesale electricity market. Thus, creating an incentive to encourage utilities to participate in what was becoming a platform for short-term sales transactions seemed important. Second, utilities at that time did not dedicate considerable dispatch and operational resources to facilitate these kinds of short-term transactions, so an incentive was determined to be important to encourage utilities to make the appropriate investments and incur certain costs which were needed to participate in the emerging broker system. Lastly, and as noted initially, the early 1980s reflected a period of energy crisis, and an incentive was deemed appropriate to facilitate greater supply-side efficiencies that would benefit both utilities and ratepayers.[2]

Q. WERE THERE ANY OTHER REASONS FOR ADOPTING THESE NEW PROCEDURES FOR OFF-SYSTEM SALES?

A Yes. Prior to the Commission's rules, off-system sales revenues were credited to base rates and were not part of the fuel adjustment clause proceedings. During that time period, the Commission and the utilities found it difficult to estimate the exact dollar amounts that should be credited to ratepayers. Thus, the Commission decided to move these transactions out of base rates and into the fuel clause for recovery with the advent of its new policies and incentives.

Q. HOW WAS THE ORIGINAL INCENTIVE POLICY STRUCTURED?

A. The Commission decided to allow utilities to share in the gains on sales made into the broker network. The incentives were structured such that utilities and their shareholders would receive 20 percent of any gains made on these relatively limited, off-system "opportunity sales," whereas ratepayers would receive, as credits through their fuel charge, the remaining 80 percent of those gains.[3]

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[2] In re: Fuel Adjustment Recovery Clauses of Electric Utilities – Treatment of Gain on Economy Sales, Order No. 12923, issued January 24, 1984, in Docket No. 830001-EU-B.

[3] In re: Fuel Adjustment Recovery Clauses of Electric Utilities – Treatment of Gain on Economy Sales, Order No. 12923, issued January 24, 1984, in Docket No. 830001-EU-B.

Q. **DID THE COMMISSION APPEAR TO EXPEND CONSIDERABLE RESOURCES IN EXAMINING AND DEVELOPING THIS INCENTIVE POLICY?**

A Yes. The Commission addressed this compelling issue in the fuel docket, and received testimony from the affected parties about the most appropriate means to incent utilities to make wholesale sales through the broker network.

Q. **HAS THE COMMISSION EVER REVISITED THIS OFF-SYSTEM SALES INCENTIVE POLICY?**

A. Yes. In 1999, the Commission decided to revisit its off-system sales incentive policies given the dramatic changes that were arising in the industry during this time period. The Energy Policy Act of 1992 included provisions that began the process of opening wholesale markets to competition. In the mid-1990s, the FERC promulgated rules (Orders 888 and 889) defining the framework in which wholesale competition would be conducted. This was the same time period in which independent power producers ("IPPs"), or "merchant power providers", started to construct for-profit generation facilities, including several in Florida. For most utilities, transactions in wholesale markets became a more important part of their overall operations. In fact, many Florida utilities during this time period independently shifted their off-system sales activities away from the cost-based broker system and towards the market-priced competitive wholesale market where off-system sales gains could be higher. These changes convinced the Commission that it needed to revisit its incentive policies.

Q. DID THE COMMISSION MODIFY ITS INCENTIVE POLICIES DURING THIS TIME PERIOD?

A. Yes. The Commission made several changes to its incentive policies during this time period. The first change was to clarify that any off-system sales incentives would apply to all non-separated,[4] non-emergency wholesale transactions and not just those on the broker system.[5] The second change was that, while the Commission maintained the 80 percent/20 percent sharing ratio between ratepayers and shareholders, respectively, the Commission set a threshold for sharing for each jurisdictional IOU on a three-year average. The Commission adopted this policy to ensure that utilities were only rewarded when their off-system sales efforts were greater than average.[6] Thus, 100 percent of any gains on off-system sales that were made below this threshold, would revert to ratepayers.

Q. DID THE COMMISSION EXPEND CONSIDERABLE RESOURCES DURING THIS REVISITED INVESTIGATION?

A Yes. In fact, the Commission went through two separate proceedings to examine whether their off-system sales incentive policies should be modified. The first examination of this issue was done within the utilities' 1999 annual fuel proceeding

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[4] Non-separated wholesale energy sales are either non-firm or less than one year in duration. The assets used to make such sales are not separated from the utility's retail rate base.

[5] The Commission clarified this policy since it found that it was being applied inconsistently across utilities. FPL, FPC (Duke Energy Florida), and TECO, for instance, applied the incentive to broker system sales only whereas Gulf Power applied the incentive to all off-system energy sales.

[6] In Re: Review of the Appropriate Application of Incentives To Wholesale Power Sales by Investor-Owned Electric Utilities. Order No. PSC-00-1744-PAA-EI, issued September 26, 2000 in Docket No. 991779-EI, at pp 10-11.

(Docket No. 990001-EI). The Commission took testimony and conducted a hearing on this matter, and, at the conclusion of the proceeding, found that a greater level of analysis, in front of the entire Commission,[7] was needed.[8] The subsequent, stand-alone proceeding (Docket 991779-EI) addressed the off-system sales incentive issue alone, ran a full seven months, included discovery, pre-filed testimony, a hearing, and briefing schedule. Thus, the Commission, understanding the importance of the changes ongoing in the industry, and the relationship of these changes to their off-system sales incentive policies, expended as much as two years examining this issue within two different proceedings.

Q. HOW DID FPL'S CURRENT MODIFIED INCENTIVE PROGRAM ARISE?

A. The current modified incentive program was included as one paragraph in what was a larger, global settlement agreement reached among several parties in the Company's last rate case (Docket No. 120015-EI).[9] OPC was not a party to the settlement and contested its terms in a subsequent settlement hearing.[10] While there was a hearing limited to the terms of the settlement agreement (including some very narrowly-scoped testimony on the modified incentive program), there was no comprehensive investigation comparable to the original incentive proceedings held in the 1980s, nor the subsequent proceedings held in the late 1990s.

[7] The fuel proceeding in which the off-system sales incentive issue was originally revisited was reviewed by a three-Commissioner panel rather than the full Commission.

[8] In Re: Fuel and Purchased Power Cost Recovery Clause and Generation Performance Incentive Factor. Order No. PSC-99-2512-FOF-EI, issued December 22, 1999, in Docket No. 990001-EI, at pp 4-5.

[9] In re: Petition for Increase in Rates by Florida Power & Light Company, Order No. PSC-13-0023-S-EI, issued January 14, 2013, in Docket No. 120015-EI, at pp. 13-15.

[10] In re: Petition for Increase in Rates by Florida Power & Light Company, Docket No. 120015-EI, Hearing Transcript, Volume 35, at p. 5177.

Q. HOW WAS THE MODIFIED INCENTIVE PROGRAM STRUCTURED IN THIS 2012 SETTLEMENT AGREEMENT?

A. The modified incentive program significantly changed and expanded the types of transactions upon which FPL could receive financial incentives. The new "modified" incentive program was defined for a four-year period, and includes at least five different types of transactions, originating from several utility assets, not just power generation. These transactions, and their supporting assets, include:

1) Gas storage utilization: Release contracted natural gas storage or sell stored natural gas.
2) Delivered city-gate gas sales using existing transport: Sales of natural gas to Florida customers combined with FPL's existing gas transportation capacity.
3) Production (upstream) area sales: Sales of natural gas in the production areas combined with FPL's existing gas transportation capacity.
4) Release natural gas pipeline capacity and electric transmission capacity: Sales of idle natural gas transportation and/or electric transmission capacity.
5) Asset Management Agreement: Outsourcing of optimization functions to a third party through assignment of transportation and/or storage rights in exchange for a premium paid to FPL.[11]

Q. WERE THE "GAINS" LIMITED TO JUST THE LEVERAGING OF THESE ASSETS ALONE?

A. No. The modified incentive program also allows the Company to share in all the "savings" it makes on off-system purchases. In other words, if FPL procures energy from the market at a cost lower than its own, it can share in the benefits it has created by making these purchases. This represents a significant departure from the

[11] In re: Petition for Increase in Rates by Florida Power & Light Company, Order No. PSC-13-0023-S-EI, in Docket No. 120015-EI, issued January 14, 2013, Attachment A, at pp.13-14.

Commission's original and updated incentive policies, and represents a divergence from what is allowed in utility regulation across the country.[12]

Q. WERE THE SHARING PERCENTAGES OR THRESHOLDS CHANGED IN THIS MODIFIED INCENTIVE PROGRAM?

A. Yes, both the thresholds and the sharing percentages were modified from the Commission's prior incentive program. The sharing threshold was set at $46 million.[13] All of the gains on sales for transactions below this threshold are credited to ratepayers. This $46 million threshold was based upon two components that includes: (1) a $36 million "customer savings threshold," purportedly based on FPL's 2013 projections for wholesale economy energy sales gains and wholesale economy energy purchases savings, and (2) an incremental $10 million threshold amount that represents the additional gains FPL anticipated from its other assets (hereafter referred to as a "stretch goal").[14]

Q. WERE THE RATEPAYER BENEFITS CREATED BY FPL'S MODIFIED INCENTIVE PROGRAM LARGER THAN THOSE EXPERIENCED DURING THE 2009-2011 TIME PERIOD UNDER THE COMMISSION'S STATUS QUO INCENTIVE POLICIES?

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[12] The Company was unable to identify any state that offered similar incentives. See FPL Response to OPC's First Set of Interrogatories (Asset Optimization), Number 7 in Docket Nos. 160021-EI and 160088-EI.

[13] In this context, "gains" shall refer to the sum of the following: 1) the difference between incremental revenue and incremental cost of wholesale economy energy sales and eligible asset optimization transactions; and 2) the difference between the transaction price for FPL's wholesale economy energy purchases and its incremental costs if FPL had met that retail load with its own resources.

[14] Direct Testimony of FPL witness Sam Forrest in Docket No. 120015-EI, filed October 12, 2012, at p. 5-6.

A. No. In fact, the reported benefits associated with the modified incentive program were considerably lower than those reported in the prior three years. For instance, FPL reported wholesale energy sales gains of $20.0 million, wholesale energy purchase savings of $182.7 million, for a combined total of $202.8 million during the 2009-2011 time period.[15] The average annual combined gains/savings level for the time period 2009-2011 was reported as $67.6 million, a level that is nearly twice as much as the Company's actual combined gains/savings performance under the modified incentive program (2013-2015). Thus, it is difficult for the Company to argue that the modified incentive program resulted in any meaningful improvement in the financial performance of its off-system sales/purchase activities. In fact, FPL's ratepayers were better off under the 2009-2011 incentive regime[16] since, during that time period, they received over $202.8 million in off-system sales gains/savings, whereas under the modified incentive program, ratepayers have received only $102.2 million.

Q. HOW WERE THE SHARING PERCENTAGES CHANGED FROM THE COMMISSION'S PRIOR INCENTIVE PROGRAM?

A. As noted earlier, all of the gains that are below the $46 million threshold are credited directly to ratepayers. All of the gains above $46 million are shared between FPL and ratepayers as follows:

- FPL retains 60 percent and ratepayers receive 40 percent of gains between $46 million and $100 million;

[15] FPL Schedules A6 and A9 filed in Docket Nos. 100001-EI (January 2010), 110001-EI (January 2011), and 120001-EI (January 2012).
[16] The Commission's current off-system sales incentive that exist for the other three IOUs as set forth by Order No. PSC-00-1744-PAA-EI, issued September 26, 2000, in Docket No. 991779-EI.

- FPL retains 50 percent and ratepayers receive 50 percent of the gains above $100 million.
- FPL credits the ratepayers' portion of all gains as a reduction to fuel costs recovered through the Fuel and Purchased Power Cost Recovery Clause ("Fuel Clause").

Q. DOES THE MODIFIED INCENTIVE PROGRAM INCLUDE ANY OTHER PROVISIONS?

A. Yes. The modified incentive program also allows the Company to recover, through the fuel clause, any incremental operations and maintenance ("O&M") costs incurred in facilitating off-system sales or purchases. These O&M costs include the incremental personnel, software and associated hardware costs incurred by the Company but that were not included in its 2013 test year. The modified incentive program also allows FPL to recover all variable power plant O&M costs (non-fuel O&M expenses and costs for capital replacement parts that vary as a function of a power plant's output) that are incurred by the Company to generate additional output in order to make wholesale economy energy sales. At the time, the Company estimated that any variable power plant O&M costs for generation above 514,000 megawatt-hours ("MWh") would be eligible for cost recovery under these provisions.[17]

Q. COLLECTIVELY, ARE THESE CHANGES SIGNIFICANT?

A. Yes. These modifications to the Commission's original incentive policies are significant and far-reaching and could have considerable near-term and longer-term ratepayer impacts. If the Commission is hesitant to reject the Company's proposal in

[17] Direct Testimony of FPL witness Sam Forrest in Docket No. 120015-EI, filed October 12, 2012, at p. 21.

the current rate case, it should at least consider the appropriateness of this modified incentive program within the context of a longer, more thoughtful proceeding much like it has done in the prior two instances in which it has addressed wholesale incentives. FPL's modified incentive program includes a very wide range of assets, many of which extend well beyond power generation, transmission, and distribution functions, including those associated with natural gas commodity and capacity assets. Further, the sales originating from these assets, including the non-power related assets, can be made anywhere, not just in Florida. It is not clear the extent to which the Commission can or should be incenting for-profit sales in other states, and in other competitive markets (like commodity natural gas sales) outside its jurisdictional footprint. Lastly, the Company's modified incentive program allows its shareholders to receive additional financial returns for doing something that most vertically integrated utilities are required to do as part of their obligation to serve (i.e., utilize the lowest cost energy resources whether they are owned by the utility or obtained from the marketplace). Collectively, the Company's modified incentive program (as well as its currently proposed changes to this incentive program) raises a wide range of regulatory, policy, economic, and financial issues that should be more closely examined.

Q. EXPLAIN HOW THE COMPANY PROPOSES TO UPDATE, OR RECALIBRATE THE MODIFIED INCENTIVE PROGRAM.

A. In this docket, the Company is proposing to recalibrate four of the terms and conditions of its modified incentive program including:

1. Reducing the program's annual sharing threshold from $46 million to $36 million.[18]
2. Removing any minimum level of wholesale energy sales in order to avoid the O&M cost crediting program included in the prior version of its modified incentive program.[19]
3. Reducing the charge (or credit) variable power plant O&M costs to the ratepayers through the Fuel Clause from $1.51/MWh to $0.97/MWh. This rate reflects lower O&M costs for the 2017 Projected Test Year spread out over a higher level of generation.[20]
4. Extending the program (with the recommended changes) until December 31, 2020.[21]

Q. DO YOU THINK THE CURRENT PROCEEDING HAS AFFORDED PARTIES AN APPROPRIATE AMOUNT OF TIME TO EXAMINE THESE ISSUES?

A No. The Company filed this application on April 15, 2016, and parties have had around nine weeks to conduct discovery and evaluate its proposed renewal. The Commission should also note that this program, when it was originally offered on the eve of the hearing in the prior rate case, (and in similar fashion to the filing in this instance) after the initial case was filed, was only evaluated over a three-month period, with limited discovery, as well. Cumulatively, there has been little formal data and information collected or provided on the workings, performance, and policy implications of this incentive program. The Company's application in the current docket is limited to 11 pages, and its pre-filed testimony on the matter is also somewhat sparse coming in at 19 pages, including exhibits. The Company's application and testimony alone provide neither the Commission nor other parties with even a minimally sufficient evidentiary record with which to ascertain the program's performance nor understand the wide

[19] Direct Testimony of FPL witness Sam Forrest, Docket No. 160088-EI, at p. 13.
[20] Direct Testimony of FPL witness Sam Forrest, Docket No. 160088-EI, at p. 14.
[21] Direct Testimony of FPL witness Sam Forrest, Docket No. 160088-EI, at p. 15.

range of policy issues imbued in the current program and its extension. While the Company has provided some historic sales margin information, it has not provided a cost-benefit analysis to indicate that continuation of the program, on a forward-going basis, will be in the public interest. In this proceeding, simply stating that the past is a good forecast for the future is not sufficient.

Q. WHY ARE YOU RECOMMENDING THAT THE COMPANY'S PROPOSAL BE SPUN-OFF INTO A SEPARATE PROCEEDING?

A. First, the information, or lack of information provided in this proceeding should lead the Commission to a decision of rejection for this modified incentive program. However, as I stated earlier, having a separate spin-off proceeding is consistent with the way the Commission has previously evaluated issues of similar significant, industry-affecting magnitude because the Commission understood the ratepayer and market implications of its decisions, and expended considerable resources, over relatively meaningful time periods, in such investigations. Further, the Commission took the time to examine these incentive policy issues in-depth and in stand-alone proceedings that involved all stakeholders since it understood the importance of uniformity and consistency, across all of its regulated utilities, in establishing and maintaining these incentive policies. The Commission also recognized, in each instance, that its incentive policy decisions would have ramifications extending well beyond simple ratemaking, including those impacting emerging markets and resource efficiency. FPL's current proposals will have the same important market and efficiency implications and should be examined within the context of a comparable proceeding if the Commission decides to not reject the proposal out of hand in the current rate case.

Q. ARE THERE ANY OTHER REASONS WHY THE COMMISSION SHOULD EXAMINE THESE ISSUES IN A SEPARATE PROCEEDING?

A Yes. As explained above, the Company's modified incentive program was approved as part of a larger rate case settlement in December 2012 that is set to expire. From a policy perspective, there is nothing in the original settlement agreement suggesting that the FPL modified incentive program, <u>on its own</u>, is in the public interest. The Commission approved the prior settlement, and all its terms and conditions, on a <u>collective, not individual basis, even though there was a separate issue on the incentive mechanism being in the public interest</u>.[22] Settlements, by their very nature, include <u>individual provisions</u> that lead to individual party benefits that may not necessarily be favorable to other parties or to parties as a whole (i.e. the public interest). Thus, there is nothing inherent in the last settlement agreement that should suggest or confer a public benefits finding on the modified incentive program on a stand-alone basis. For that reason, the Commission should let the modified incentive program expire, deny it outright, or examine this issue further in a separate, generic proceeding.

IV. <u>MODIFIED INCENTIVE PROGRAM PERFORMANCE</u>

Q. DOES THE COMMISSION CURRENTLY ALLOW UTILITIES TO EARN INCENTIVE RETURNS FROM ITS OFF-SYSTEM GENERATION SALES?

[22] Order No. PSC 12-0529-PCO-EI, issued October 3, 2012, in Docket No. 120015-EI, at p. 11.

A Yes. The Commission's current policies allow utilities (with the exception of FPL which utilizes its modified incentive program) to receive incentive returns on any "gains on sales" made from economy sales of energy. These economy sales are typically one-time, opportunity sales that arise in the market when hourly, or other short-term wholesale prices rise above a utility's marginal cost, where the marginal cost, in this instance, is defined as the cost for the next increment of electricity generated by a utility from its available capacity. The financial returns, which are shared with ratepayers, are limited to those that are in excess of any utility's prior three-year average. The Commission adopted this three-year threshold in 2000 in order to assure that utilities were actually receiving benefits from extraordinary, not average, efforts. Thus, even if the Commission were to schedule an independent proceeding to investigate FPL's modified incentive program, FPL (in the same fashion as Florida's other IOUs) will continue to receive financial incentives from its off-system generation transactions utilizing the original incentive policies.

Q. HAS FPL PROVIDED ANY EVIDENCE OF ITS PERFORMANCE UNDER THE NEW INCENTIVE?

A. Yes. The Company did provide some limited information regarding its performance on its modified incentive program in its pre-filed testimony. The information shows that the overwhelming amount of the incremental improvement in off-system transactions arose with regards to its Company-owned natural gas transportation capacity and commodity.[23] In total, the Company recorded total gains of some $32.9

[23] Direct Testimony of FPL witness Sam Forrest, Docket No. 160088-EI. EXH SAF-1, at pp. 1-4.

million in these natural gas commodity and capacity sales. Ratepayers received $25.2 million of this benefit while the remainder accrued to the Company and its shareholders.[24]

Q. DOES THE EVIDENCE PROVIDED BY THE COMPANY SUGGEST ITS MODIFIED INCENTIVE PROGRAM HAS BEEN AN UNEQUIVOCAL SUCCESS?

A No. While the Company has been able to more advantageously leverage its natural gas assets, its combined power generation, transmission and purchase performance is no better than it was prior to the approval of this program. The leveraging of the Company's natural gas assets also raises a number of troubling issues. First, it would appear, from the evidence provided by the Company, that it has never attempted to leverage its natural gas assets in the past. The Company appears to have not actively attempted to lower ratepayers costs through these off-system natural gas sales prior to 2012, despite the fact that it believed there was at least some ambiguous claim it could have made on these natural gas sales gains prior to such time.[25] Further, leveraging natural gas assets is not a core electric utility function which is the generation, transmission, and/or distribution and sale of electricity.

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[24] Direct Testimony of FPL witness Sam Forrest, Docket No. 160088-EI. EXH SAF-1, at pp. 1-4.
[25] FPL Response to OPC's First Set of Interrogatories (Asset Optimization), Numbers 1-3, Docket Nos. 160021-EI and 160088-EI.

Q. DOES THE COMPANY'S MODIFIED INCENTIVE PROGRAM THRESHOLD INCLUDE ANY BASELINE LEVEL OF NATURAL GAS ASSET-SUPPORTED SALES?

A Yes. The current modified incentive program, created by the 2012 Settlement, has a threshold level, in which gains are allocated between ratepayers and shareholders, at $46 million. The $46 million threshold was based upon FPL's projected 2013 gains on wholesale economy energy sales and savings from wholesale economy energy purchases of approximately $36 million (customer savings threshold), plus a stretch goal of $10 million annually attributable to its so-called optimization activities.[26]

Q. HAS THE COMPANY PROVIDED ANY PROJECTIONS ON THE POSSIBLE GAINS IT ANTICIPATES FROM AN EXTENSION OF ITS MODIFIED INCENTIVE PROGRAM?

A. No. The Company has not provided any explicit forecasts of the anticipated annual average gains it anticipates from a continuation of its relatively generous incentive program. Presumably, these gains will be lower for ratepayers because part of the Company's proposal is to reduce the customer savings threshold by $10 million to $36 million. The rationale FPL uses to justify this modification is the expiration of the Unit Power Sales ("UPS") contract for 928 MW of capacity from gas and coal-fired units that it had with Southern Company for wholesale energy.[27]

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[26] Direct Testimony of FPL witness Sam Forrest, Docket No. 120015-EI, at pp. 5-6.
[27] Direct Testimony of FPL witness Sam Forrest, Docket No. 160088-EI, at p.12.

Q. WOULD YOU VIEW THE COMPANY'S PERFORMANCE UNDER ITS MODIFIED INCENTIVE PROGRAM AS A SUCCESS?

A. No. The modified incentive program does not appear to have been a success since the overall gains on off-system sales and purchases did not expand during this time period, and there does not appear to be any meaningful change in the utilization of the program's eligible assets. The source of the margins on the Company's natural gas assets appears questionable. Lower commodity prices and lower commodity pricing volatility have likely reduced margin opportunities from a pricing perspective on its natural gas assets, leaving open the question regarding whether or not accumulated capacity inefficiencies are the source of these gains over the past several years. Overall, the fact that the Company is proposing to lower its financial threshold targets to a total of $36 million by eliminating the $10 million ratepayer stretch goal, suggests that the program did not meet the Company's margin expectations, and that their opportunity to capitalize on margins will be lower, not higher on a forward-going basis.

Q. IS FPL DEVELOPING ANY GENERATION CAPACITY THAT WILL OFFSET THIS UPS CONTRACT?

A. Yes. Over the next five years, FPL will install an incremental 2,951 MW of firm capacity and associated energy to serve its retail load and make wholesale economy energy sales.[28] The largest capacity additions include the following:

1) 1,237 MW natural gas-fired combined cycle unit at Port Everglades with a commercial in-service date of April 2016[29];

[28] 2016 FPL Ten Year Site Plan, Table ES-1, at p. 10.
[29] 2016 FPL Ten Year Site Plan, Table ES-1, at p. 10.

2) Incremental 400 MW natural gas-fired combustion turbine units at Lauderdale with a commercial in-service date of December 2016[30]; and

3) 1,633 MW natural gas-fired combined cycle unit at Okeechobee with a commercial in-service date of June 2019[31].

These collective capacity additions should put FPL in the position of replacing the lost UPS contract capacity plus an additional 100 MW from which it can make additional economy energy sales. Thus, the UPS contract expiration does not serve as a meaningful rationale for eliminating the $10 million stretch goal within the Company's modified incentive program.

Q. PLEASE EXPLAIN THE COSTS AND RISKS THAT ARE INCURRED BY RATEPAYERS FOR THESE TYPES OF OFF-SYSTEM TRANSACTIONS.

A. Ratepayers are the party paying for and securing the assets that support these off-system sales transactions. Power plants, power transmission investments, storage facilities, commodity purchases, and natural gas transmission capacity are capital investments paid for by the customers and recovered in their rates. If FPL is successful in marketing the unused capacity of these under-utilized assets, it attains a benefit. If, however, FPL is unable to take advantage of these market opportunities, ratepayers will be the party that is required to continue to cover the capital costs associated with these assets. FPL shares in the upside benefits of the use of these assets, but does not share in the downside risk of their use. Even if the Company were expending resources and capital in marketing the output of these assets, the securitization of those assets' capital costs

[30] 2016 FPL Ten Year Site Plan, Table ES-1, at p. 10.
[31] 2016 FPL Ten Year Site Plan, Table ES-1, at p. 10.

likely dwarfs any incremental cost incurred by the Company in facilitating an off-system sales transaction.

Q. ARE THE SHARING PERCENTAGES ASSOCIATED WITH THE COMPANY'S MODIFIED INCENTIVE PROGRAM MISALIGNED?

A. Yes. The sharing percentages associated with the Company's modified incentive program are misaligned. Ratepayers are getting a far smaller share of the "upside" potential they should be afforded given the risk they incur in securitizing (or financially backing) these assets. The Company's modified incentive program reduces the ratepayers' sharing percentages from 80 percent (for ratepayers under the Commission's long-standing policies) down to 40 percent (under the modified incentive program).

Q. ARE THE SHARING PERCENTAGES INCORRECTLY INVERTED?

A. Yes. The direction of the sharing percentages is incorrectly inverted. The Company and its shareholders get a lower sharing percentage for higher levels of off-system sales gain. For instance, the Company and its shareholders get 60 percent of all savings in asset sales margins (and purchase savings) that are between $46 million to $100 million. Those percentages drop, not increase, if annual sales margins (and purchase savings) increase above $100 million. Put another way, the Company is provided with a higher return on relatively lower risk outcomes than ratepayers. Ratepayers only get additional sharing percentages if relatively lower probability and higher risk outcomes arise (i.e., exceptionally abnormal gains on sales).

Q. DO YOU AGREE WITH THE COMPANY'S CHARACTERIZATION OF THIS MODIFIED INCENTIVE PROGRAM AS AN ASSET MANAGEMENT PLAN?

A No. The Company's modified incentive program lacks many characteristics that comprise a well-managed, well-executed asset management program. These characteristics included establishing a set of upfront, well-defined goals, testing the competitive market for cost-effective third party management services, and developing a program that results in measurable improvements in capacity utilization and costs, among, other things.[32]

Q. DO YOU HAVE ANY OTHER POLICY CONCERNS ABOUT THE COMPANY'S CHANGES TO THE MODIFIED INCENTIVE PROGRAM AND HOW THAT RELATES TO THE COMMISSION'S OVERALL INCENTIVE POLICIES?

A Yes. The Commission has several incentive polices in place, many of which date back decades to a time well before the introduction of competitive wholesale markets. Some of these policies appear to be overlapping and could lead to unintended outcomes. It would be worthwhile for the Commission to evaluate these in an independent proceeding to understand: (a) these programs' past and continued effectiveness; (b) the implications these programs have for retail operations and competitive wholesale markets; and (c) whether or not one, broader composite incentive should be established

[32] See, as one example, a discussion provided by Ken Costello. *Outsourcing of Gas Procurement and Related Functions: A Report to the Colorado Public Utilities Commission.* National Regulatory Research Institute. June 2008.

to increase transparency, to reduce regulatory costs, and to increase regulatory effectiveness.

Q. WHAT DO YOU MEAN BY ONE COMPOSITE INCENTIVE?

A. The broad goal for an electric utility should be one that encourages it to maximize its capacity utilization and its thermal efficiencies. Capacity utilizations are usually measured by capacity utilization rates. Thermal efficiencies are typically measured by unit and/or system-average heat rates, defined as the thermal inputs utilized to generate one kilowatt-hour ("kWh) of electricity. In fact, the Commission already has an incentive that is tied to both measures in the Generation Performance Incentive Factor ("GPIF"). The Commission originally adopted this measure in order to tie incentives to known and measureable performance that is within a utility's operational control.[33] Measures such as market gains on sales are means to greater efficiency and while this is an important statistic for ratemaking purposes, it is not, in and off itself, an efficiency measure. The Commission may find that the use of one single, transparent, yet effective efficiency measure upon which to base an incentive return is more meaningful and effective than a compilation of other factors that have several complicated market and ratemaking implications. I recommend the Commission include such an analysis in my recommended spin-off general proceeding, if the Commission does not outright deny FPL request to continue its modified incentive program.

[33] In re: Investigation of Fuel Cost Recovery Clause Application to Investor-owned Electric Utilities, Order No. 9558, issued September 19, 1980, in Docket No. 800400-CI.

V. OVER CAPACITY INCENTIVES

Q. PLEASE EXPLAIN WHAT YOU MEAN BY AN OVERCAPACITY INCENTIVE RESULTING FROM THE COMPANY'S CHANGES TO THE MODIFIED INCENTIVE PROGRAM.

A. FPL currently makes a number of investments in power generation and transmission facilities in order to serve its load. The Company also makes a number of longer-term natural gas commodity, transportation, and storage investments. These natural gas capacity investments can be contractual in nature, such as the longer-term natural gas transportation agreements it has with the Florida Gas Transmission, Gulfstream, SESH, Transco, and Gulf South pipelines. Overcapacity development, a form of overcapitalization, can be said to arise when the Company secures an amount of capacity for any of these resources that is over and beyond what is needed to reliably serve its retail load.

Q. HOW DOES THE COMPANY'S MODIFIED INCENTIVE PROGRAM LEAD TO OVERCAPACITY INCENTIVES?

A. The Company's modified incentive program effectively expands the scope of its market from just serving its jurisdictional retail load, to one that allows it to use ratepayer-supported resources to compete in a broader set of energy markets. The expansion of this market scope likely creates incentives, particularly at the margin, for the Company to secure greater levels of wholesale power and natural gas capacity than it would without the modified incentive program. This additional capacity provides the Company with the additional resources it needs to expand its ability to earn incentive returns. The greater the capacity, the greater the ability FPL has to leverage that capacity to make a variety of power and natural gas off-system sales.

Q. WOULD THE COMMISSION BE ABLE TO IMMEDIATELY RECOGNIZE THIS OVERCAPACITY DEVELOPMENT?

A. No, not necessarily. Utility resource requirements decisions often include a certain degree of subjectivity since they are tied to a utility's assessment of the capacity required to serve its load in a reliable fashion. Couple this subjectivity with the asymmetrical information that often exists between regulators and regulated companies, and the difficulty in identifying excess capacity becomes more apparent. Further, potential capacity decisions leading to overcapitalization will likely be made at the margin: the purchase of an additional 4.25 percent of capacity on one transaction; coupled with an additional 3.5 percent capacity on another transaction; coupled with an additional 6.2 percent capacity on a third transaction can ultimately lead to a cumulatively large amount of additional capacity and investment.

Q. CAN YOU PROVIDE AN EXAMPLE OF HOW THIS MARGINAL OVERCAPITALIZATION CAN ARISE?

A. Yes. Consider an example where the Company is evaluating a multi-year natural gas transportation agreement for firm capacity. At the same time, the Company is also considering an offer for a level of comparable transportation capacity that is five percent above its requirements, but that additional capacity, at the margin, is being offered at a slightly lower unit price. The Company's modified incentive program will likely incent the purchase of this additional capacity since (a) the cost of securing this capacity will be recovered in rates and (b) the additional lower unit cost capacity can be leveraged to make off-system sales for a profit that will inure to the Company's shareholders.

Q. WOULD THE PURCHASE OF THIS LOWER UNIT-COST TRANSPORTATION CAPACITY BE A GOOD THING FOR RATEPAYERS?

A. No. Granted, on its face, the natural gas transmission example just discussed looks like a good deal for both the utility and for ratepayers. In this example, the utility gets an expanded base of marketable capacity upon which it can earn incentive returns. The utility also bears no risk for securing this capacity since the cost for this additional capacity will be recovered in rates. Ratepayers in this example could, at least in theory, also see benefits in this hypothetical transaction through both the lower unit cost transportation capacity and any additional incentive returns that would arise <u>if</u> the additional capacity is successfully marketed. However, the downside is that ratepayers will have to incur all of the financial risk associated with securing this capacity through rates. If this additional capacity is not sold in the market, then ratepayers will pay the costs for this underutilized capacity and will receive no benefits from the unused resource.

Q. ARE THERE ANY OTHER REGULATORY CHALLENGES THAT COULD ARISE FROM THIS OVERCAPACITY DEVELOPMENT?

A. Yes. Historically, regulators have used cost and investment disallowances as a means of disciplining utility expenditure and investment decisions. A utility that over-purchases capacity, other things being equal, could be subject to an investment disallowance if that capacity is found to be inconsistent with the "used and useful" standard for evaluating investment prudence. FPL's modified incentive program, however, could make a claim that capacity investments, even if they are idle, are used and useful if they were purchased to (a) lower overall capacity unit costs and (b) support an option to make a sale into competitive wholesale energy markets.

Q. EARLIER YOU NOTED THAT RESOURCE PLANNING INCLUDES SOME DEGREE OF SUBJECTIVITY. DO YOU HAVE ANY EXAMPLES RELATIVE TO FPL?

A. Yes. FPL conducts its long-term resource planning based upon three criteria[34] that includes: (1) a 0.1 day per year Loss of Load Probability ("LOLP"); (2) a 20 percent reserve margin; and (3) a 10 percent generation-only reserve margin. The 20 percent reserve margin arose from a 1999 Commission order approving a stipulation between the State's IOUs agreeing to this particular reserve margin.[35] Other jurisdictional utilities are required to meet a 15 percent reserve margin as defined by Rule 25-6.035(1), Florida Administrative Code ("FAC"). FPL's third criteria, however, is part of its own internal resource planning criteria adopted in 2014 and not part of the

[34] In re: Petition for determination of need for Okeechobee Clean Energy Center Unit 1, by Florida Power & Light Company,Order No. PSC-16-0032-FOF-EI, issued January 19, 2016, in Docket No. 150196-EI. p 4.
[35] In re: Generic Investigation into the Aggregate Electric Utility Reserve Margins Planned for Peninsular Florida, Order No. PSC-99-2507-S-EU, issued December 22, 1999, in Docket No. 981890-EU.

Commission's rules. The Company noted that it adopted this additional requirement in order to assure that it could serve all retail load during historical extreme weather events and future peak load days.[36]

Q. WHAT PROMPTED FPL INTO ADOPTING THIS ADDITIONAL RELIABILITY CRITERIA?

A. The prompt appears to have arisen as a result of FPL reporting an all-time peak of 24,872 MW on January 11, 2010. Prior to that event, FPL forecasted a winter 2010 peak of 18,676 MW or some 6,000 MWs lower than what was reported that winter. At the time, FPL had an 8.4 percent internal generation reserve margin, much lower than its current 10 percent standard, and yet was still able to serve its firm peak demand with an additional 1,144 MW of load management still available if needed. In fact, even if the Company's largest unit had tripped off-line during this extreme weather event,[37] FPL could have still served all firm peak demand by implementing additional load management resources.[38] FPL, however, still opted to increase its generation-only reserve margin to 10 percent despite the fact that an 8.4 percent margin[39] proved adequate to meet that extreme event. Today, the generation capacity difference between these two reserve margin levels is almost 390 MWs.

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[36] Amended Rebuttal Testimony of Dr. Steven R. Sim, Exhibit SRS-11, "The Need for a 3rd Reliability Criterion for FPL: A Generation-Only Reserve Margin (GRM) Criterion", filed November 25, 2015, in Docket No. 150196-EI, In Re: Petition for determination of need for Okeechobee Clean Energy Center Unit 1, by Florida Power & Light Company. pp 14-17.

[37] Turkey Point Unit No. 4

[38], Amended Rebuttal Testimony of Dr. Steven R. Sim, Exhibit SRS-11, "The Need for a 3rd Reliability Criterion for FPL: A Generation-Only Reserve Margin (GRM) Criterion" in Docket No. 150196-EI, at pp 16-17.

[39] Amended Rebuttal Testimony of Dr. Steven R. Sim, Exhibit SRS-11, "The Need for a 3rd Reliability Criterion for FPL: A Generation-Only Reserve Margin (GRM) Criterion" in Docket No. 150196-EI, filed November 25, 2015, at pp 24-25

Q. DID FPL SEEK OR RECEIVE EXPLICIT COMMISSION APPROVAL FOR THE 10 PERCENT GENERATION-ONLY RESERVE MARGIN PLANNING CRITERIA?

A. No. FPL neither sought nor received explicit Commission approval for the 10 percent generation-only reserve margin planning criteria because, as the Company explained at the time, Tampa Electric had similarly adopted a unilateral change in its own generation-only reserve margin ten years earlier.[40] However, the point here is not to take issue with the Company's methods for changing its internal reliability criteria, as much as it is to highlight that FPL's decision that: (1) it needed a 10 percent generation-only reserve margin was subjective and (2) it had been made unilaterally without prior Commission approval. This opens the door for the Company to make similar changes in the future if it feels such changes could simultaneously improve overall reliability and facilitate its opportunities for additional off-system generation sales.

Q. IS THE OVERCAPACITY ISSUE RESTRICTED TO JUST POWER GENERATION AND TRANSMISSION CAPACITY ONLY?

A. No. The Company secures natural gas transportation and storage capacity based upon its perceived needs for natural gas supplies from producing basins to its natural gas generation resources in Florida. Natural gas storage and transportation capacity determinations are often a function of numerous variables that include the economics of supply sources and regional constraints, as well as customer load requirements.

[40] Amended Rebuttal Testimony of Dr. Steven R. Sim, Exhibit SRS-11, "The Need for a 3rd Reliability Criterion for FPL: A Generation-Only Reserve Margin (GRM) Criterion" in Docket No. 150196-EI, filed November 25, 2015, at pp 22.

Natural gas-fired utility power generation typically needs relatively secure supplies of natural gas and natural gas capacity. Reliability levels chosen by utility power generators are based upon the risk management decisions made by utilities. As I noted earlier, those decisions will likely be influenced by the Company's modified incentive program if it is continued and approved. This modified incentive program creates profit opportunities that will likely, at the margin, send signals to the utility to secure additional capacity, or to continue to maintain current capacity levels even though those capacity requirements may be unnecessary.

VI. COMPETITIVE MARKET IMPLICATIONS

Q. PLEASE EXPLAIN HOW THE COMPANY'S MODIFIED INCENTIVE PROGRAM CAN NEGATIVELY IMPACT WHOLESALE COMPETITION.

A. The Company's modified incentive program allows it to compete in a number of competitive power and gas markets with energy capacity assets that are securitized (or financially-supported) by its retail customer base. A large number of other wholesale energy market participants are not afforded a similar benefit when they compete in these wholesale markets. If market prices are high, relative to the costs of FPL's energy capacity investments, the Company can sell any unused capacity to the market and earn an additional profit that is over and beyond the just and reasonable rate of return included in its base rates. If market prices are low, however, FPL will not be required to reduce its normal level of profits (recovered through rates) like other market participants. The return of, and on, the assets utilized for these market transactions will be recovered during these market downturns from the Company's retail customer base.

Thus, the Company's modified incentive program not only gives it a free option on the unused portion of its regulated assets, but also supports those assets with a pricing floor that is not available to any other market participant.

Q. PLEASE EXPLAIN HOW EXTRA ORDINARY RETURNS ARE GENERATED WITHIN THE COMPANY'S MODIFIED INCENTIVE PROGRAM.

A. Through normal ratemaking, FPL is allowed an opportunity to earn a just and reasonable rate of return on its prudently-incurred capital investments. Those capital investments are recovered through base rates, or a comparable rate that allows for a return on and of any longer-lived capital investments. The Commission has had a long-standing policy of allowing utilities to recover the cost, including a just and reasonable rate of return, of capital projects through the fuel clause if fuel savings from such projects are greater than the capital expenditures.[41] FPL gets the opportunity to earn this reasonable rate of return on this capacity independent of any anticipated off-system sales. For instance, the forecasted billing determinants developed by FPL to establish its proposed base rates do not include any credits for a forecasted level of off-system sales. In fact, as I noted earlier in my testimony, at one point in the early 1980s these sales were included in base rates, but were then removed, given the uncertainty and potential gamesmanship associated with determining an appropriate forecast in any

[41] In re: Fuel and Purchased Power Cost Recovery Clause and Generating Performance Incentive Factor, Order No. PSC-95-1089-FOF-EI, issued September 5, 1995, in Docket No. 950001-EI, at p 19; In re: Fuel and Purchased Power Cost Recovery Clause and Generating Performance Incentive Factor, Order No. PSC-96-1172-FOF-EI, issued September 19, 1996, Docket No. 960001-EI, at pp 16-17; In re: Fuel and Purchased Power Cost Recovery Clause and Generating Performance Incentive Factor, Order No. PSC-96-0353-FOF-EI, issued March 13, 1996, Docket No. 960001-EI, at pp 14-15; In re: Petition to Recover Capital Costs of Big Bend Fuel Cost Reduction Project through the Fuel Cost Recovery Clause, by Tampa Electric Company, Order No. PSC-14-0309-PAA-EI, issued June 12, 2014, Docket No. 140032-EI, at p 7.

given year. Thus, the incentive payments that FPL incurs for off-system sales gains in excess of its threshold, represent a level of profits that are over and beyond the levels recovered in base rates and can be considered "additional" to the just and reasonable level included in base rates.

Q. CAN THE COMPANY'S MODIFIED INCENTIVE PROGRAM IMPACT MARKET OUTCOMES?

A. Yes. The Company's modified incentive program actively encourages (incents) FPL to participate in a wide range of competitive energy markets. The Company itself indicates that without these incentives, it would not have the appropriate incentives, and presumably motivation, to engage in these activities.[42] In fact, the Company cites, as an example of the impact it has had on markets, the additional gains it has attained through the leveraging of its natural gas assets.[43] In other words, but for the modified incentive program, FPL would not participate in competitive wholesale natural gas markets. The modified incentive program, however, allows FPL to participate in wholesale commodity markets in ways that differ from other market participants since the Company can price the output of its capacity at levels independent of any return on and of the invested capital supporting these sales.[44] This is not a pricing luxury afforded to other market participants over the longer run since all of the costs supporting their

[42] FPL's response to OPC's Twelfth Set of Interrogatories, Number 299, Docket Nos. 160021-EI and 160088-EI.
[43] Direct Testimony of FPL witness Sam Forrest, Docket No. 160088-EI, at p. 11.
[44] FPL's response to OPC's First Set of Interrogatories (Asset Optimization), Number 8, Docket Nos. 160021-EI and 160088-EI

market participation will need to be supported by market prices, otherwise they will go out of business and exit the industry.

Q. DOES FPL HAVE THE OPPORTUNITY FOR A HIGHER LEVEL OF INCENTIVE RETURNS FROM ITS OFF-SYSTEM SALES THAN OTHER FLORIDA UTILITIES?

A. Yes. FPL has two different opportunities for higher financial incentives relative to other Florida IOUs. First, FPL is afforded a higher sharing percentage than the other Florida IOUs for gains that exceed its fixed threshold. Second, FPL has an opportunity to earn incentive returns on a broader set of off-system transactions than the other Florida IOUs including those associated with a number of competitive wholesale natural gas transactions.

Q. HAVE ANY OTHER FLORIDA UTILITIES REQUESTED AN OFF-SYSTEM SALES INCENTIVE PROGRAM COMPARABLE TO THE ONE FPL IS REQUESTING TO EXTEND?

A. Yes. In 2013, Tampa Electric filed a petition which sought an incentive program similar to the Company's 2012 modified incentive program in terms of the eligible transaction types and the allocation of gains between ratepayers and shareholders.[45] The primary difference between Tampa Electric's proposal and the Company's modified incentive program was that the threshold values were scaled to Tampa Electric's relative size compared with the Company. After months of discussion among

[45] Petition for Expedited Approval of Asset Optimization Incentive Mechanism, by Tampa Electric Company, filed January 23, 2013, in Docket No. 130024-EI.

Tampa Electric, intervening parties, and Commission staff, the Commission granted Tampa Electric's request to hold its petition in abeyance.[46] It appears likely that this petition will be refiled or resurrected in the very near future given the renewed FPL effort.

Q. DO THE COMPETITIVE MARKET IMPLICATIONS OF THE COMPANY'S MODIFIED INCENTIVE PROPOSAL WARRANT FURTHER INVESTIGATION IN A GENERIC PROCEEDING?

A. Yes. Wholesale energy markets have changed dramatically since 1999, which was the last time the Commission reviewed its incentive policies regarding off-system sales. In addition, as noted above, other Florida IOUs appear to be interested in modifying their incentive opportunities in ways similar to FPL's program. The time appears to be ripe for a separate generic proceeding to consider the role of incentives in promoting utility supply-side efficiencies, and to ensure that the Commission's policies on these matters: (1) are consistent across all utilities, (2) lead to an appropriate balance of risks and rewards between utilities and ratepayers, and (3) minimize or eliminate opportunities for inappropriate wholesale market distortions.

VII. JURISDICTIONAL POLICY ISSUES

Q. DO YOU HAVE ANY JURISDICTIONAL POLICY CONCERNS ABOUT THE COMPANY'S MODIFIED INCENTIVE PROGRAM?

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[46] In re: Tampa Electric Company's Petition for Expedited Approval of Asset Optimization Incentive Mechanism, Order No. PSC-13-0295-PCO-EI, issued June 25, 2013, in Docket No. 130024-EI.

A Yes. I am concerned, from a policy perspective, that the Company's modified incentive program includes the opportunity to earn extra profits on a wide range of natural gas transactions that go beyond optimizing its core electrical generation, transmission, and production assets. The modified incentive program, for instance, also actively encourages the Company to: (1) utilize contracted storage space to sell stored natural gas when not needed by the utility; (2) deliver and sell natural gas wholesale upstream and mid-stream using the Company's gas transportation capacity that is not needed; (3) sell released unneeded natural gas and electric transmission capacity; and (4) outsource asset optimization through transfer and/or assignment of rights in exchange for a premium to be paid to the Company. Most of these transactions are associated with natural gas markets that are highly competitive in nature, and are not geographically limited to the State of Florida.

Q. WHAT ARE YOUR JURISDICTIONAL POLICY CONCERNS?

A. The Company's modified incentive program allows it to earn additional profits beyond its allowed rate of return through the utilization of assets that are secured by regulated ratepayers. FPL's additional profits under this program do not arise through sales or efficiencies in providing regulated electric generation, transmission, and distribution service to its Florida ratepayers but are earned through actions it takes in competitive natural gas markets inside and outside the state. As I noted earlier in my testimony, ratepayers' securitization of these assets reduces FPL's risks, and affords the Company a competitive advantage not afforded to other competitive market participants. If the market prices fall, ratepayers will continue to support the costs associated with these assets even if they are idle: such an outcome does not arise in competitive natural gas markets for competitive energy marketers who do not have a regulated base of customers. This appears to be neither the type of financial incentive nor market activity that falls within the traditionally legislatively authorized ambit of electric utilities providing generation, transmission, or distribution of electricity in Florida.

Q. FROM A POLICY PERSPECTIVE, HOW DO FLORIDA STATUTES DEFINE AN ELECTRIC UTILITY?

A. Section 366.02(2), Florida Statutes, defines electric utility as an entity that ". . . owns, maintains, or operates an electric generation, transmission, or distribution system within the state." While natural gas assets are important in facilitating FPL's electric generation, based on my years of work in regulation in Florida, I am not aware of any explicit statutory language that allows the Commission to adopt policies that encourage electric utilities to leverage their natural gas assets for profits, much less profits that are over and beyond what is fair and reasonable and already included in base rates. By definition, incentive returns are those that are over and above (investment) costs since the (investment) costs utilized for ratemaking purposes include a fair and reasonable utility return. Section 366.041(1), Florida Statutes, notes that in setting fair, just and reasonable rates, the Commission "is authorized to give consideration, among other things, to . . . .the cost of providing such service and the value of such service to the public[.]" Yet again, the allowance for incentive returns on a competitive natural gas activity, that is also likely outside the state of Florida, does not appear, from a policy perspective, to be inclusive of either the "cost" or "value" of electric service as defined by state statutes.

Q. HAS THE FLORIDA SUPREME COURT RECENTLY OPINED ON A SIMILAR MATTER?

A. Yes. This past May, the Florida Supreme Court issued a decision regarding the Commission's approval of FPL's purchase of upstream natural gas reserves in the Woodford Shale region of Oklahoma.[47] The Court's decision noted that FPL's natural gas reserves purchases required its end-users (ratepayers) to ". . . guarantee the capital investment and operations of a speculative oil and [natural] gas venture without the Florida Legislature's authority."[48] I am concerned that, from a policy perspective, the same defect exists with regards to FPL's modified incentive program: it forces ratepayers to financially support a set of natural gas assets for competitive market sales that, even if "small" in volume or dollar-value, that: (1) have nothing directly to do with the generation, transmission or distribution of electricity to FPL's ratepayers, (2) are speculative and opportunistic, and (3) include a financial return that goes beyond what has been determined as being just and reasonable by the Commission in a base rate case. The modified incentive program provides direct, active, and Commission-sanctioned financial incentives (profits) that encourages FPL to use its regulated assets in a way that can affect market outcomes both inside and outside the state, regardless of how small these transactions may be in the overall competitive natural gas market.

[47] *Citizens of the State of Florida v. Graham*, 41 Fla. L. Weekly S231 (Fla. May 19, 2016).
[48] *Citizens of the State of Florida v. Graham*, 41 Fla. L. Weekly S231 (Fla. May 19, 2016) at 2.

VIII. INCENTIVES FOR OFF-SYSTEM PURCHASES

Q. PLEASE EXPLAIN THE OFF-SYSTEM PURCHASES COMPONENT OF THE COMPANY'S MODIFIED INCENTIVE PROGRAM.

A. The Company's modified incentive program allows it to receive a financial incentive on any savings it makes on market purchases of more cost-effective electricity. In other words, under the Company's modified incentive program, it can receive a financial reward if it can purchase lower-cost electricity on the market rather than utilize electricity generated from its own power plants. Mechanically, the "savings" associated with these types of transactions are estimated as the difference between the cost of the purchased power (and transmission service, if applicable) and the (marginal) fuel costs that FPL would have incurred if it had produced the power with its own generation.[49]

Q. HOW DOES THIS INCENTIVE PROVISION RUN COUNTER TO STANDARD REGULATORY PRINCIPLES AND PRACTICE?

A. Rate regulation in markets dominated by natural monopolies is a proxy for competition in those markets.[50] Firms in competitive markets tend to produce at their lowest cost in order to improve market share and secure their profits. If a competitive firm has a choice between internalizing a particular function or outsourcing that function to another firm, theory and practice suggests that competitive firms will choose the least

[49] FPL response to OPC's First Set of Interrogatories (Asset Optimization), Interrogatory No. 8, Docket Nos. 160021-EI and 160088-EI.

[50] Phillips, Jr., Charles F. *The Regulation of Public Utilities.* Arlington, VA: Public Utilities Reports, Inc. 1993. p 50. Bonbright, James C., Danielson, Albert L., and Kamerschen, David R. *Principles of Public Utility Rates* Arlington, VA: Public Utilities Reports, Inc. 1988. p 30. Kahn, Alfred E. *The Economics of Regulation: Principles and Institutions.* Cambridge, MA: The MIT Press, 1988, p. 20

cost option. The firm needs no additional incentive to choose a lower cost provider of a service outside the normal rate of return it earns in the market. The same should be true for a utility if regulation is emulating competition. Utilities should need no additional incentive to provide least-cost service outside of their allowed rate of return. To do otherwise suggests either: (a) the utility is not afforded a reasonable allowed rate of return or (b) regulation is not emulating competition and free markets.

Q. ARE UTILITIES OBLIGATED IN ANY WAY TO UTILIZE HIGHER COST ELECTRICITY FROM THEIR OWN GENERATORS?

A No. I have always understood, from my professional and academic research experience, that utilities are required to provide efficient service to ratepayers upon the terms established by a Commission: this is true generally in the State of Florida.[51] The Commission, on the other hand, is authorized to consider the efficiency of facilities and services in setting utility rates and terms provided it does not deny a utility its opportunity for a fair return.[52] Efficiency is typically attained when a firm minimizes the cost of providing a service given a fixed level of output. Efficiency makes no differentiation between whether costs are minimized through the use of an internal input or one external to the firm. In fact, the Commission, in its 2010 Annual Ten Year Site Plan review noted that electric utilities "... <u>must</u> continue to explore <u>all available measures</u> to ensure the most efficient means of producing and delivering reliable and affordable power to their customers"[53] (emphasis added). In addition, each of the

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[51] Section 366.03, Florida Statutes.
[52] Section 366.041, Florida Statutes.
[53] FPSC Review of 2010 Ten Year Site Plans for Florida's Electric Utilities, at p 2.

state's electric utilities have interpreted this efficiency requirement as requiring cost-effectiveness.[54]

Q. HAS THE COMMISSION RECOGNIZED THAT UTILITIES HAVE AN OBLIGATION TO PURCHASE LEAST COST RESOURCES FROM THE MARKET WHEN THEY ARE AVAILABLE?

A. Yes. In 2002, the Commission explicitly noted in an FPL need determination order that utilities have ". . . the statutory obligation to serve retail consumers, the utility is responsible for deciding which generation resources it should build or buy in order to ensure reliable and cost-effective power for its consumers."[55] Likewise, in an earlier 1998 need determination hearing, the Commission in evaluating a generation development request by the City of New Smyrna Beach and Duke Energy New Smyrna Beach Power Company Ltd., L.L.P. noted:

> Our underlying policy in deciding need determination petitions is to protect electric utility ratepayers from unnecessary expenditures and ensure a safe reliable grid. In approving the proposed plant, we are effectuating our longstanding policy. Duke New Smyrna, as proposed, would be a wholesale provider of electricity. <u>Retail utilities, with the obligation to serve, may purchase from Duke New Smyrna, if it is economic to do so. The Project provides a choice to retail utilities in meeting the needs of their customers. If a retail utility purchases from Duke New Smyrna, those retail customers would realize economic benefits due to the existence of the Duke New Smyrna project</u> (emphasis added).[56]

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[54] <u>In re: Proposed Revisions to Rule 25-22.082, F.A.C., Selection of Generating Capacity,</u> Comments of Investor-owned Electric Utilities, filed June 28, 2002, inDocket No. 020398-EQ, at p 12.

[55] <u>In re: Petition to Determine Need for an Electrical Power Plant in Martin County by Florida Power & Light Company; and In re: Petition to Determine Need for an Electrical Power Plant in Manatee County by Florida Power & Light Company,</u> Order No. PSC-02-1743-FOF-EI, issued December 10, 2002, in Dockets Nos. 020262-EI and.020263-EI, at p 13.

[56] <u>In re: Joint petition for Determination of Need for an Electrical Power Plant in Volusia County by the Utilities Commission, City of New Smyrna Beach, Florida, and Duke Energy New Smyrna Beach Power Company Ltd., L.L.P.,</u> Order No. PSC-99-0535-FOF-EM, issued March 22, 1999, in Docket No. 981042-EM, at p 39 (emphasis added). This need determination order was reversed by the Florida Supreme Court on other grounds by *Tampa*

Q. HAVE ANY FLORIDA UTILITIES RECOGNIZED THAT SECURING LEAST COST RESOURCES FROM THE MARKET IS PART OF THEIR OBLIGATION TO SERVE?

A. Yes. Duke Energy Florida's parent, Duke Energy Corporation, noted in its 2014 10-K that its regulated utilities' generation portfolio is

> ...a balanced mix of energy resources having different operating characteristics and fuel sources designed to provide energy at the lowest possible cost to meet its obligation to serve retail customers. All options, including owned generation resources and purchased power opportunities, are continually evaluated on a real-time basis to select and dispatch the lowest-cost resources available to meet system load requirements.[57]

Q. HAS THE COMMISSION CONSIDERED OFF-SYSTEM PURCHASES IN ITS PAST OFF-SYSTEM INCENTIVE PROCEEDINGS?

A. No. The current regulatory treatment for wholesale economy energy transactions is limited to allowing financial returns on any gains from wholesale economy energy sales, not purchases. The Commission, throughout its lengthy deliberations in the three incentive dockets discussed earlier, never considered whether the savings from a wholesale economy purchase should be eligible for shareholder financial rewards.[58] The Commission's orders from these dockets are quite clear: wholesale economy energy sales were the only transaction type considered for a shareholder incentive treatment.

Elec. Co. v. Garcia, 767 So. 2d 428 (Fla. 2000), but the policy of the Commission to "protect electric utility ratepayers from unnecessary expenditures and ensure a safe reliable grid" was not affected by the Court's decision.

[57] Duke Energy Corporation 2014 Form 10K, at p. 11
[58] Docket Nos. 830001-EU-B, 990001-EI, and 991779-EI.

Q. DOES THE ALLOWANCE FOR FINANCIAL INCENTIVES FROM OFF-SYSTEM PURCHASES REPRESENT A RADICAL DEPARTURE FROM CURRENT COMMISSION POLICY?

A. Yes. There are a number of underlying policies supporting several of the Commission's current rules that are contradicted by the Company's off-system purchases incentive. This particular incentive runs counter to the *quid pro quo* policy underlying the Commission's fuel and purchased power cost recovery programs. The off-system purchases incentives also contradict the market-test obligation that each utility has prior to: (a) developing its own energy resources[59] or (b) purchasing a service or acquiring a resource from an affiliate company. [60]

Q. DOES THE OFF-SYSTEM PURCHASE INCENTIVE RUN COUNTER TO THE COMMISSION'S FUEL AND PURCHASED POWER CLAUSE POLICIES?

A. Yes. The off-system purchases incentive appears to run counter to the *quid pro quo* associated with the development of the Commission's fuel and purchased power cost recovery policies. When the Commission adopted its fuel and purchased power cost recovery mechanisms, it did so in order to insulate utilities from the risk of large, volatile, and often uncontrollable commodity prices.[61] In return, utilities are expected to secure the optimum least-cost, reliable resources on behalf of their ratepayers,

[59] Rule 25-22.082, F.A.C., Selection of Generating Capacity.
[60] Rule 25-6.1351, F.A.C. Cost Allocation and Affiliate Transactions.
[61] In re: General Investigation of Fuel Adjustment Clauses of Electric Companies, Order No. 6357, issued November 26, 1974, in Docket No. 74680-CI. In re: General Investigation of Fuel Adjustment Clauses of Electric Companies, Order No. 7653, issued February 22, 1977, in Docket No. 74680-CI (CR).

regardless of whether those resources are self-generated, or come from the market. Allowing FPL to attain an incentive on its off-system purchases upsets the balance between the ratepayers' assumption of commodity pricing risk, and the utilities' obligation to ensure they purchase or utilize the most cost-effective resources available. Under the Company's modified incentive program, it is not only insulated from commodity pricing risk, but it now gets an incentive for engaging in activities that it should be doing or already doing as part of its obligation to serve, as well as its *quid pro quo* for having a fuel adjustment and purchased power recovery mechanism.

Q. HOW DO THE OFF-SYSTEM PURCHASE INCENTIVES RUN COUNTER TO THE POLICY PRINCIPLES INCLUDED IN THE COMMISSION'S COMPETITIVE BIDDING RULE?

A. The Commission expects each public utility, as part of its obligation to serve, to test the market prior to proposing any new generation resources through a Request for Proposals ("RFP") process.[62] The underlying principle in these rules is that utilities need to ascertain whether or not there is a lower-cost alternative in the market before adding capacity. The state's IOUs, collectively, noted that the purpose of this provision is "to encourage the selection of least cost generation."[63] Utilities are required to choose least-cost options; utilities do not need incentives to comply with this obligation. The least-cost selection option is simply part of their obligation to serve. There should be little difference, in principle, between how a utility makes a short run

[62] Rule 25-22.082(4), F.A.C.
[63] In re: Proposed Revisions to Rule 25-22.082, F.A.C., Selection of Generating Capacity, Comments of Investor-owned Utilities, filed June 28, 2002, in Docket No. 020398-EQ, at p 46.

generation decision (i.e., incremental dispatch vs. purchase) and a longer run generation decision (i.e., a capacity addition): both should be made on a least-cost basis, even if that least-cost option is from the market and not a utility-owned resource.

Q. HOW ARE THE COMPANY'S OFF-SYSTEM PURCHASE INCENTIVES INCONSISTENT WITH THE POLICY PRINCIPLES OUTLINED IN THE COMMISSION'S AFFILIATE TRANSACTIONS RULES?

A. The underlying principle of the Commission's affiliate transaction rule[64] is that a utility, in entering into a transaction with an affiliate, must show that the costs of this transaction are equal to or less than what is available in the market.[65] Utilities are not given a financial incentive in order to ascertain whether or not the market affords a lower price service, but are expected, as part of their obligation to serve, to show that any affiliate transaction has been tested, or is comparable to the market. The Company's off-system purchase incentives are inconsistent with the principles in the Commission's affiliate rule since these incentives suggest that there is no requirement to test the market for a lower cost resource if there is at least one Company-owned resource that could provide this service, regardless of cost.

IX. <u>CONCLUSIONS AND RECOMMENDATIONS</u>

Q. PLEASE SUMMARIZE YOU RECOMMENDATIONS.

A. I recommend that the Commission reject the Company's request to extend and recalibrate its modified incentive program for two primary reasons. First and foremost,

[64] Rule 25-6.1351, F.A.C. Cost Allocation and Affiliate Transactions
[65] Rule 25-6.1351(3)(c), F.A.C.

FPL has simply not met its burden of proof nor shown that extension and proposed recalibration of its modified incentive program is in the public interest. The Company has provided a dearth of information on the modified incentive program and whether it has led to verifiable and positive changes in the Company's actions, and how, if at all, those changes have resulted in net public benefits. In addition, the Company has provided no information, nor attempted to quantify, how the proposed changes to its modified incentive program will lead to future ratepayer benefits over and beyond what would otherwise occur under the Commission's long-standing off-system sales incentive policies. Therefore, the Commission must reject the proposal given the lack of compelling information supporting a public interest finding. This rejection will ultimately result in the Company's modified incentive program expiring at the same time as its rate case settlement agreement.

Second, the current proceeding has not afforded parties enough time to review the broad policy implications of this proposal particularly as it relates to the state's other electric utilities. If the Commission is hesitant to discontinue the program, it should hold FPL's request in abeyance until the matter can be explored in greater detail in a separate proceeding where all of these incentive issues can be thoroughly and fully vetted for not only the Company, but also for all Florida utilities. In past proceedings involving these types of incentive programs, the Commission recognized that its incentive policy decisions would have ramifications extending well beyond simple ratemaking, including those impacting existing and emerging markets and resource efficiency. FPL's current proposals will have the same important market and efficiency implications and should be examined within the context of a comparable proceeding.

Q. WHAT INCENTIVES WILL FPL HAVE TO ENGAGE IN OFF-SYSTEM SALES IF THE COMMISSION ALLOWS THIS MODIFIED INCENTIVE PROGRAM TO EXPIRE?

A. The Commission should keep in mind that the Company has a regulatory obligation to provide safe, reliable, and economic (least cost) service to its ratepayers. Maximizing the efficiency of its assets, and reducing costs, therefore, is a core part of a utility's obligation to serve. This regulatory obligation should serve as an appropriate incentive for the Company to seek out opportunities to reduce ratepayer costs through off-system sales credits. That notwithstanding, the Commission has a long-standing incentive policy allowing utilities to retain 20 percent of the gains from their off-system generation sales provided the gains on those sales are above a three-year average threshold. This incentive program is in place today for three other investor-owned utilities ("IOUs") in Florida and will apply to FPL once the current modified incentive program is allowed to expire. Thus, FPL will not be harmed, and, in fact, the Company will continue to have the opportunity to retain a significant level of financial incentives even if the current modified incentive program is allowed to expire.

Q. WHY ARE YOU RECOMMENDING THAT THE COMPANY'S PROPOSAL BE SPUN-OFF INTO A SEPARATE PROCEEDING?

A. I am only making this recommendation if the Commission opts to not reject the Company's proposal to extend and change its modified incentive program in the current rate case. I am making this recommendation because that is how the Commission has evaluated similar issues in the past. The Commission's off-system sales incentive policies date back to the early 1980s, as well as the late 1990s. In each instance, the Commission, understanding the ratepayer and market implications of its decisions, expended considerable resources, over relatively meaningful time periods, in stand-alone proceedings. The Commission examined these incentive policy issues in stand-alone proceedings since it understood the importance of uniformity and consistency, across all of its regulated utilities, in establishing and maintaining these incentive policies. The Commission also recognized, in each instance, that its incentive policy decisions would have ramifications extending well beyond simple ratemaking, including those impacting emerging markets and resource efficiency. FPL's current proposals will have the same important market and efficiency implications and should be examined within the context of a comparable proceeding.

Q. ARE THERE ANY OTHER REASONS WHY THE COMMISSION SHOULD EXAMINE THESE ISSUES IN A SEPARATE PROCEEDING?

A. Yes. The Company's modified incentive program was approved as part of a larger rate case settlement in December 2012. From a policy perspective, there is nothing in the original settlement agreement suggesting that the FPL modified incentive program, on its own, is in the public interest. The Commission approved the prior settlement, and all its terms and conditions, on a collective, not individual basis. Settlements, by their very nature, include individual provisions that lead to individual party benefits that may not be necessarily favorable to other parties or to parties as a whole (i.e., the public interest). Thus, there is nothing inherent in the last settlement agreement that should suggest or confer a public benefits finding on the modified incentive program on a stand-alone basis. For that reason, the Commission needs to examine this issue further in a separate proceeding.

Q. DOES THIS CONCLUDE YOUR DIRECT TESTIMONY FILED ON JUNE 17, 2016?

A. Yes. However, I would request the right to supplement this testimony as additional information and discovery responses become available during the course of this proceeding. If I do supplement my testimony, it will occur at the same time that intervenor direct testimony is due in the Company's pending base rate case on July 7, 2016.

DIRECT TESTIMONY

OF

OF DAVID E. DISMUKES

On Behalf of the Office of Public Counsel

Before the

Florida Public Service Commission

Docket No. 160021-EI, et al (consolidated)

I. INTRODUCTION

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is David E. Dismukes. My business address is 5800 One Perkins Place Drive, Suite 5-F, Baton Rouge, Louisiana 70808.

Q. WOULD YOU PLEASE STATE YOUR OCCUPATION AND CURRENT PLACE OF EMPLOYMENT?

A. I am a Consulting Economist with the Acadian Consulting Group ("ACG"), a research and consulting firm that specializes in the analysis of regulatory, economic, financial, accounting, statistical, and public policy issues associated with regulated and energy industries. ACG is a Louisiana-registered partnership, formed in 1995, and is located in Baton Rouge, Louisiana.

Q. DO YOU HOLD ANY ACADEMIC POSITIONS?

A. Yes. I am a full Professor, Executive Director, and Director of Policy Analysis at the Center for Energy Studies, Louisiana State University ("LSU"). I am also a full

Professor in the Department of Environmental Sciences and the Director of the Coastal Marine Institute in the School of the Coast and Environment at LSU. I also serve as an Adjunct Professor in the E. J. Ourso College of Business Administration (Department of Economics), and I am a member of the graduate research faculty at LSU. Attachment A provides my academic vitae, which includes a list all of my publications, presentations, pre-filed expert witness testimony, expert reports, expert legislative testimony, and affidavits.

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. I have been retained by the Florida Office of Public Counsel ("OPC"), on behalf of the Citizens of the State of Florida ("Citizens"), to provide an expert opinion to the Florida Public Service Commission (the "Commission" or "FPSC") on Florida Power & Light Company's ("FPL" or the "Company") load forecast and test year billing determinants included in the Company's rate case filing. I am also offering an opinion about the assumed inflation factor included in the Company's rate case filing.

Q. CAN YOU PLEASE SUMMARIZE YOUR LOAD FORECASTING RECOMMENDATIONS?

A. Yes. I recommend the Commission reject the Company's energy sales forecast (also referred to as the "Net Energy for Load" or "NEL" forecast) as unacceptable for ratemaking purposes, and instead adopt the energy sales forecast included in the Company's 2015 Ten Year Site Plan ("TYSP"). The 2015 TYSP energy sales forecast is virtually the same as the one filed later in the 2015 Okeechobee need determination. In fact, the Commission approved the Okeechobee need determination based upon the fact that the energy and peak demand forecasts submitted in that proceeding were consistent with the 2015 TYSP forecasts. While the energy sales forecasts provided in the 2015 TYSP and the Okeechobee need determination are comparable, neither of these forecasts are consistent with the energy sales forecasts filed in this rate case. In fact, the differences are quiet considerable, go far beyond updating the forecast models with more contemporaneous data, and have not been explained by the Company. Adoption of the 2015 TYSP NEL forecast will increase test year weather-normalized retail delivered energy by 3,896 gigawatt-hours or 3.5 percent. Likewise, the proposed adjustment will increase subsequent year weather-normalized retail delivered energy by 4,882 gigawatt-hours, or 4.3 percent. The adjustment will decrease the Company's needed revenue requirement increase by $206.5 million in 2017 and $259.5 million in 2018.

Q. CAN YOU PLEASE SUMMARIZE YOUR INFLATION FACTOR RECOMMENDATIONS?

A. I recommend the Commission adopt an inflation rate equal to a weighted average of the median result of the Wall Street Journal's June survey of economic analysts, and the official median projection of the Federal Open Market Committee ("FOMC") for use in computing expected near-term inflation. Specifically, I recommend a weighted average that places a 60 percent weighting on the forecasts of the FOMC and a 40 percent weighting on the forecasts of other industry professionals. This results in a 2016 general price inflation of 1.44 percent, and a subsequent 2017 general price inflation of 2.06 percent. I additionally recommend this 2.06 percent level be maintained for 2018, consistent with the FOMC's long-term monetary policy of maintaining a 2.0 percent rate of general price inflation. This inflation estimate is used in estimating the Company's operations and maintenance ("O&M") cost benchmark and is also used by other OPC witnesses in the development of their test year expense recommendations.

Q HOW IS THE REMAINDER OF YOUR TESTIMONY ORGANIZED?

A. The second section of my testimony addresses the Company's load forecast while the third section of my testimony addresses the Company's proposed inflation factor in this proceeding.

II. COMPANY'S LOAD FORECASTING PROCESS

A. Discussion of the Company's Forecasting Process

Q. PLEASE EXPLAIN THE COMPANY'S CUSTOMER AND SALES FORECASTING PROCESS.

A. The Company's forecasting process involves multiple econometric models for customer growth, future electric load requirements, and winter/summer peak load requirements. The Company notes that the forecasts included in its rate filing are the same as those used for all business purposes[1] including those used for generation planning purposes and its TYSP filing.

[1] Direct Testimony of Rosemary Morley, at p. 9, lines 12-13.

Q. PLEASE EXPLAIN HOW THESE FORECASTING MODELS ARE ORGANIZED.

A. The Company's load forecasting models can be grouped into three categories. First, there are 13 separate customer and sales models estimating individual monthly customer and energy sales by major customer class (e.g. residential, small commercial, large commercial, small industrial, and large industrial). Second, the Company has two peak demand models to estimate summer and winter peaks. Finally, there is the Net Energy for Load ("NEL") model that estimates aggregate monthly energy requirements. The NEL model is estimated separately from the Company's monthly customer class sales models (which estimate energy on a per-class, as opposed to aggregate, basis), so any discrepancy between the two models (i.e., the sum of the individual customer class models versus the results from the aggregate energy sales, or NEL model) is allocated on an equal percentage basis between the Company's residential and commercial classes.[2]

Q. PLEASE DISCUSS THE COMPANY'S NEL FORECAST.

A. The Company's aggregate energy sales forecast, or its NEL forecast, is estimated on a per-customer basis utilizing an econometric process with 23 separate independent variables.[3] Most of these variables control for monthly cooling and heating requirements across four months (December, January, February, and March). The remaining seven variables are included to: measure the impact of energy efficiency codes and standards; the impact of changes in real electricity prices and per capita income; a dummy variable to account for the presence of a leap year; and a first-order auto-regressive term.

[2] See FPL Response to Staff's Third Set of Interrogatories, Interrogatory No. 67.
[3] Direct Testimony of Rosemary Morley, at p. 8, lines 8-9; and Petition, Schedule F-5.

Q. PLEASE DEFINE WHAT IS MEANT BY AN AUTOREGRESSIVE MODEL.

A. An autoregressive model refers to an econometric model that conditions future occurrences on past observations. Thus, the Company's NEL forecast assumes that its overall load requirement in any given month is partially dependent on its load requirement in the previous month, in addition to a baseline load requirement. In other words, the Company assumes that deviations in load in any given month other than that explained by weather, economic, or efficiency standards, partially persist in the next month and influence the Company's load requirement in that month.

Q. PLEASE DISCUSS THE COMPANY'S SUMMER PEAK DEMAND FORECAST.

A. The Company's summer peak demand forecast is also estimated on a per-customer basis and utilizes an econometric process based on historical information. The Company's summer peak demand model contains seven independent variables that include two variables to account for weather fluctuations, as well as three other variables to account for the effect of more stringent energy efficiency codes and standards on peak usage, the effect of energy price inflation on consumer demand, and the effect of economic growth through increased household disposable income. The final two variables in the Company's model are dummy variables for the years 1990 and 2005 that are used to specifically control for historical summer peaks seen in these years.[4]

[4] The Company failed to provide adequate documentation through testimony, discovery, or its Minimum Filing Requirements regarding its reason for the 1990 and 2005 dummy variables.

B. **<u>Problems with the Company's Proposed Forecast</u>**

Q. WHAT EVIDENCE DOES THE COMPANY OFFER AS SUPPORT FOR ITS CUSTOMER AND SALES FORECASTS?

A. The Company notes that in 2015 it saw a 1.4 percent growth in customers. The Company forecasts customer growth at a compound annual rate of 1.5 percent per year during the 2015-2020 period. Likewise, the Company states that weather-normalized retail-delivered sales grew at a 0.8 percent compound rate between 2011 and 2015 and projects a weather-normalized retail delivered sales growth rate of 0.7 percent on a compounded basis between 2015 and 2020.

Q. IS THE COMPANY'S LOAD PROJECTIONS CONSISTENT WITH HISTORICAL TRENDS?

A. No. The Company's appeal to historic trends as support for its overall forecast hides a number of problems. These historic comparisons, for instance, are done on an aggregate basis across a five year time period, not individually for each year. For instance, the Company's analysis compares growth rates for the 2011-2015 time period to those expected to arise during the 2015-2020 time period. The Company's forecasting discussion includes no annual comparisons across this broad 2015-2020 time period. Most importantly, the Company fails to highlight the specific forecasting results for its 2017 test year and its proposed 2018 adjustment and how those forecasting results compare to annual historic trends.

Q. HAVE YOU PREPARED A COMPARISON OF HISTORIC WEATHER-NORMALIZED SALES TO PROJECTED SALES?

A. Yes. This comparative analysis is presented in Exhibit DED-1 and is comprised of two pages. The first page examines the historic and expected trends in the Company's retail delivered sales for the years 2011-2020. The second page of the exhibit examines the historic and anticipated trends in total sales for the years 2011-2020. For clarification, retail delivered sales are defined as being exclusive of the Company's wholesale contracts, whereas the Company's total sales is inclusive of these wholesale contracts.

Q. WHAT DOES THIS COMPARISON SHOW?

A. Exhibit DED-1 highlights some important problems with the Company's sales projections, particularly as they relate to recent historical trends. The Company, for instance, projects that its retail delivered sales for its 2017 test year will be 0.16 percent less than what was reported in 2016, and 0.55 percent less than sales reported for 2015. Furthermore, the Company projects that its 2018 retail delivered sales will only be 0.58 percent greater than its 2017 projection (which itself is anticipated to fall relative to 2016). This projected decline in energy sales is even more prevalent when the forecast for wholesale sales are included (page 2 of Exhibit DED-1), wherein the Company projects that it will not reach its 2015 level of delivered sales until 2019, well after the end of its projected test year, and subsequent adjustment, in this proceeding. In other words, the Company is anticipating a contraction (decrease) of overall sales relative to reported 2015 numbers, and that its overall sales numbers will not recover until 2019.

Q. HAVE YOU DONE ANY COMPARISONS BETWEEN THE COMPANY'S NEL FORECASTS AND ITS PEAK LOAD FORECASTS?

A. Yes. Exhibit DED-2 compares the percentage growth in the Company's NEL forecast to its projections for total customers and summer peak demand. The comparison shows continual and consistent customer and peak demand growth, but not continual and consistent sales growth. Specifically, the Company expects 2016 customer growth of 1.45 percent, and 2017-2018 customer growth of 1.48 percent. Likewise, the Company projects its summer peak to increase by 5.27 percent in 2016, 0.69 percent in 2017, and 1.11 percent in 2018. In all future years, 2016-2018, the Company forecasts both a growing customer base and a growing peak load requirement. The Company's sales estimated from its NEL model, on the other hand, are inconsistent with those estimated in the customer and peak demand models. The Company forecasts a decrease, not an increase, in its energy sales of 0.28 percent and 0.66 percent in 2016 and 2017, respectively. Energy sales are forecast to increase, at a very tepid rate of 0.62 percent in 2018. Thus, the Company's customer and peak demand forecasts are moving in one direction (upwards) while its energy sales forecasts are estimated to move in an entirely opposite direction (downwards).

Q. IS THERE AN INCONSISTENCY BETWEEN THE COMPANY'S SALES AND PEAK DEMAND FORECASTS?

A. Yes, there appears to be a serious disconnect between the Company's peak demand, customer, and sales forecasts. The Company anticipates relatively strong and consistent customer and peak demand growth; however, at the same time, it anticipates flat sales growth (excluding wholesale sales) relative to 2015 levels. If the Company's rate case forecasts are accurate, then it would imply that its system average load factor, a degree of aggregate demand efficiency, is falling, not increasing.

Q. PLEASE DEFINE WHAT IS MEANT BY A "LOAD FACTOR."

A. A load factor is defined as the ratio of the average load to the peak or maximum load.[5] A utility's annual average load factor is expressed as a percentage and is derived by dividing system energy sales by the product of peak demand and the number of hours in the year.[6] A system that is estimated to have a high load factor is often thought to be utilizing electricity more efficiently since electric use is relatively consistent and does not swing between average and peak periods by any considerable level.[7] Conversely, systems with low load factors must maintain idle capacity in order to meet the relatively large swings in load between average and peak periods.

Q. HAVE YOU ANALYZED THE COMPANY'S HISTORIC AND PROJECTED SYSTEM LOAD FACTORS?

A. Yes, and this analysis is shown in Exhibit DED-3. Over the period 2008 to 2015, the Company's annual system load factor has remained stable with no clear upward or downward trend. Indeed, during the eight years 2008 through 2015, the Company's annual system load factor averaged 58.77 percent, ranging from a 2009 low of 56.81

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[5] Electric Utility Cost Allocation Manual (January 1992), National Association of Regulatory Utility Commissioners, p. 168.
[6] Electric Utility Cost Allocation Manual (January 1992), National Association of Regulatory Utility Commissioners, p. 82.
[7] Managing Your Electrical Demand, Penn State Extension, available online at: http://extension.psu.edu/natural-resources/energy/energy-use/resources/farm-program/educational-materials/managing-your-electrical-demand

percent to a 2008 high of 60.22 percent: a relatively tight spread of around 3.4 percent from the high to low observations. The Company's forecasts filed in this proceeding, however, suggests that its 2016 system average load factor will decline to 56.50 percent. This decrease is some 2.27 percent below the eight year average, and 0.31 percent below the lowest load factor (56.81 percent) recorded by the Company over the recent past.

Q. IS 2016 THE ONLY YEAR PROJECTED TO SEE SUCH A SIGNIFICANT LOAD FACTOR DECREASE?

A. No. The Company projects its annual load factor to continue to decline on a forward-going basis, dropping each and every year for the foreseeable future. By 2025 the Company forecasts its load factor to reach a level of 53.5 percent, some 5.3 percent below the average over the past eight years, and some 3.3 percent below the lowest load factor ever recorded over the past eight years. Such a forecast implies that either (a) the Company is about to witness a significant and consistent reduction in end-use efficiency that will have considerable cost and generation resource planning implications or (b) the Company's projections, particularly its load projections arising from its NEL model, are significantly understated.

Q. DO THE OTHER FLORIDA INVESTOR-OWNED UTILITIES PROJECT SIMILAR TRENDS?

A. No. Exhibit DED-4 provides both a table and a chart comparing FPL's projected load factor trends relative to other Florida electric investor-owned utilities ("IOUs"). All of the other IOUs are projecting load factors that are generally within their historic high/low ranges. FPL, on the other hand, is the only Florida IOU projecting a consistently decreasing load factor over the 2016 to 2025 time period.

Q. DID YOU ADJUST THE COMPANY'S FORECAST DATA FOR WEATHER?

A. Yes. The data used in the Company's forecast is not weather-normalized. Instead, it uses a series of weather-related variables to estimate the impact of weather on usage. Thus, the historic data used in the above comparisons, which comes from the Company's input data and forecasting results, are not controlled directly for weather. In looking at the 2015 data, Florida experienced one of the warmest Aprils on record resulting in large electricity loads for that month. Exhibit DED-5, however, examines the Company's historic averages and projections on a weather-normalized basis and shows results similar to the ones discussed earlier (i.e., declining load factor). On a weather-normalized basis, the Company's projections imply that its load factors, for each of the next three years (2016, 2017, and 2018), will be lower than any other reported since 2009 (over the past six years).

Q. HAS THE COMPANY PROVIDED ANY EVIDENCE THAT THESE LOAD FACTOR DECREASES COULD BE ATTRIBUTABLE TO ITS ENERGY EFFICIENCY EFFORTS?

A. No. However, the Company's energy sales forecast and peak demand models do contain adjustments for energy efficiency. Exhibit DED-6 estimates the forward-looking load factors removing the potential impacts associated with energy efficiency. Even correcting for energy efficiency activities and the weather, the Company's projected system average load factor will consistently be at levels below any it has seen over the past eight years, with the exception of 2009.

Q. WHAT WOULD BE THE BILLING DETERMINANT ADJUSTMENT IF THE COMPANY'S PROJECTED ENERGY SALES WERE INCREASED TO BRING ITS LOAD FACTORS INTO HISTORIC NORMS?

A. Exhibit DED-7 provides an estimate of the billing determinant impacts of raising the Company's energy sales forecasts to levels comparable with its historic load factor trends. The exhibit compares the Company's projected test year billing determinants to those that would arise if its system average load factor in the respective forecast year were comparable to the 2011-2015 average (58.87 percent). The difference is an estimated shortfall of 6,677 gigawatt-hours of electricity sales in 2017, and 7,340 gigawatt-hours of electricity sales in 2018. This suggests that the NEL forecasts need to be 5.6 and 6.1 percent higher over the two rate years in order to bring the Company's estimated load factor in line with historical averages.

C. <u>Differences between Current and Prior Company Load Forecasts</u>

Q. ARE THE COMPANY'S CURRENT FORECASTS CONSISTENT WITH THOSE FILED IN OTHER RECENT COMMISSION PROCEEDINGS?

A. No. The Company's load forecasts in this proceeding differ from the ones it filed in (1) its most recent Okeechobee need determination and (2) its most recently-approved TYSP (2015). The Company has failed to provide any information explaining the differences between the currently-filed load forecast and the one included in these two prior proceedings, despite claims that:

> [t]he evidence presented to the Commission in the Okeechobee Need Determination docket was updated to reflect this October 2015 load forecast. . . . with the exception of a new price of electric projection, . . . the models and assumptions incorporated into the October 2015 load forecasts are identical to those utilized in the load forecast supported in the current proceeding.[8]

Q. WERE THE OKEECHOBEE NEED DETERMINATION AND THE 2015 TYSP LOAD FORECASTS FILED OVER A RELATIVELY CONTEMPORANEOUS TIME PERIOD?

A. Yes. The Company filed two NEL and peak demand forecasts with the Commission over a 12 month period prior to this rate case. The first set of forecasts (NEL and peak demand) were filed in the 2015 TYSP proceeding. The second set of forecasts were filed five months later during the Commission's investigations into the Company's 2015 Okeechobee need determination.[9] The Company indicated in the Okeechobee need determination that the load forecasts supporting its generation need (filed in that proceeding) were virtually the same as the ones included in the TYSP.[10] While it is true that both of these forecasts (Okeechobee need determination and TYSP) are relatively comparable to one another, they differ considerably, both in form and results, from the load forecast provided in this rate case, particularly the NEL forecast provided in the

[8] Direct Testimony of Rosemary Morley, at p. 10, lines 3-12

[9] See, In re: Petition for Determination of Need for Okeechobee Clean Energy Center Unit 1, by Florida Power & Light Company Docket No. 150196-EI, Petition.

[10] See, In re: Petition for Determination of Need for Okeechobee Clean Energy Center Unit 1, by Florida Power & Light Company Docket No. 150196-EI, Direct Testimony of Richard Feldman, at p. 29, lines11-14; See also, In re: Petition for Determination of Need for Okeechobee Clean Energy Center Unit 1, by Florida Power & Light Company Docket No. 150196-EI, Company's response to Staff's First Set of Interrogatories No. 9.

instant proceeding. In fact, the sales (NEL) forecast included in the current rate case is projected to be over six percent less in 2023 than what was filed in the 2015 TYSP and 2015 Okeechobee need determination proceedings.

Q. DID THE COMPANY CLAIM THE LOAD FORECAST FILED IN THIS RATE CASE WAS THE SAME AS WHAT WAS FILED IN THE 2015 OKEECHOBEE NEED DETERMINATION?[11]

A. Yes. The Company states that, with the exception of one minor change, its current model is identical to that filed by the Company in its 2015 Okeechobee need determination, and makes allusions to it being essentially the same as the 2015 TYSP.[12] The Company, however, provides no narrative nor quantitative comparison of its current load forecasts to its 2015 TYSP. However, in response to discovery, the Company provided a workpaper that included such a comparative analysis.[13]

Q. HOW DID THE COMPANY'S RATE CASE FORECAST DIFFER FROM THE PRIOR 2015 TYSP AND OKEECHOBEE NEED DETERMINATION FORECASTS?

A. The Company's own comparison of the load forecast filed in this proceeding to the one included in the 2015 TYSP, shows that, on a weather-normalized retail delivered basis, the Company's current (rate case) load forecast is between 1.5 percent and 6.0 percent lower than the one included in the 2015 TYSP. With regards to the Company's 2017 test

[11] Direct Testimony of Rosemary Morley, at p. 10, lines3-12.
[12] Direct Testimony of Rosemary Morley, at p. 10, lines 3-12.
[13] Company's response to OPC First Request for Production of Documents, POD OPC-2, "Peak and Energy Jan 2016 TYSP LT Price True-Up.xlsx."

year in particular, the forecast filed in this proceeding estimates load being 3,896 gigawatt-hours lower, or 3.5 percent lower than the 2015 TYSP. This discrepancy grows to being 4,882 gigawatt-hours lower, or 4.3 percent lower, for the 2018 rate adjustment year.

Q. DID THE COMMISSION BASE ITS DECISION IN THE COMPANY'S OKEECHOBEE NEED DETERMINATION ON THE LOAD FORECASTS PROVIDED IN THAT PROCEEDING?

A. Yes. The Commission's approval for the new generation resource is clearly conditioned on the originally-filed load forecasts in the Okeechobee need determination since the Order explicitly notes that the approval is based upon the fact that the Okeechobee need determination forecast results are virtually the same as those included in the Company's 2015 TYSP.[14] The Commission noted in its Okeechobee need determination Order that the Company's expected growth in its peak demand and NEL were driven mainly by an expected growth in its customer base of approximately 1.3 percent per year.[15] Thus, the Commission acknowledged in its Order that trends in NEL growth should be consistent with those reported for customer growth and peak demand growth.[16] A result that differs significantly from the energy sales forecast (NEL forecast) filed in the instant rate case.

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[14] In re: Petition for Determination of Need for Okeechobee Clean Energy Center Unit 1, by Florida Power & Light Company, Order No. PSC-16-0032-FOF-EI, issued January 19, 2016, Docket No. 150196-EI, at p. 6 ("Okeechobee Need Determination Order" or "Order").
[15] Okeechobee Need Determination Order at p. 7.
[16] Okeechobee Need Determination Order at pp. 8-9.

Q. DID ANY PARTIES RAISE QUESTIONS ABOUT THE ACCURACY OF THE COMPANY'S PEAK DEMAND FORECAST IN THE OKEECHOBEE PROCEEDING?

A. Yes. The Company's peak demand forecast was challenged as being over-stated by Environmental Confederation of Southwest Florida ("ECOSWE").[17] The Commission explicitly rejected these arguments siding with the Company, and stating its belief that the Company's peak demand forecasts were accurate, noting:

> [b]eginning with planning year 2009, FPL's forecasting error was significantly reduced, and the variance between the projected and actual summer peak demand started to show both over- and under-forecasting. Three out of ten of the "five years out" forecasts, for the period of 2005 through 2014, were under-forecasts . . . , which demonstrates that FPL's "five years out" forecasts are not consistently over-forecasts, as ECOSWF asserted. The cumulative number of over- and under- forecasts for one to five years out . . . also indicate that FPL's overall summer peak demand forecasts show almost an equal chance of an over-forecast or an under-forecast, which demonstrates that no systematic over-forecasting or under-forecasting is taking place.[18]

Q. WAS THE COMMISSION'S OKEECHOBEE NEED DETERMINATION DECISION BASED IN ANY WAY ON THE FACT THAT THE LOAD FORECASTS INCLUDED IN THAT PROCEEDING WERE CONSISTENT WITH THE 2015 TYSP?

A. Yes. The Commission explicitly noted:

> <u>FPL's load forecasts in this proceeding are the same forecasts FPL presented in its 2015 Ten-Year Site Plan (TYSP).</u> These forecasts are generated using econometric models, including customer models, summer and winter peak demand per customer models,

[17] See, Okeechobee Need Determination Order at p. 7.
[18] Okeechobee Need Determination Order at p. 8.

> and a net energy for load (NEL) per customer model. FPL asserts that we have consistently relied on these models for various forecasting purposes, and the modeling results have been reviewed and accepted by us in past proceedings.[19]
>
> * * *
>
> In summary, we analyzed FPL's load forecasting models and found the models to be appropriate for forecasting purposes in the instant proceeding. We also reviewed the forecast assumptions of anticipated economic and demographic conditions, as well as the [out-of-model] adjustments FPL made to its estimates produced by the forecasting models, and found the assumptions and adjustments used by FPL appropriate. Finally, we note that none of the intervenors in this proceeding proffered any forecasting model or forecasts of FPL's customers, summer peak demand, and net energy for load. No intervenor challenged FPL's methodology, input data, assumptions, or out-of-model adjustments used to project load. Therefore, based on the record, we find FPL's load forecasts appropriate for consideration in this proceeding.[20]

Q. HAVE YOU COMPARED THE COMPANY'S 2015 TYSP LOAD FORECASTS TO THE ONE SUBMITTED IN THIS PROCEEDING?

A. Yes, and the comparisons of summer peak demand and NEL forecasts from the two proceedings are included in Exhibit DED-8. While there are some differences between the two peak demand forecasts, those differences are relatively small. For instance, the Company's rate case 2017 peak demand forecast is slightly higher by 0.35 percent, while its rate case 2018 summer peak forecast is down by 0.17 percent relative to what it filed in its 2015 TYSP. The large difference, however, is between the two NEL forecasts. The Company's current rate case NEL forecast for 2017 and 2018 are understated by more than four percent relative to the NEL forecast it provided in its 2015 TYSP.

[19] Okeechobee Need Determination Order at p. 6.
[20] Okeechobee Need Determination Order at p. 9.

Q. DID THE COMPANY'S 2015 TYSP INCLUDE ANY DECLINING SYSTEM LOAD FACTOR ESTIMATES?

A. No, and I have provided a comparison of the two forecasts (2015 TYSP versus the current rate case) in Exhibit DED-9. The load factor implied by the Company's TYSP (NEL load divided by peak) is very comparable to the 2011-2015 historic average of 58.77 percent I discussed earlier. In fact, the forecast included in the 2015 TYSP shows relatively consistent and reasonable load factor projections that range between 56.8 and 58.3 percent for the 2016-2024 time period. In other words, the implied load factors included in the 2015 TYSP are consistent with the historic averages and trends over the past decade; however, the one included in this rate case is not. As I noted earlier, the Company's annual average load factor is calculated as the quotient of its annual load and its peak demand (times the number of hours in the year). The implied load forecast estimated from the Company's load forecast and peak demand forecasts reveals trends that are dramatically at odds with historic trends. This leads to one of the following conclusions that either (1) the Company's NEL forecast is in error in this proceeding or (2) the Company's peak demand forecast is in error in this proceeding. However, the weight of the evidence suggests that it is the Company's NEL forecast that is in error since (1) the peak demand forecast included in this proceeding is relatively consistent with the peak demand forecasts in the Okeechobee need determination and the 2015 TYSP, and (2) the Commission explicitly found that the peak demand forecasts in the TYSP and the Okeechobee need determination were appropriate. Thus, the Company's NEL forecast needs to be adjusted for ratemaking purposes in this proceeding.

Q. HAVE YOU EXAMINED ANY OTHER INFORMATION THAT INDICATES THE COMPANY'S RATE CASE NEL FORECAST IS FLAWED?

A. Yes. I also compared the Company's NEL forecast to the sum of its individual revenue class models and these results are provided in Exhibit DED-10. These revenue class models, as I indicated earlier, estimate the energy requirements for most major customer classes: residential; small commercial and large commercial.[21] These revenue class models can be thought of as a "bottoms-up" approach to estimating total retail energy sales requirements since they model energy usage at the major customer class level and can then be summed to arrive at an alternative estimate of the Company's overall energy sales requirements. These revenue class models, however, are not used in estimating total billing determinants, but instead are used to allocate the total retail sales forecast arising from the NEL model to each major customer class.[22] However, the results from both sets of models (NEL versus revenue class models) should be, in theory, close to one another if they are intended to be accurate, unbiased estimates for future load, regardless of whether that is load is estimated in the aggregate (NEL forecast) or on a per revenue class basis.

Q. WHAT DOES THE COMPARISON BETWEEN THE NEL AND REVENUE CLASS FORECASTS SHOW?

A. The comparison shows that the NEL model is significantly under estimating total retail sales by as much as two percent in 2016, three percent in 2017 and more than four percent in 2018. The revenue class models, collectively, estimate retail sales that start

[21] Petition, Schedule F-5.
[22] See, Direct Testimony of Rosemary Morley, at p. 38, line 12, to p. 39, line 2.

around 115 million MWhs in 2015 and increase to 119 million MWhs in 2018. The Company's NEL model, which it uses for billing determinant purposes, estimates retail sales at around 114 million MWhs for the entire period 2015 to 2018.

Q. DID THE COMPANY'S LAST RATE CASE REPORT SUCH LARGE DIFFERENCES BETWEEN THE NEL AND REVENUE CLASS ENERGY SALES FORECASTS?

A. No. Exhibit DED-11 compares the Company's NEL and revenue class forecast reconciliations in the last rate case to the current rate case. In the Company's last rate case, its NEL forecast was only 1.5 percent lower than the sum of its revenue class models. That percent difference is more than twice as large in the instant rate case, clearly indicating that something is amiss with the Company's current rate case NEL forecast.

Q. HAVE YOU COMPARED THE COMPANY'S CURRENT RATE CASE FORECAST TO THE ONE IT RECENTLY SUBMITTED IN ITS 2016 TYSP FILING?

A. Yes, and the NEL forecast provided in the Company's recent 2016 TYSP is just as flawed as the one included in the current rate case. In fact, it appears that the load forecasts included in the instant rate case proceeding are very similar, if not the same as those included in the Company's 2016 TYSP. Like the forecasts included in the instant proceeding, the Company's 2016 TYSP contains a load forecast that the Company describes as "moderately lower over the long-term" relative to that forecasted by the

Company in its 2015 TYSP.[23] It is my understanding, however, that the 2016 TYSP forecast is still under review by the Commission and that its usefulness for planning purposes has yet to be determined. Thus, my recommendation is that the Commission, for purposes of this rate case, continue to rely upon the load forecasts included in the prior-approved 2015 TYSP, and not those provided in the instant rate case, nor the 2016 TYSP. While TYSP forecasts are not officially "approved" by the Commission, the forecasts included in the 2015 TYSP can be thought of as "approved" since they form part of the evidentiary support for the Commission's decision authorizing the development of the Okeechobee generation facility.

D. <u>Recommendations Regarding the Company's Load Forecasts</u>

Q. WHAT ARE YOUR RECOMMENDATIONS REGARDING THE COMPANY'S PROPOSED LOAD FORECASTS?

A. I recommend the Commission reject the Company's energy sales forecast as unacceptable for forecasting purposes, and instead adopt the energy sales forecast included in the Company's 2015 TYSP. The 2015 TYSP energy sales forecast is virtually the same one filed later in 2015 in the Okeechobee need determination. In addition, the Commission approved the Okeechobee need determination based upon the fact that the forecasts submitted in that proceeding were consistent with the 2015 TYSP forecasts. While the energy sales forecasts provided in the 2015 TYSP and Okeechobee need determinations are comparable, neither of these forecasts are consistent with the

[23] Ten Year Power Plant Site Plan: 2016-2025 (April 1, 2016), Florida Power and Light, at p. 28.

energy sales forecasts filed in this rate case. To the contrary, the differences are quiet considerable and have not been explained by the Company.

Q. WHAT IS THE IMPACT OF THE PROPOSED ADJUSTMENT?

A. Adoption of the 2015 TYSP NEL forecast will increase test year weather-normalized retail delivered energy by 3,896 gigawatt-hours or 3.5 percent. Likewise, the proposed adjustment will increase subsequent year (2018) weather-normalized retail delivered energy by 4,882 gigawatt-hours, or 4.3 percent.

Q. HAVE YOU ESTIMATED THE RESULTING REVENUE IMPACT OF THIS PROPOSED ADJUSTMENT?

A. Yes, and this is shown in Exhibit DED-12. This adjustment increases projected revenues for 2017 and 2018, which results in a decrease in the Company's needed revenue requirement increase by $205.7 million in 2017 and $257.9 million in 2018.

III. PROPOSED INFLATION ADJUSTMENT

A. Introduction

Q. HOW IS INFLATION DEFINED IN ECONOMIC TERMS?

A. Inflation refers to the sustained increase in the general price level of goods and services in the economy over a period of time. Typically, this is caused by a general increase in the money supply present in the economy as more dollars are chasing the same relative number of goods.

Q. DOES THE COMPANY INCLUDE AN INFLATION ADJUSTMENT IN ITS TEST YEAR?

A. Yes. The Company's test year accounts for the impact of inflation in two ways. First, inflation, along with a factor for customer growth, is utilized in the development of its operations and maintenance ("O&M") benchmark. The Company's benchmark indicated that it expects 2017 O&M expenses to increase by more than 13 percent from 2013 levels.[24] Second, the Company utilizes its inflation estimates to adjust the costs associated with several other goods and services identified in its internal budgeting process.[25] These adjustments likewise impact the Company's estimated test year revenue requirement.

Q. DO ALL PARTICIPANTS IN THE ECONOMY EXPERIENCE INFLATION AT THE SAME RATE?

A. No, since consumers and producers purchase different goods at different levels. To make generalizations on price inflation easier, government agencies, such as the Bureau of Labor Statistics ("BLS"), publish separate price indexes based on relative prices of a basket of goods determined through survey instruments.[26]

Q. WHAT MEASURE OF INFLATION DOES THE COMPANY USE IN ITS FILING?

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[24] Petition, Schedule C-40, O&M Compound Multiplier Calculation.
[25] Direct Testimony of Rosemary Morley, at p. 48, lines 8-9.
[26] See, "Overview of BLS Statistics on Inflation and Prices," U.S. Bureau of Labor Statistics, available online at: http://www.bls.gov/bls/inflation.htm.

A. The Company uses what is referred to as the Consumer Price Index ("CPI") for all urban consumers ("CPI-U").[27] The CPI-U is calculated monthly by the BLS, and is sometimes referred to as the "head-line rate" due to its prevalence in media reports to track the overall price inflation in the economy. The CPI-U is often reported in both "core" and "energy" component terms. The "core" component of the CPI-U measures price inflation to urban consumers in the same manner as the CPI-U, but with the exclusion of food and energy prices.[28] The energy component of the CPI-U, however, is restricted to measuring changes in volatile consumer energy prices. These separate inflation measures (energy and core components) are often looked at independently since energy prices are viewed as relatively volatile compared to other items within the CPI-U basket of goods.[29] The Company's test year forecast, however, is based upon the total (or aggregate) CPI-U that includes both core and energy components.[30]

Q. HOW IS THE COMPANY'S INFLATION FACTOR DEVELOPED?

A. The Company primarily relies on an outside economic forecasting entity, IHS Global Insight (hereafter "Global Insight"), as the source of its inflation projections.[31] The Company also states that it reviewed forecasts developed from other sources and considers historical trends to assess the reasonableness of Global Insight's forecast.[32]

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[27] See, Petition, Schedule C-40, O&M Compound Multiplier Calculation; see also, Direct Testimony of Rosemary Morley, at p. 48, lines 8-9.
[28] See, Frequently Asked Questions, U.S. Bureau of Labor Statistics, available online at: http://www.bls.gov/cpi/cpifaq.htm#Question_7; "core" CPI is published by the BLS as an CPI index labeled "All items less food and energy".
[29] See, Frequently Asked Questions, U.S. Bureau of Labor Statistics, available online at: http://www.bls.gov/cpi/cpifaq.htm#Question_7 and http://www.bls.gov/cpi/cpifaq.htm#Question_13.
[30] Direct Testimony of Rosemary Morley, at p. 48, lines 8-9.
[31] Direct Testimony of Rosemary Morley, at p. 50, lines14-15.
[32] Direct Testimony of Rosemary Morley, at p. 50, lines15-17.

Q. IS THE COMPANY USING THE SAME MEASURE OF INFLATION IN THIS RATE CASE AS IT HAS IN PAST PROCEEDINGS?

A. Not in all respects. In the Company's last rate case (Docket 120015-EI), it utilized the energy component of the CPI-U as an element of its forecast of NEL, which the Company has removed in the current proceeding.[33] Likewise, the Company uses the energy component of the CPI-U to forecast the Company's summer peak demand needs. In both the Company's last rate case and the current rate case, the Company has used the CPI-U to benchmark its O&M costs.[34]

Q. DID THE COMPANY EXPLAIN THE RATIONALE FOR ITS REMOVAL OF ITS INFLATION MEASURE IN ITS FORECAST OF NET ENERGY FOR LOAD?

A. The Company states that it based this change on the position that "many customers need to budget for their total energy purchases, not just electricity, particularly when rising energy prices, such as those for gasoline, exceed the overall cost of living."[35] Likewise, the Company notes that recent fluctuations in energy prices have caused the link between energy prices and short-term electricity consumption to decouple.[36]

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[33] Direct Testimony of Rosemary Morley, at p. 32, lines 14-16.
[34] Direct Testimony of Rosemary Morley, at p. 48, lines 8-9.
[35] Direct Testimony of Rosemary Morley, at p. 32, lines 16-18.
[36] Direct Testimony of Rosemary Morley, at p. 32, lines 18-21.

Q. ARE THERE ANY DIFFERENCES IN THE USE OF THESE TWO INFLATION MEASURES FOR PURPOSES OF ESTABLISHING THE COMPANY'S TEST YEAR?

A. Yes. The Company indicates that the energy component portion of the CPI-U (the method used in its prior rate case) yields inflation rates of 0.9 percent from 2015 to 2016, 6.0 percent in 2016, and 7.3 percent in 2017.[37] The overall CPI-U (which the Company uses in this rate case) is forecast by Global Insight to yield inflation measures of 2.0 percent (2016) and 2.5 percent (2017).[38]

Q. WHICH MEASURE OF INFLATION IS BETTER FOR ADJUSTING UTILITY EXPENSES?

A. Neither measure is an appropriate gauge of cost inflation for a regulated electric utility. The CPI-U represents the general level of price inflation in the economy, and recent empirical evidence, as I will discuss later, shows that those general trends do not often follow the same cost inflation trends as U.S. electric utilities.

Q. PLEASE EXPLAIN THE DIFFERENCE BETWEEN GENERAL PRICE INFLATION AND COST INFLATION FOR ELECTRIC UTILITIES.

A. The CPI is an index number, developed from a survey that estimates price inflation across a basket of consumer goods that is defined by BLS. The price inflation measure is designed to measure the average change over time in the prices of goods and services

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[37] Petition, Schedule F-7, at p. 13.
[38] Direct Testimony of Rosemary Morley, at p. 51, lines 4-5.

consumers buy for day-to-day living.[39] In other words, the CPI covers only consumer purchases in the U.S. economy, and excludes investment items such as stocks, bonds, and real estate.[40] It also does not measure the average changes in prices received by domestic producers for their output, such as the average change in input prices for electric utilities.[41] The CPI is based upon consumer items such as toothpaste, breakfast cereal, bedroom furniture, jewelry and pet products: none of which are used as inputs, nor have anything to do with the provision of electricity service.[42]

Q. DO YOU HAVE AN EMPIRICAL EXAMPLE THAT SHOWS THE DIFFERENCES BETWEEN GENERAL PRICE INFLATION AND ELECTRIC UTILITY COST INFLATION?

A. Yes. This past year (2015), *Public Utilities Fortnightly* ("PUF" or "Fortnightly") published an article titled "Electric Rates Losing Ground to the CPI."[43] This article provided an example of how the baseline CPI for 2015 increased 0.7 percent while the electricity component of the CPI fell 1.2 percent during the same annual period. The article further noted that the 2015 increase is not a recent trend, and that electricity prices have generally increased at a slower rate than prices for all goods generally. A replication of a chart included in the PUF article is provided in Exhibit DED-13.

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[39] BLS Handbook of Methods, Chapter 17: Consumer Price Indexes, Bureau of Labor Statistics, at p. 1.
[40] BLS Handbook of Methods, Chapter 17: Consumer Price Indexes, Bureau of Labor Statistics, at p. 3.
[41] BLS Handbook of Methods, Chapter 14: Producer Price Indexes, Bureau of Labor Statistics, at p.1.
[42] See, Frequently Asked Questions, U.S. Bureau of Labor Statistics, available online at: http://www.bls.gov/cpi/cpifaq.htm#Question_7.
[43] Mitnick, Steve (December 2015), "Electric Rates Losing Group To The CPI", *Public Utilities Fortnightly*.

Q. ARE THERE ANY OTHER GOVERNMENT INFLATION MEASURES OF UTILITY COST INFLATION?

A. Yes. In addition to publishing a CPI, the BLS also publishes a Producer Price Index ("PPI") to measure the average changes in input prices for domestic industries. Because of the wide variability in industry prices, the BLS publishes hundreds of individual PPIs that are organized by North American Industry Classification System ("NAICS") codes. The NAICS code representing FPL's industry is Electric Power Generation, Transmission, and Distribution: NACIS 2211, which covers electric utilities and is a subset of sector Utilities: NAICS 22.[44] The BLS PPI shows that input prices for electric utilities have been generally flat since mid-2008, corresponding roughly to the start of the last recession. Indeed, such input price trends have been trending downwards for the last two years after reaching highs at the beginning of 2014. Current input price estimates in the electric utility sector for April 2016 finds such costs to be only 3.4 percent higher than the same estimates for input costs in April of 2008. This corresponds to an annual price inflation factor of slightly more than 0.4 percent, or less than one-half of one percent annually.

Q. DOES THE COMPANY ADDRESS THE DISCONNECT BETWEEN THE CPI AND THE PPI AS MEASURES OF UTILITY COST INFLATION?

A. Yes. The Company acknowledges that CPI and PPIs are two common measures of the national economy's general price levels, and that while the CPI-U has shown price inflation growth of 2.21 percent between December 2012 and December 2014, the PPI

[44] Industries at a Glance; Utilities: NAICS 22, U.S. Bureau of Labor Statistics, available online at: http://www.bls.gov/iag/tgs/iag22.htm.

for all manufactured goods has only increased by 0.72 percent.[45] In this, the Company recognizes that consumers over the past two years have seen more than three times the rate of price inflation as that seen by producers of manufactured goods.

Q. WHAT IMPACT DOES AN OVERSTATEMENT OF INFLATION HAVE ON THE COMPANY'S TEST YEAR?

A. An unreasonably high inflation rate will tend to overstate test year expenses and will cause the Company's O&M cost projections (and performance) to appear reasonable since it will be compared to an inflated O&M benchmark.

B. <u>Inconsistency with consensus inflation estimates</u>

Q. ARE THERE ANY OTHER PROBLEMS ASSOCIATED WITH THE COMPANY'S PROPOSED INFLATION MEASURE?

A. Yes. The Company's proposed inflation measure is based solely upon the opinions of Global Insight, without any input from other economic forecasters who routinely assess and forecast inflationary pressures within the economy. This is a very limited approach in developing an inflation factor forecast since academic research has consistently shown that a survey of economic forecasts is more accurate than relying too heavily on a single forecast which may have intrinsic biases from the forecaster.[46]

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[45] Direct Testimony of John J. Reed, at p.15, lines 3-9.

[46] See, Clemen, Robert T. (1989), "Combining forecasts: A review and annotated bibliography," *International Journal of Forecasting*, 5: 559-583. This survey notes "considerable literature has accumulated over the years regarding the combination of forecasts. The primary conclusion of this line of research is that that forecast accuracy can be substantially improved through the combination of multiple individual forecasts. Furthermore, simple combination methods often work reasonably well relative to more complex combinations."

Q. DID THE COMPANY CONSULT ANY OTHER ECONOMIC FORECAST BESIDES BY GLOBAL INSIGHT?

A. The Company claims that it "review[ed] the forecasts developed by other sources and considers historical trends in order to assess the reasonableness of IHS Global Insight's forecast."[47] However, in response to discovery requests, the Company was unable to provide proof of any such analysis besides those produced by Global Insight, in addition to claiming work product privilege regarding an internal analysis of customer growth statistics.[48] Regardless, the Company did not use any of this additional research in developing its proposed inflation factor for this rate case.

Q. DID THE COMPANY REFERENCE ANY OTHER AUTHORITATIVE SOURCES FOR INFLATION PROJECTIONS IN ITS FILING?

A. Yes. The Company claims that its forecast of overall CPI is "consistent with the inflation projections developed by other experts, including the Philadelphia Federal Reserve Banks Survey of Professional Forecasters and the National Association for Business Economics ("NABE")."[49]

Q. HAVE YOU REVIEWED THE FEDERAL RESERVE BANK OF PHILADELPHIA'S SURVEY OF PROFESSIONAL FORECASTERS?

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[47] Direct Testimony of Rosemary Morley, at p.50, lines 15-17.
[48] FPL Response to OPC Eight Set of Request for Production of Documents, No.108.
[49] Direct Testimony of Rosemary Morley, at p.52, lines 6-9.

A. Yes. Federal Reserve Bank of Philadelphia released its survey of professional forecasters for the second quarter of 2016 on May 13, 2016.[50] In this release, the survey reported "little reason to change their views on headline CPI inflation in 2016, 2017, and 2018 compared with (the survey's) predictions of three months ago."[51] The survey finds an average estimate for CPI-U inflation of 1.5 percent for 2016, and 2.1 percent for 2017.[52]

Q. HAVE YOU REVIEWED THE INFLATION PROJECTIONS DEVELOPED BY THE NATIONAL ASSOCIATION FOR BUSINESS ECONOMICS?

A. Yes. The most recent economic outlook published by NABE was released publicly on June 6, 2016.[53] In this release, NABE noted its expectations that inflation would "remain modest" going forward.[54] The median annual forecast of CPI-U was estimated to be 1.6 percent for 2016, and 2.3 percent for 2017.[55]

Q. HOW DOES THE PROPOSED INFLATION RATES FOR 2016 THROUGH 2018 COMPARE TO HISTORICAL AVERAGES?

A. The Company's analysis shows that its proposed test year inflation measure differs from recent trends with no explanation for the rationale of those differences. Specifically, the Company notes that between 2010 and 2014, the overall CPI increased at a compound annual rate of 2.1 percent a year, and that the overall CPI during this time was fairly steady, fluctuating between 3.1 percent and 1.5 percent a year though the four year period

[50] Second Quarter 2016 Survey of Professional Forecasters (May 13, 2016), Federal Reserve Bank of Philadelphia.
[51] Second Quarter 2016 Survey of Professional Forecasters (May 13, 2016), Federal Reserve Bank of Philadelphia.
[52] Second Quarter 2016 Survey of Professional Forecasters (May 13, 2016), Federal Reserve Bank of Philadelphia.
[53] NABE Outlook (June 2016), National Association for Business Economics.
[54] NABE Outlook (June 2016), National Association for Business Economics, at p.1.
[55] NABE Outlook (June 2016), National Association for Business Economics, at p.8.

(2010-2014).[56] The overall CPI in 2015 was virtually flat, increasing only 0.1 percent from the level of prices in 2014.[57]

Q. DOES THE COMPANY PROVIDE ANY EXPLANATION FOR THIS ABOVE TREND INFLATIONARY INCREASE?

A. Yes. The Company states that its inflation forecast is "consistent with the consensus view that a moderately positive rate of inflation can be expected for the next few years. Contributing to this consensus view is the expectation that energy prices should eventually stabilize following their sharp declines in 2015."[58]

Q. ARE THERE ANY INHERENT CONCEPTUAL PROBLEMS WITH THE COMPANY'S PROPOSED RATES OF INFLATION OVER THE NEXT TWO YEARS?

A. Yes. In the aftermath of the high inflation era of the late 1970s and the decades since this period, the Federal Open Market Committee ("FOMC") has taken renewed interest in each element of its mandate to ensure price stability and maximum employment. This has caused the FOMC to define an annual target inflation rate of 2.0 percent over time as most consistent with its mandate, and thus sets monetary policy with this target in mind.[59]

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[56] Direct Testimony of Rosemary Morley, at p. 49, lines 6-9.
[57] Direct Testimony of Rosemary Morley, at p. 49, lines 12-13.
[58] Direct Testimony of Rosemary Morley, at p. 51, lines 6-8.
[59] Current FAQs, "Why does the Federal Reserve aim for 2 percent inflation over time?" Board of Governors of the Federal Reserve System, available online at: https://www.federalreserve.gov/faqs/economy_14400.htm.

Q. WHAT IS THE FOMC?

A. The FOMC is a committee within the Federal Reserve System charged with overseeing open market operations, and influences the demand for, and supply of, balances that depository institutions hold at Federal Reserve banks.[60] The FOMC sets the interest rate, called the federal funds rate, at which depository institutions lend day-to-day balances at the Federal Reserve to other depository institutions, and thus indirectly influences other short-term interest rates and ultimate price inflation on goods and services.[61] The FOMC consists of the seven members of the Board of Governors, including the chair of the Board of Governors, referred to as the Federal Reserve chairman; the president of the Federal Reserve Bank of New York; and four of the remaining eleven Reserve Bank presidents divided by geographical region (i.e. the northeast and mid-Atlantic, the industrial mid-west, southeast and Texas, and the north-central and western regions).[62]

Q. DOES THE FOMC EXPRESSLY STATE A DESIRE TO MAINTAIN AN ANNUAL INFLATION RATE OF 2.0 PERCENT?

A. Yes. As noted above, the FOMC has defined a 2.0 percent annual inflation target as most consistent with its mandate to oversee price stability and achieve maximum employment. This target is expressly defined and referenced to on the Federal Reserve's website under a frequently asked question page.

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[60] The Federal Reserve System: Purposes & Functions (June 2005), Board of Governors of the Federal Reserve System, 9th ed., at p. 11.
[61] The Federal Reserve System: Purposes & Functions (June 2005), Board of Governors of the Federal Reserve System, 9th ed., at p. 3.
[62] The Federal Reserve System: Purposes & Functions (June 2005), Board of Governors of the Federal Reserve System, 9th ed., at pp. 11-12; and fn. 1.

> **Why does the Federal Reserve aim for 2 percent inflation over time?**
> The Federal Open Market Committee (FOMC) judges that inflation at the rate of 2 percent (as measured by the annual change in the price index for personal consumption expenditures, or PCE) is most consistent over the longer run with the Federal Reserve's mandate for price stability and maximum employment. Over time, a higher inflation rate would reduce the public's ability to make accurate longer-term economic and financial decisions. . . . The FOMC implements monetary policy to help maintain an inflation rate of 2 percent over the medium term.[63]

Q. HOW DOES THIS RELATE TO THE COMPANY'S PROPOSED INFLATION FORECAST?

A. While it is not impossible for inflation to increase to a rate of 2.5 percent, as assumed by the Company, it is unlikely that the FOMC would not engage in aggressive monetary action if such an outcome started to materialize. The Company's inflation forecast assumptions are, therefore, inconsistent with the goals of U.S. monetary policy. In fact, the Federal Reserve's hesitancy to raise short term rates repeatedly over several recent semi-quarterly meetings underscores their belief that inflation is far below levels requiring monetary action, despite the fact that crude oil prices are nearly double their 10-year record low reported January 20th of this year.[64]

Q. HAVE YOU REVIEWED PUBLIC MATERIALS ON INFLATION EXPECTATIONS?

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[63] Current FAQs, "Why does the Federal Reserve aim for 2 percent inflation over time?" Board of Governors of the Federal Reserve System, available online at: https://www.federalreserve.gov/faqs/economy_14400.htm.

[64] See, "Petroleum & Other Liquids: Spot Prices", U.S. Department of Energy, U.S. Energy Information Administration, Available online at: https://www.eia.gov/dnav/pet/pet_pri_spt_s1_d.htm.

Docket No. 160021-EI

DIRECT TESTIMONY OF
DAVID E. DISMUKES, PH.D.
ERRATA

Page	Footnote	Change From	Change To
9:1-2		HAVE YOU PREPARED A COMPARISON OF HISTORIC WEATHER-NORMALIZED SALES TO PROJECTED SALES?	HAVE YOU PREPARED A COMPARISON OF HISTORIC SALES TO PROJECTED SALES?
24:1		quiet	quite
33	55	at p.8.	at p.7.
37:18		Project	Projection

A. Yes. The Wall Street Journal conducts a survey of more than 60 economists on 10 major economic indicators, and their expectations, on a monthly basis.[65] The average expectations as of June 15, 2016, is that CPI levels will reach 1.8 percent by the end of 2016, and then level off at 2.3 percent by the end of 2017.

Q. IS THIS CONSISTENT WITH THE EXPECTATIONS OF THE FEDERAL RESERVE?

A. No. At the FOMC's March 16, 2016 meeting, the FOMC decided not to raise borrowing costs and scaled back its forecasts for interest rates.[66] The FOMC's official median projection found that inflation would not reach two percent until early 2018. Specifically, the FOMC only expected inflation to reach 1.2 percent by the end of the year, and increase to 1.9 percent by the end of 2017.[67]

Q. WHAT ARE YOUR RECOMMENDATIONS FOR THE COMPANY'S INFLATION FORECAST?

A. I recommend the Commission adopt an inflation rate equal to a weighted average of the median result of the Wall Street Journal's June survey of economic analysts, and FOMC's official median project for use in computing expected near-term inflation. Specifically, I recommend a weighted average that places a 60 percent weighting on the forecasts of the FOMC and a 40 percent weighting on the forecasts of other industry professionals. This results in a 2016 general price inflation of 1.44, and a subsequent

[65] Economic Forecasting Survey, Wall Street Journal, Available online at: http://projects.wsj.com/econforecast/#ind=gdp&r=20.
[66] Randow, Jana (March 16, 2016), "Fed Scales Back Rate-Rise Forecasts as Global Risks Remain," Bloomberg.
[67] Randow, Jana (March 16, 2016), "Fed Scales Back Rate-Rise Forecasts as Global Risks Remain," Bloomberg.

2017 general price inflation of 2.06 percent. I additionally recommend this 2.06 percent level be maintained for 2018, consistent with the FOMC's long-term monetary policy of maintaining a 2.0 percent rate of general price inflation.

Q. DO YOU BELIEVE THAT YOUR PROPOSED INFLATION FORECAST REPRESENTS A CONSERVATIVE ESTIMATE OF THE COMPANY'S ADDITIONAL REVENUE NEEDS TO ACCOUNT FOR GENERAL PRICE INFLATION?

A. Yes. As noted previously, the Company as an electric utility does not experience price inflation in a manner similar to a household consumer contending with increasing food and healthcare costs. Historically, input cost inflation for electric utilities has been significantly lower than that seen in the economy as a whole. In the interest of being conservative in my adjustment to the Company's requested revenue requirement, I have maintained the Company's practice of utilizing the CPI-U as a measure of cost inflation for the utility. However, I have placed a 60 percent weight on the lower FOMC inflation rate forecast to temper the Company's proposed increase to test year expenses.

Q. DOES THIS CONCLUDE YOUR TESTIMONY FILED ON JULY 7, 2016?

A. Yes.

MS. CHRISTENSEN: And I would ask that the witness be allowed to give a summary of both of his testimonies at this time.

CHAIRMAN BROWN: Oh, actually. Staff does have some, right?

MS. BROWNLESS: Yes, ma'am.

CHAIRMAN BROWN: Okay.

EXAMINATION

BY MS. BROWNLESS:

Q Hello, Dr. Dismukes. Lovely to see you.

Did you have an opportunity to review Exhibit 579, which is a list, the composite exhibit list, that the staff put together?

A Yes, I did.

Q Okay. And with regard to the exhibits that are identified next to your name, 525, 526, 527, and 528, were those prepared by you or under your direct supervision and control?

A Yes, ma'am, they were.

Q Okay. And are they true and correct, to the best of your knowledge and belief?

A Yes, ma'am, they are.

Q And would your answers be the same today to the requests therein, if you were asked?

A Yes, they would.

Q Okay. Are there any portions of your list of exhibits that are confidential?

A No, ma'am, not to my knowledge.

MS. BROWNLESS: Thank you, sir.

MS. CHRISTENSEN: I would ask at this time that the witness be allowed to provide a summary of his testimonies.

THE WITNESS: Good afternoon, Commissioners.

The purpose of my testimony -- I have two pieces of testimony that address two different issues. The first has to do with the company's load forecast that's used for its billing determinants in this rate case. And I'm also testifying on the revised incentive mechanism that the company has proposed for the renewal as well.

I would like to start with the load-forecasting issues. And my recommendation is that the company -- that the Commission reject the company's load forecast in this particular proceeding and, instead, use the load forecast that was included in its more recent Okeechobee need determination.

And I am basing this recommendation on a number of different reasons that I outline in my testimony. The first is that the current rate-case forecast does not follow a lot of commonly-accepted trends that you would tend to see with the load forecast, particularly the energy sales, the peak demand, and customer numbers; whereas, the Okeechobee need-determination forecast does.

Some of the results from the rate-case forecast are inconsistent with the prior 10-year site plan in 2015; that need-determination forecast that I talked about before, as well as being internally inconsistent with some of the revenue-class models that are included in the company's rate-case forecast.

And then lastly, if you look at the company's current rate-case forecast, it has some unexplainable changes that are associated with calculating load factors on a projected basis that are inconsistent with the historic trends you have seen with the company in the past.

The forecasted trends that you would have seen have a comparable forecast in the Okeechobee need determination as well as the historical load factor trends seen with other utilities in the state of Florida.

As I mentioned earlier, I am also testifying on the off-system-sales incentive issue that was included as part of settlement in the last rate case. This settlement differs from the off-system-sales incentives that the Commission has in place for several decades for the utilities here in the state of Florida and is currently in place for the other investor-owned utilities.

This mechanism not only substantially changes the substant- -- the sharing percentages associated with off-system-sales incentives, but it also is a -- considerably expands the set of assets, from which FPL can make gains, including, the most importantly, off-system purchases, which is -- which I have argued in my testimony is something that ought to be an obligation associated with providing service for a utility.

I also have a number of concerns associated with renewing this particular program; the potential that incentives like this could have, potentially for over capitalization; some of the competitive market implications associated with an incentive mechanism like this; the potential for potential jurisdiction -- jurisdictional issues, particularly as it relates to off-system sales of gas assets and gas optimization; and then allowing utilities to get a return associated with purchasing lower-cost electricity. That is something that ought to be an obligation to serve.

I am familiar with doing lots of fuel audits around the country and purchase power audits for electric utilities. And I have never heard of anyone getting an incentive associated with the purchases they make for off-system economic purchases on behalf of the ratepayers.

And so I recommend that you not approve that. There certainly hasn't been a preponderance of information that's shown there would be a benefit. And, keeping in mind that, by not approving this, there will still be a default going back to the Commission's current incentive mechanisms where there is an 80/20 split on the thresholds that you've set back in the 1990s.

MS. CHRISTENSEN: Thank you, Dr. Dismukes.

I would tender the witness for cross.

CHAIRMAN BROWN: Thank you.

And welcome, Dr. Dismukes.

THE WITNESS: Thank you.

CHAIRMAN BROWN: FIPUG, any friendly -- I meant, no friendly.

MR. MOYLE: No, we don't have any.

CHAIRMAN BROWN: I got you there.

Hospitals.

MR. SIQVELAND: We also have nothing on this witness. Thank you.

CHAIRMAN BROWN: Okay. Retail Federation.

MR. LAVIA: No questions. Thank you.

CHAIRMAN BROWN: FEA?

MR. JERNIGAN: No questions.

CHAIRMAN BROWN: Sierra?

MS. CSANK: No questions.

CHAIRMAN BROWN: AARP.

MR. COFFMAN: No questions?

CHAIRMAN BROWN: Florida Power & Light?

MS. MONCADA: Yes, ma'am, we have some.

EXAMINATION

BY MS. MONCADA:

Q Good afternoon, Dr. Dismukes.

A Good afternoon.

Q As you indicated in your oral summary, you, testified on a few discrete topics. And this afternoon, I have a few questions on each one of them. And I'll take incentive mechanisms first --

A Okay.

Q -- followed by the load forecast.

A Okay.

Q With regard to the incentive mechanism on page

five of your testimony --

CHAIRMAN BROWN: Can you specify which testimony, the July or the June?

MS. MONCADA: That's the June, ma'am. Thank you.

BY MS. MONCADA:

Q Beginning on line 31, you make note -- you state that a utility's -- part of a utility's obligation to serve is to provide least-cost service, and failure to do so should represent grounds for imprudence. Do you see that?

A Yes, ma'am.

Q Can you point me to a statute in Florida that describes the duty of the utility in terms of least-cost service and imposes a finding of imprudence in the absence of providing least-cost service?

A I believe there was some cited in my testimony. I will have to find the page.

CHAIRMAN BROWN: Take your time.

THE WITNESS: Thank you.

MR. MOYLE: You know, we've used that convention about, can you show me where -- what line you're referring to kind of thing. Might save time if FPL's counsel could point him to it.

CHAIRMAN BROWN: FPL?

MS. MONCADA: I have nothing to point him to other than the statement that I pointed out in my question.

CHAIRMAN BROWN: Maybe Public Counsel can help.

THE WITNESS: I found it. I am sorry for the delay.

I think I reference it in Footnote 51 and 52 on page 42. And I think I also provided a number of examples where the Commission has utilized least-cost principals, whether it be for a competitive bidding for the procurement of new generating resources, whether it had to do with testing the market associated with affiliate transactions, among other examples.

BY MS. MONCADA:

Q Dr. Dismukes, I happen to have a set of the Florida Statutes Chapter 366 here with me. And the first section you cite is 366.03. Can you point me to where 366.03 refers to least-cost service?

MS. CHRISTENSEN: I am going to object to the extent that they're asking him to draw a legal conclusion. He is here to testify as an expert in fuel-cost mechanisms. And I think he has cited to the provisions. But I think when we start to pick apart statutes, you might be asking for a legal opinion as opposed to an expert opinion in which he is an expert.

MS. MONCADA: Madam Chair, as I read in the first question that I asked Dr. Dismukes, he says: Part of the utility's obligation to serve is to provide least-cost service.

I think these questions are fair.

CHAIRMAN BROWN: I agree. Objection overruled.

THE WITNESS: So I can answer from a policy perspective. And I am not -- as counsel mentioned, I am not offering a legal opinion, but if you look at the first sentence, it says: Each public utility shall furnish to each person applying thereof reasonably sufficient, adequate, and efficient service upon terms as required by the Commission.

As an economist, "efficient" means minimizing inputs for a given level of output. And minimizing inputs are cost.

BY MS. MONCADA:

Q "Reasonable" is one of the qualifying terms there; is it not?

A Reasonably sufficient, adequate, and

efficient. I think the statute reads for itself. And, as I mentioned earlier, I interpret efficient as minimizing cost associated with a given level of output, just like most economists would.

Q That was really fast. I didn't hear the end of what you said, but I will move on.

Are you aware that Florida -- I am sorry -- that FPL's typical residential bills for at least the past six years have been the lowest among all Florida IOUs?

A I do not know.

Q Will you accept that, subject to check?

A Yes, ma'am.

Q So assuming, as it is, that Florida -- that FPL has the lowest of all Florida IOUs with regard to their typical residential bills, is it your opinion, then, that all other IOU's in Florida are imprudent?

A No, it has nothing to do with my statements associated with making least-cost purchases from the market. It's like apples and oranges. I don't even understand what the relationship between the two would be.

The fact that you stack in a relative comparison to other utilities in a favorable fashion doesn't change or negate the obligation that you have to continue to reduce costs, to minimize those costs and to do it, not only today, but on a forward-going basis.

And it doesn't have anything to do with the standing of your rates relative to other utilities. You could have the highest ones, as long as you're taking advantage of those market opportunities.

Q So it's relative to market opportunities is what you're saying.

A Well, in this instance, it's relative to your cost -- your marginal cost of generation relative to what's out in the market, yes, ma'am.

Q Dr. Dismukes, turn to page three of your testimony, if you could, please.

MS. CHRISTENSEN: I'm sorry. Could you repeat the page number?

MS. MONCADA: Page three.

CHAIRMAN BROWN: Page three, June?

MS. MONCADA: Of June, yes.

Madam Chair, when we switch to July testimony I will make it clear.

CHAIRMAN BROWN: I figured.

MS. MONCADA: Thanks.

BY MS. MONCADA:

Q And you state there, Dr. Dismukes, that FPL has simply not met its burden of proof, nor shown that

extension of the proposed recalibration of its modified incentive program is in the public interest?

A Yes, ma'am.

Q So are you aware that the PSC allowed all of the parties the ability to ask FPL 850 interrogatories, request for admissions, and requests for production?

A I don't know what the specific number was, but it's my understanding that the Commission allows discovery to be asked.

Q And in fact, your attorneys, the Public Counsel, did, in fact, propound at least 147 interrogatories related strictly to the incentive mechanism in this case?

A I am not aware of the number.

Q You are not aware of the number, but did -- were you able to review the responses that FPL provided?

A Yes. Yes.

Q And that would include hundreds of pages of data that they provided in response to incentive-mechanism questions?

A Yes, ma'am.

Q Were you invited to help formulate any of those questions?

A Yes, ma'am.

Q And you reviewed the answers that were

provided in response to your questions?

A Either I did or my staff did, yes, ma'am.

Q And you are also aware the Commission allows the parties to take depositions in the event they still feel there is anything unclear about the subject matter?

A Yes, ma'am.

Q And are you aware that Mr. Forrest, who testifies about the incentive mechanism, made himself available for deposition?

MS. CHRISTENSEN: Object. I think this is going well beyond the scope of this witness' testimony.

CHAIRMAN BROWN: I will allow it. If he knows it, he knows it. He helped with the discovery responses, so he may know.

THE WITNESS: I don't know.

BY MS. MONCADA:

Q All right. Were you aware that the Public -- Public Counsel chose not to take Mr. Forrest's deposition?

A It's my understanding he was not deposed.

Q All right. Are you aware that, with regard to the incentive mechanism, this commission performed -- has performed an audit following the years 2013, 2014, and 2015?

A Yes, ma'am.

Q And you are aware that they have -- there have been no negative audit findings with regard to this incentive mechanism?

A I am not aware of any.

Q But that would have been additional sources of information regarding the incentive mechanism, yes?

A Yes, ma'am.

Q Okay. And now, same piece of testimony, page 27. You see on line one you have a section titled "overcapacity incentives." And you dedicate, oh, the next six or seven pages or so on that topic.

A Yes, ma'am.

Q So with regard to that, you are aware, aren't you, that the UPS contracts that enabled FPL to create value for customers during the years 2013 through the beginning of this year -- again, the UPS contracts have expired?

A Yes, ma'am.

Q And that, roughly $10 million of FPL's gains per year came from that set of contracts?

A Yes, ma'am.

Q Did you have an opportunity to listen to Mr. Forrest's live testimony?

A No, ma'am, I did not.

Q Okay. But are you aware that Mr. Forrest explained that FPL did not renew the UPS contracts because, on an overall system basis, they were not beneficial for FPL's customers?

A I do remember seeing something about the fact that they were not economic to enter into on a forward-going basis, yes.

Q So you would agree that this means that FPL did not renew contracts in spite of the fact that they could be used to create optimization gains in which FPL could share?

A Yes, ma'am.

MS. MONCADA: Madam Chair and Dr. Dismukes, I am now turning to the July testimony. This is on the topic of load forecasting.

BY MS. MONCADA:

Q Start on page 14 of that testimony.

A Okay.

Q At the bottom, on line 22, you make a statement that the company has failed to provide any information explaining the differences between the currently-filed load forecast and the one included. And there you are referencing the 10-year -- the 2015 10-year site plan and the Okeechobee need determination?

A Yes, ma'am.

Q So without rehashing all the questions that I asked regarding the first testimony, are you aware that Dr. Morley answered literally hundreds of questions, and that that included at least nine that provided very specific details regarding the change in her model?

A I am aware she -- that she filed -- filed discovery and there were discovery responses. I don't know that any of them were responsive enough in making those explanations.

Q And if they were -- if you believe that they weren't responsive enough, you understand that you -- you and your attorneys could have asked her more questions during her deposition.

A Yes.

Q Okay. Turning now to your Exhibit DED-1, page two of two.

A Okay.

Q And this reflects -- well, why don't you tell me what it reflects.

A This is looking at the company's projections for its load forecast, for its net energy for load from 2015 forward and looking at the historic trends with those forecasts. And then the dashed line is just kind of drawing where the 2015-year sales level was.

Q Okay. And you state in one of the boxes here,

toward the middle right, that the company projections will not regain 2015 sales levels until 2019?
A   Yes, ma'am.
Q   All right. If we look over on the left-hand side, starting with 2010 --
A   Yes, ma'am.
Q   -- and we move over to the year 2011?
A   Uh-huh.
Q   You would agree with me that the actual 2011 -- 2011 non-weather normalized sales -- this is non-weather normalized, correct?
A   Yes, ma'am.
Q   The level of 2011 non-weather normalized sales are lower than the 2010 sales.
A   Yes.
Q   And the same for 2012. They are lower than the actual 2010 sales.
A   Yes.
Q   And for 2013, it is lower than the 2010 sales.
A   Yes.
Q   So would you agree with me that the pattern of having -- of taking up to a few years to catch up to a year of what might be categorized as abnormal whether was also a pattern in the years of 2011 through 20 -- at least 2013.

A It was also a significant recession, plus recession and recovery years, too.

Q Is it -- is it your testimony that those years were recession years?

A Yeah, those were recovery years coming out of the recession, yeah. I don't think Florida jumped back in the year after the recession, in 2010.

Q Okay. So -- but those --

A I think this was the worst housing market in the United States, if I'm not mistaken.

Q Well, Dr. Dismukes, you're saying that for the years '11, '12, and '13?

A I think it was a relatively long recovery period, yeah.

MS. MONCADA: Thank you. I have no further questions.

CHAIRMAN BROWN: Okay. Thanks.

Staff, you have a few questions?

MS. BROWNLESS: Unfortunately, yes, ma'am.

CHAIRMAN BROWN: No, it's great. Come on. It looks like you're handing out an exhibit; is that correct?

MS. BROWNLESS: That is for my co-counsel. That's not me.

CHAIRMAN BROWN: Okay.

MS. BROWNLESS: We will be talking to Dr. Dismukes about that.

CHAIRMAN BROWN: We will be starting at 712.

MS. BROWNLESS: Thank you.

CHAIRMAN BROWN: Go ahead, Ms. Brownless.

MS. BROWNLESS: Okay.

EXAMINATION

BY MS. BROWNLESS:

Q Good afternoon, Dr. Dismukes.

A Good afternoon.

Q Were you provided responses to staff's interrogatories in POD requests associated with your subject area as they became available?

A Yes, ma'am.

Q Okay. And, in fact, in your July 7th testimony, you utilized the response to staff's third set of interrogatories, number 67; is that right?

A Yes, ma'am.

Q And you also, subsequently in that testimony, utilized -- okay. I am sorry. Strike that.

Were you also provided responses associated with your subject areas of FIPUG's, FEA's, South Florida's, AARP's discovery responses?

A Yes, ma'am, I was.

Q Okay. And did you prepare discovery questions

for OPC in your subject areas that were subsequently turned into interrogatories or requests?

A Yes, ma'am -- yes, ma'am. Either I did or my staff did.

Q And did you receive and review responses to that discovery?

A Yes, ma'am, either I did or my staff did. Yes, ma'am.

Q Thank you.

Now, if you can turn to page 15 of your June 17th testimony. And I am looking at lines -- let's see -- eight through 11.

A I'm sorry, Ms. Brownless. What page were you on again? I lost you.

Q I am on page 15 --

A 15, I'm sorry.

Q -- lines eight through 11 of your --

A Okay.

Q -- June 17th testimony?

A Okay. I'm there.

Q Oakie-doke.

Am I correct that you are expressing in this section some concerns about out-of-state transactions?

A Yes, ma'am.

Q And the impact of the proposed incentive

mechanism on out-of-state transactions?

A Yes, ma'am.

Q Okay. Under the incentive mechanism that is in place for -- currently in place for every one except FP&L, which -- which I will refer to as the old incentive mechanism -- does FP&L receive credit for incentives for out-of-state wholesale power sales?

A I believe they do, yes, ma'am.

Q Okay.

A But I think, you know, the emphasis here and the more -- the larger concern is on the gas side. The gas -- while the company is leveraging its generating assets that it owns and is part of its core competency, according to statute, and it's selling those in the market, whether it be in the State or -- or not, it's still part of its core generation transmission distribution functions.

When your starting to sell pipeline capacity, storage capacity and the producing basins or wherever it may be, those are assets, the cost of which have typically been rolled through on fuel, which have typically been treated as pass-throughs. And they are not typically part of that generation transmission and distribution function.

Yes, they are related. I would admit they are related, but going out and selling and optimizing a gas storage asset in coastal Louisiana is a lot different than making an off-system sale from power plant to somebody in Southern Company.

Q So basically you're focusing on transactions that have been added --

A Yes, ma'am.

Q -- to the traditional --

A Yes, ma'am.

Q -- transaction covered by what I refer to as the old incentive mechanism?

A Yes, ma'am. That's a good characterization.

Q Thank you so much.

A Uh-huh.

EXAMINATION

BY MS. HARPER:

Q Good afternoon, Dr. Dismukes, I am Adria Harper. And I am also with staff. And I just have a few questions, but mine are more focused toward the load forecasting.

A Okay.

Q And I am going to refer you now to that exhibit that we handed out. I want to make sure everybody has it. And, perhaps, we can mark it. It's the one labeled "portions of Witness Dismukes'

workpapers, Exhibit DED-1"?

CHAIRMAN BROWN: We are going to mark that as 712.

(Whereupon, Exhibit No. 712 was marked for identification.)

CHAIRMAN BROWN: Dr. Dismukes, do you have a copy of that?

THE WITNESS: Yes, ma'am, I do.

CHAIRMAN BROWN: All right.

Please proceed, Ms. Harper.

BY MS. HARPER:

Q I believe this was referenced a little bit earlier in your discussion, but this is just a portion, a specific portion of DED-1. And I am going to ask you just a few questions about it.

A Sure.

Q Could you please review the document and confirm that the one that I've provided you or we provided you represents the workpapers for your exhibit DED-1, which OPC has provided as a discovery response in this proceeding.

A It appears to be that way, yes, ma'am.

Q Great. Thank you.

Do you recognize the first page of this exhibit as your chart depicted in your Exhibit DED-1, page one of two to your direct testimony in this proceeding?

A Yes, ma'am.

Q Now, please turn to the last page of the staff exhibit here showing the column data with the main heading annual sales and 2015 annual sales?

A Yes, ma'am.

Q Okay. I want to direct your attention to the data in the first column on the page with the heading "retail." Is this data the data you used to create the chart depicted in your Exhibit DED-1, page one of two?

A I believe it is, but without looking at the link, I can't tell for sure.

Q Okay. Could you tell if this is the data series related to FPL's weather-normalized retail sales and projected sales for the years shown?

A I don't know. I will defer to the workpapers. Unfortunately, I am looking at a snapshot of it, so I can't tell if it's weather-normalized or not. It may be -- it may be. I just can't -- I can't tell from the labels, unfortunately. I mean, I can agree, subject to check, if you've looked at it.

MS. HARPER: Okay. Thank you we have no further questions.

CHAIRMAN BROWN: Thank you.

Commissioners.

Redirect.

FURTHER EXAMINATION

BY MS. CHRISTENSEN:

Q Thank you. And good afternoon, Dr. Dismukes. And I guess we could go back to the last exhibit that was handed out, which shows a portion of your workpapers.

I just wanted to ask: Do you think anything else, in fairness, should be included to this exhibit to make it representative of the workpapers that were submitted related to DED-1, page one and page two of two that were attached to your testimony? Do you think there is anything else from your workpapers that should have been included?

A I don't -- I don't know. I've got to look at the spreadsheet. So I can't tell you. I don't know the context of which tab this came out of, et cetera, so --

Q Okay. And what spreadsheets did you provide as part of your workpapers to sponsor Exhibit DED-1?

A I think all of our workpapers were provided at one time or another.

Q Okay. In what format were those provided?

A I think they were all provided -- well, they were all provided in electronic-spreadsheet format.

Q Okay. And is that an Excel spreadsheet format?

A Yes, ma'am.

Q Okay. And does this appear to be only a portion of the Excel spreadsheet that was provided as part of the workpapers?

A I think so.

Q Okay. Now, I think you were asked by staff regarding the old and -- what they are calling the old incentive mechanism.

A Yes, ma'am.

Q To your recollection, was natural gas part of the previously-approved commission's longstanding gain on sales mechanism?

A No, ma'am.

Q Okay. To your recollection in reviewing the material, when was, if at all -- when was natural gas transactions added to the request for incentive mechanisms?

A They were asked, as part of the incentive mechanism that was included in the settlement for the company's last rate case.

Q Okay. Now, you were also asked questions by FPL's counsel. Do you recall those?

A Yes, ma'am.

Q Okay. I think you were asked a few questions about the termination of the UPS contract. And I think she asked you, specifically related to your statements about overcapacity -- providing an overcapacity incentive as far as the incentive mechanism?

And I just wanted to ask you: Does the termination of the UPS contract, or the fact that FPL terminated that UPS contract -- does that change your opinion on whether or not the incentive mechanism proposed by FPL in this proceeding creates an overcapacity incentive?

A No. And, in fact, the examples I include in my testimony go beyond longer-term purchase power agreements and actually look more on the physical-development side than they do on the PPA side.

Q And can you explain what you mean on the physical-development side?

A The construction of generating facilities.

Q Okay. So it would more relate to the overcapacity of building additional generation rather than additional PPA-type contracts? I just want to make sure I am clear on your testimony.

A Well, those would -- those would be examples of other things that go beyond just the PPA.

Q Okay. Let me ask you: Do you recall being

asked a series of questions about -- well, specifically related to Dr. Morley's testimony in relationship to, I guess, her -- her lack of -- as you termed it, lack of explanation in reconciling the 2015 NEL with the deviations in the current base-rate NEL? Do you recall those questions?

A Yes, ma'am.

Q Okay. And do you recall counsel suggesting that there was lots of discovery that has been propounded in this case related to that subject matter?

A I do recall that.

Q Okay. You -- have you reviewed the discovery responses in this case?

A Yes, ma'am.

Q Did the number of discovery responses, in your opinion, improve or change the quality of the responses that were provided to discovery?

A I would just say that, through a variety of different questions, those explanations were not forthcoming, at least in the discovery that we examined. It was certainly the case that discovery was provided.

And there were -- there was differences in the reported output from the different load forecasts, but there was no explanation, there was no discussion of decomposing a large portion of those differences to really explain why you're seeing this big difference.

Now, Dr. Morley explained in her testimony that there was this difference in terms of switching one price variable from another. But if you are looking at a relatively robust load forecast, which in a price term ought to not result in a relatively significant shift in load -- in your overall load forecast.

That's not an explanation. That's just saying, I changed variables. That's not going -- explaining exactly what in that variable or what in the actual model output is actually changing that's making this a lot different.

So if you go back and you look at the load forecast that was done for 2015 Okeechobee need determination, those load forecasts tend to show relationships that you tend to see that are consistent with about 50 to 60 years worth of electricity-demand modeling.

Primarily the relationships that show the price elasticity terms associated with that load forecast tends to be lower than the income elasticities; that is, your price responsiveness on the absolute value is a little bit less sig- -- less -- is large, say, as your income responsiveness.

What you see in that switch, for some

unexplained reason, is an exact inverse of that, which is contrary to probably about, like I said before, 50 to 60 years worth of demand modeling; and that is, the price-elasticity terms are much greater than the income-elasticity terms.

So when the FPL increases its prices on a forward-going basis through time, it winds up essentially lowering that load just through changing that price term, as opposed to -- and it swaps out, essentially, any economic growth that would be associated with those forecasted time periods.

Q Okay. And back on a related question related to the quantity of discovery that was propounded that was asked by FPL. Do you think with the quantity of discovery that was propounded on FPL -- that they had ample opportunity to provide an explanation of the discrepancy between the modeling?

MS. BROWNLESS: Objection. Calls for speculation on the part of the witness.

MS. CHRISTENSEN: I think he can answer whether or not, in his opinion as an expert, there was opportunity provided to give that explanation.

CHAIRMAN BROWN: Can you restate the question?

MS. CHRISTENSEN: Certainly. He obviously -- this relates to FPL's discussion of the numerous

amounts of interrogatories that were propounded.
And I am asking this expert witness, in his opinion, whether or not, in those numerous interrogatories and production of document requests that were propounded on FPL -- in his opinion were there ample opportunities to provide explanation for the discrepancy between the 2015 modeling and the base-rate case modeling.

CHAIRMAN BROWN: Objection overruled.

You may answer the question.

THE WITNESS: Yes, ma'am.

BY MS. CHRISTENSEN:

Q Can you explain, in your opinion, whether or not you think there was ample opportunity to describe why there was a discrepancy between the 2015 modeling and the base-rate case modeling?

A I think -- I think we asked discovery in a variety of different ways on multiple different occasions for the inputs and the changes in these models, and asked for verifications because I think there was actually a reference in Dr. Morley's testimony about the cloaked similarities between the load forecast filed in this proceeding versus the one that was filed in the Okeechobee need determination, as well as a subsequent update that was suggested it was provided in that. So, yeah, there were opportunities for that.

Q Okay. I think FPL's counsel also asked you about whether or not you were aware that there were audits done in 2013, '14 and '15, and whether that was -- data was available.

Would the audit of the incentive mechanism program for 2013, '14, and '15, change your opinion in your testimony regarding the incentive mechanism?

A No, ma'am.

Q Okay. I think the -- another question you were asked by FPL's attorney was regarding the low-cost bills related -- I'm not sure -- I assume she was trying to relate it to economic purchases.

Do you -- do those two concepts have anything in relationship to each other?

A Not with respect to the points that I was trying to make in my testimony; and that, is a utility has an obligation to provide least-cost service. And just because its rates stand in a particular pecking order relative to in-state utilities, out-of-state utilities, regional utilities, et cetera, is different than that -- defining that fundamental obligation.

Q Okay. And I think you brought up, you were asked to point to Florida Statutes where you believed there was -- where least-cost service was imposed on the

utilities. And I think you said the use of the word "efficiency" was where you -- from an economic standpoint. Can you please clarify that response for me?

A Oh, well, efficiency according to economists is when you're essentially minimizing your -- your inputs for a given output. So by definition, if you are minimizing those inputs, you're minimizing your cost for a given level of output.

Q And from an economist's standpoint, are you equating that to least-cost?

A Yes, ma'am.

MS. CLARK: Okay. Thank you.

I have no further questions.

CHAIRMAN BROWN: All right. On to exhibits. 149 through 162 are listed as Dr. Dismukes' exhibits. Would you like those --

MS. CHRISTENSEN: Yes, we would ask to have those moved into the record please.

CHAIRMAN BROWN: Any objection?

MS. MARCAIDA: No objection.

CHAIRMAN BROWN: Seeing none, we will move in 149 to 162 into the record.

(Whereupon, Exhibit Nos. 149 to 162 were received into evidence.)

CHAIRMAN BROWN: Staff, you have 712.

MS. HARPER: Yes, we would like to move that into the record.

CHAIRMAN BROWN: Objections?

Seeing none --

MS. CHRISTENSEN: Well, I do. And this -- this is the reasoning. It's -- it's not that I object.

CHAIRMAN BROWN: Because it's a portion.

MS. CHRISTENSEN: It's incomplete.

MS. HARPER: Then we could move -- we would ask to move the enter DED-1 into the record as the alternative.

CHAIRMAN BROWN: Is that acceptable?

MS. CHRISTENSEN: The entirety of the workpapers related to DED-1?

MS. HARPER: To DED-1, yes.

CHAIRMAN BROWN: Is that acceptable?

MS. CHRISTENSEN: I think if we put in the entire workpapers and the Excel file related to DED-1, that would be acceptable.

CHAIRMAN BROWN: Any objection to that?

MS. HARPER: No. Thank you.

CHAIRMAN BROWN: Any objection?

Okay. We will move 712 with the entire

workpapers, which staff will provide to the clerk, into the record.

(Whereupon, Exhibit No. 712 was received into evidence.)

CHAIRMAN BROWN: Are we ready to move 711 in? I just saw a hand from the back, from Public Counsel.

MS. CHRISTENSEN: Oh, no. No. With that -- with that understanding -- I have -- I am okay with the entirety being moved in.

CHAIRMAN BROWN: It's already been moved in.

MS. HARPER: We have a -- yeah, and we have a copy, Madam Chair.

CHAIRMAN BROWN: Please provide.

MS. HARPER: Okay.

CHAIRMAN BROWN: Thank you.

Would you like this witness to be excused?

MS. CHRISTENSEN: Yes, I would ask that he be excused from the hearing. Thank you.

CHAIRMAN BROWN: Have a great, safe travels back to Louisiana.

THE WITNESS: Thank you.

(Witness excused.)

MR. LAVIA: Madam Chair, just a point of clarification, was Mr. Dismukes' errata sheet moved into the record?

CHAIRMAN BROWN: Was that identified as a separate exhibit?

MS. CHRISTENSEN: I don't know that we did, but we can go ahead for clarity of the record and mark it as 713. And I would ask to have it moved into the record, please.

CHAIRMAN BROWN: Hold on. We are getting a little -- getting a little sloppy here. I missed something, OPC.

So we are going to label, mark, 713 Dr. Dismukes' errata sheet at this time.

(Whereupon, Exhibit No. 713 was marked for identification.)

CHAIRMAN BROWN: I would like all the parties to know, if you would like the errata sheet moved into the record separately as an exhibit, please make -- make sure it's now at the beginning of the testimony so we can mark it accordingly.

Are there any objections to 713 the errata sheet? Okay. We are going to move that into the record at this time.

(Whereupon, Exhibit No. 713 was received into evidence.)

MR. SAYLER: Madam Chair, Erik with Office of

Public Counsel. Exhibit 711, the errata Dr. Woolridge's testimony is being passed out right now.

CHAIRMAN BROWN: Okay.

MR. SAYLER: And we would move it into the record, but I don't know if the parties have had a chance to look at it.

CHAIRMAN BROWN: Have the parties had a chance to look at Dr. Woolridge's errata sheet at this time? And if they -- if so, do you have any objections to us moving it into the record at this time?

MR. MOYLE: No objection.

CHAIRMAN BROWN: No objection.

FPL? You just got it. You want to wait?

MR. BUTLER: I don't think so. I am trying to figure out what the changes are that are being referenced.

MR. SAYLER: I can explain those, if that would be helpful.

CHAIRMAN BROWN: No. Let -- let's just move on to Shultz at this time.

Shultz -- hi.

THE WITNESS: Hello.

CHAIRMAN BROWN: How are you?

THE WITNESS: I am fine.
MR. BUTLER: Madam Chair?
CHAIRMAN BROWN: Yes.
MR. BUTLER: While we are making the transition, if I may, I can pass out the redlined versions of Mr. Allis' revised testimony.
CHAIRMAN BROWN: Let's do that. Why don't we take about a couple-minute break, five-minute break.
MR. REHWINKEL: Madam Chairman, while we're all heading to the break, I just wanted to inform the Commission, I am looking, and it looks like Mr. Smith's flight is running 20 minutes late. I just wanted to keep you posted on that.
CHAIRMAN BROWN: Okay. Five-minute break.
(Brief recess.)
MR. BUTLER: Madam Chair.
CHAIRMAN BROWN: Yes.
MR. BUTLER: While we are all taking our seats, may I real quickly tell people you what you have and what I handed out? It might --
CHAIRMAN BROWN: Sure.
MR. BUTLER: -- shorten the questions on it later. During the break, I handed out -- there is two separate clipped-together documents here, which

are the redlined version of Mr. Allis' rebuttal testimony as revised, removed references to Mr. Pous as well as Exhibit NW-83 to his rebuttal testimony, same -- same revisions to it.

These were prepared using kind of standard comparison software. And it works really well except on exhibits where sometimes it's kind of confusing whether the exhibit is in or out.

If there is a line down the left-hand side of the page, it's out; if there isn't, it's in. If anybody has any questions, certainly feel free to ask me and I will walk them through it.

I think it, otherwise, should be pretty clear -- you know, standard underlined for additions and strike-throughs for deletions.

CHAIRMAN BROWN: Would you like that marked at this time?

MR. BUTLER: If you would like, it's fine. I handed it out more as a courtesy copy. We're filing and serving the sort of the clean copy, the un-redlined version of his testimony. But if you would like to mark this so we can have it in the record for clarity, certainly fine with me.

CHAIRMAN BROWN: Okay. Let's do that. We are going to mark it as 714.

(Whereupon, Exhibit No. 714 was marked for identification.)

MR. BUTLER: And that would be both composite of his testimony and the separate stack of the NW-83 exhibit?

CHAIRMAN BROWN: Okay. So what would you like to call it?

MR. BUTLER: Redlined version of Allis rebuttal testimony.

CHAIRMAN BROWN: Okay. All right. So we marked it as such as Exhibit 714. Okay.

Any other housekeeping items before we get to Mr. Shultz?

MR. MOYLE: Can I just ask one question about it? I appreciate you making it a part of the record.

CHAIRMAN BROWN: Sure.

MR. MOYLE: It's two documents, but the second document obviously ties to the first; is that right?

MR. BUTLER: That's right. The first, the bigger one, is actually his question-and-answer narrative testimony; the second, the thinner one, is, Exhibit NWA-3 that is attached to the narrative testimony.

CHAIRMAN BROWN: Okay. Any of other housekeeping items? All right.

Welcome, Mr. Shultz. Have you been sworn in?

THE WITNESS: Yes, I have.

CHAIRMAN BROWN: Okay. Mr. Rehwinkle.

MR. REHWINKEL: Thank you, Madam Chairman. And Citizens call Helmuth Shultz to the stand.

CHAIRMAN BROWN: Could you put your mic on? You are a little soft.

MR. REHWINKEL: Okay. Thank you, Madam Chairman.

EXAMINATION

BY MR. REHWINKEL:

Q Mr. Shultz, have you prepared two sets of direct testimony for filing in this consolidated docket?

A Yes, I did.

Q On June 17, 2016, did you file or cause to be filed 11 pages of prefiled testimony in the -- what's known as the storm-hardening docket?

A Yes, I did.

Q If I asked you the questions contained in your prefiled direct testimony today, would your answers be the -- let me step back and ask you: Do you have any recollections or changes to make to that testimony?

A No, sir.

Q If I ask you this -- the questions contained in your prefiled direct testimony, would your answers be the same?

A Yes, sir.

MR. REHWINKEL: Okay. Madam Chairman, Mr. Shultz has an exhibit attached to his testimony, but it is identical to his -- it's named HWS-1 and is identical to his HWS-1 that I'm about to introduce. So I will not introduce that one you. And it is not listed in the exhibit list.

BY MR. REHWINKEL:

Q Mr. Shultz, did you also, on July 7, 2016, cause to be filed some 45 pages of prefiled direct testimony in the rate-case portion of this docket?

A Yes, sir.

Q Did you also cause to be provided or filed an errata to the testimony and exhibits in your rate-case testimony?

A Yes, sir.

MR. REHWINKEL: Madam Chairman, I have passed out an exhibit that is the errata to direct testimony of Helmuth Shultz and Exhibits HWS-2 HWS-3, 4, 5 and 9.

CHAIRMAN BROWN: Yes.

MR. REHWINKEL: And I would ask that they be given a number.

CHAIRMAN BROWN: 715. And we will mark it as errata to Mr. Shultz's --

MR. REHWINKEL: Okay.

CHAIRMAN BROWN: -- testimony.

(Whereupon, Exhibit No. 715 was marked for identification.)

BY MR. REHWINKEL:

Q Mr. Shultz, could you first explain the basis for the changes to your testimony and exhibits?

A The -- my original testimony had some -- basically what would be classified as estimates for the O&M expense factor and lacked a little bit of precise detail. And that was pointed out by Ms. Slattery in her rebuttal testimony.

And the -- the adjustments for the most part are adjustments to reflect errors in my direct that she had pointed out in addition to having the information from a deposition exhibit of hers and responses that I did not have fully available when I prepared the testimony.

In addition, there was the adjustment to reflect the impact of the removal of Jack Pous' testimony.

Q Okay. Thank you.

In your errata, you have some changes to your testimony, itself; is that correct?

A That's correct.

Q Okay. With those changes, and if I asked you the questions that are contained in your testimony, would your answers be the same?

A Yes, they would.

MR. REHWINKEL: Madam Chairman, I would ask that the direct testimonies of Mr. Shultz be admitted into the record as though read.

CHAIRMAN BROWN: We will insert Mr. Shultz's June 17th and July 7th prefiled testimony into the record as though read.

(Prefiled direct examination inserted into the record as though read.)

DIRECT TESTIMONY

OF

Helmuth Schultz III

On Behalf of the Office of Public Counsel

Before the

Florida Public Service Commission

Docket Nos. 160021-EI, 160061-EI, 160062-EI & 160088-EI

I. STATEMENT OF QUALIFICATIONS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Helmuth W. Schultz III. My business address is 15728 Farmington Road, Livonia, Michigan 48154.

Q. BY WHOM ARE YOU EMPLOYED?

A. I am a Senior Regulatory Analyst with Larkin & Associates, P.L.L.C.

Q. PLEASE DESCRIBE THE FIRM LARKIN & ASSOCITES, P.L.L.C.

A. Larkin & Associates, P.L.L.C., performs independent regulatory consulting primarily for public service/utility commission staffs and consumer interest groups (public counsels, public advocates, consumer counsels, attorney generals, etc.). Larkin & Associates, P.L.L.C., has extensive experience in the utility regulatory field as expert witnesses in over 600 regulatory proceedings, including water and sewer, gas, electric and telephone utilities.

Q. **HAVE YOU PREPARED AN EXHIBIT WHICH DESCRIBES YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE?**

A. Yes. Attached as Exhibit No.__(HWS-1), is a summary of my background, experience and qualifications.

Q. **BY WHOM WERE YOU RETAINED, AND WHAT IS THE PURPOSE OF YOUR TESTIMONY?**

A. Larkin & Associates, P.L.L.C., was retained by the Florida Office of Public Counsel ("OPC") to review the rate increase requested by Florida Power & Light Company (the "Company" or "FPL"), including interrelated dockets. In electric utility rate cases, one of the areas that I have focused on in Florida and elsewhere has been a holistic analysis of utility storm hardening and vegetation management activities, as well as the methods and prudency of cost incurrence and recovery for these activities. This was one of the areas of focus the OPC specifically asked me to look at when I was retained. Accordingly, I am appearing on behalf of the Citizens of Florida ("Citizens") who are customers of FPL.

II. BACKGROUND

Q. **WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?**

A. The Company is requesting approval of its 2016-2018 Storm Hardening Plan ("Plan"), which was initially filed in Docket No. 160061-EI, but has since been consolidated with the general rate case in Docket No. 160021-EI. Given the limited time to do so, my testimony is addressing the Company's request for approval of the Plan, and the interrelationship of the Plan and the base rate costs associated with that Plan.

III. STORM HARDENING PLAN

Q. WOULD YOU ORDINARILY LOOK AT THE STORM HARDENING PLAN AND THE ASSOCIATED BASE RATE COSTS ON A SEPARATE BASIS?

A. No. I believe that the storm hardening activities should be analyzed along with the base rate costs that they generate. The Commission should make determinations about the efficiency of the proposed activities and evaluate the results they expect to achieve: (1) to ensure that customers are receiving the appropriate value; and (2) to further ensure that costs are being incurred in a prudent way and appropriately spread over the correct timeframes.

Q: WHY IS IT NECESSARY TO HIGHLIGHT THE INTERRELATEDNESS OF THE COMPANY'S REQUEST FOR APPROVAL OF A PLAN AND THE BASE RATE COSTS ASSOCIATED WITH THE PLAN?

A. This docket has been consolidated with FPL's base rate increase docket because FPL is requesting base rate increases in certain costs to implement its storm hardening plans. For example, in Docket No. 160021-EI, FPL witness Robert Barrett Jr. refers to the filing in this storm hardening docket, Docket No. 160061-EI, as being having been contemporaneously filed. That strongly suggests that FPL anticipated the issues related to the Plan and its costs would be considered simultaneously. Since FPL filed testimony in both dockets and there are strong links between the Plan issues and the related Plan rate case cost issues, this necessitates that responsive intervenor testimony be filed in both dockets and should be considered in an integrated fashion. This is especially so because I believe that the Company testimony in this docket (Docket No. 160061-EI) does not fully address all of the related storm hardening issues. This deficiency dictates integration of the issues rather than bifurcation. Further, because the Plan and its base rate costs are so interrelated, it is hard to prepare separate testimony addressing only the Plan without necessarily analyzing the Plan's costs. Because Plan issues and Plan cost issues in the rate case are so interrelated, I may need to address the Plan again in my testimony on Plan related costs in the rate case.

Q. WHAT RELATED STORM HARDENING ISSUES ARE NOT DIRECTLY ADDRESSED IN THIS STORM HARDENING DOCKET BY COMPANY TESTIMONY?

A. The testimony for the Storm Hardening Plan, Docket No. 160061-EI, does not address vegetation management or pole inspections. However, if you refer to FPL witness Manuel Miranda's testimony in the rate case, Docket No. 160021-EI, his discussion covers the Plan in more depth and the directly related areas of hardening that includes vegetation management and pole inspections.[1] This presentation of evidence by FPL makes it very difficult to tease out only storm hardening issues from the rate case issues and address them in an isolated way in this docket.

Q. ARE YOU CONCERNED THAT A DECISION TO APPROVE THE PLAN IN DOCKET NO. 160061-EI COULD RESULT IN AUTOMATIC ASSUMPTION THAT THE COSTS ASSOCIATED WITH THE PLAN WILL BE ALLOWED AS PART OF DOCKET NO. 160021-EI?

A. Yes. My concern will decrease some, so long as the Storm Hardening Plan issues remain open to revision based on the votes on the related rate base cost issues since the voting on all the consolidated issues will be done on the same day. However, I am

[1]Testimony of Manuel Miranda at pages 9-23 in Docket No. 160021-EI.

concerned that by treating the dockets as if they are not deeply interrelated, the sequence of consideration on the date of voting alone could create an unreasonable presumption that the costs that follow the Plan must be approved without consideration of the prudence of the levels of the activities or the way those costs are incurred. The Company filed its testimony contemporaneously because the two requests are essentially directly related. In Docket No. 160061-EI, FPL witness Miranda does not address costs at all in his testimony on storm hardening. In the rate case, Docket No. 160021-EI, witness Miranda testifies about "storm hardening the infrastructure."[2] In Docket No. 160021-EI, Company witness Barrett testified that the "storm hardening investment program represents about $175 million of the revenue requirement increase in 2017."[3] However, witness Barrett's testimony is not filed in the Storm Hardening docket. Thus, absent the simultaneous consideration of all Storm Hardening related issues, it is unclear how witness Barrett's testimony can be addressed alongside the consideration of the activities that it purports to quantify. Notably, witness Miranda's testimony in Docket No. 160061-EI is very similar and in some cases exactly the same as the rate case testimony in Docket No. 160021-EI which the Company is relying on as support for the Company's rate request dollars.

Q. WHAT DOLLARS ARE REFLECTED IN THE COMPANY'S BASE RATE REQUEST?

A. In the rate case, Docket No. 160021-EI, the Company asserts that it will invest $1.7 billion for storm hardening from 2014 to 2017 and they are seeking approval of the recovery of these costs from customers. In my overall comprehensive look at the storm

[2] Testimony of Manuel Miranda at pages 8-16 in Docket No. 160021-EI.
[3] Testimony of Robert Barret Jr. at pages 30-31 in Docket No. 160021-EI.

hardening plan, the associated costs, methods of cost incurrence, and the prudence of these activities, I have identified (and am continuing to identify through discovery and analysis) issues with the request with respect to consistency, the level of spending over the previous plan period, and the current plan period.

Q. HAVE YOU IDENTIFIED SOME ISSUES RELATED TO THE STORM HARDENING PLAN AND THE RELATED BASE RATE COSTS?

A. Yes. First and foremost, I am concerned about the significant increase in storm hardening costs in the year when new base rates are to go into effect. As part of the investment in storm hardening, the Company is proposing to spend $604 million in 2017, the first year of its rate request. This is important because the currently approved Plan is for 2013-2015 and the requested Plan is for 2016-2018. The $1.7 billion investment referenced by FPL witness Barrett is an overlap of these two plan periods. Based on the Company response to OPC's Fourth Set of Interrogatories, Interrogatory No. 111, the 2017 requested spending is $604 million, an increase of $133 million over the 2016 projected spending of $471 million, and $307 million more than what was actually expended in 2015. The projected level of spending causes concern because of the Company's confident, self-assessment of the system today and given FPL's historic level of spending. The significant increase in a year when rates are to go into effect should concern the Commission and all parties affected by the rate request.

Q. WHAT DID YOU MEAN WHEN YOU STATED THERE IS CONCERN GIVEN THE COMPANY'S CONFIDENT, SELF-ASSESSMENT OF THE SYSTEM TODAY?

A. Company witness Miranda states in his testimony that FPL is one of the most storm-resilient and reliable systems in the nation.[4] He further states how FPL was recognized by U.S. Energy Secretary Ernest Moniz for its system hardening.[5] This suggests that FPL does not actually need all of its $604 million request, and that the lower historic level of spending has already made FPL's one of the most storm-resilient and reliable systems in the nation.

Q. ARE YOU CONCERNED THAT THE COMPANY PLAN IS EXCESSIVE AND NOT NECESSARY?

A. Yes. While a storm hardening plan is necessary, I am concerned with the excessive level of spending and the timing of when the spending occurs. Additionally, as stated earlier, I am concerned that by separately addressing the Plan in this docket and the base rate costs in Docket No. 160021-EI at different times, that any possible approval of the Storm Hardening Plan could be construed as approval of the proposed spending that is reflected in the base rate request in Docket No. 160021-EI. The Company's achievement to date is commendable and the continued effort to harden the system is encouraged. However, hardening should not be accomplished with a blank-check approach where the costs are automatically allowed because the Plan was considered wholly apart from the base rate costs issues that are being addressed in the rate case.

Q. OTHER THAN THE SIGNIFICANT INCREASE IN SPENDING IN THE RATE EFFECTIVE YEAR, HAVE YOU IDENTIFIED ANY OTHER CONCERNS?

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[4]Testimony of Manuel Miranda at pages 3, lines 3-4 in Docket No. 160061-EI.
[5]Testimony of Manuel Miranda at pages 4, lines 5-13 in Docket No. 160061-EI.

A. Yes. There are some inconsistencies between the proposed Plan, FPL's testimony, and FPL's discovery responses that need clarification. For example, the response to OPC's Fourth Set of Interrogatories, Interrogatory No. 111 indicates a total storm hardening cost of $604 million for 2017. Exhibit MBM-1 in Docket No. 160061-EI, at page 6, indicates lateral hardening costs of $490 million for 2017. Also, FPL's response to OPC Fourth Set of Interrogatories, Interrogatory No. 113 indicates that distribution feeder hardening costs will also be $487 million in 2017. There is clearly a disconnect in the 2017 total amount, because $490 million for lateral hardening plus $487 million for feeder hardening exceeds the total storm hardening costs that FPL projects for 2017. Given how the Company has distinguished between laterals and feeders[6] in witness Miranda's rate case testimony and the fact that there are other 2017 hardening costs, it must be rectified how the 2017 storm hardening costs can total $604 million as identified in response to OPC Interrogatory No. 111 in Docket No. 160021-EI.

Another example of inconsistency is the 2018 end results of feeder hardening. FPL's response to OPC's Interrogatory No. 113 in Docket No. 160021-EI indicates that the cumulative feeders hardened by the end of 2018 will be at 46%. FPL Exhibit MBM-1 in Docket No. 160061-EI, at page 5, states that after 2018, 40% of the feeder system will need to be addressed. This is an inconsistency that needs to be addressed between the information provided in these dockets. According to the response to Interrogatory No. 113, since 46% of feeders will be completed, 54% will need to be completed after 2018, however, this is different from the 40% to be completed as stated in Exhibit MBM-1.

[6]Testimony of Manuel Miranda at pages 14 (Feeders) and page 15 (laterals) in Docket No. 160021-EI.

Further, there are base rate cost impacts of the Storm Hardening Plan related to vegetation management and pole inspections that are not addressed in FPL's testimony in this docket, Docket No. 160061-EI. This lack of testimony appears to be inconsistent with FPL's response to OPC's Eleventh Set of Interrogatories, Interrogatory No. 259 which references how vegetation management was realigned with on-going hardening activities.

Another concern is that the Company's filing has indicated a reduction in pole inspection costs due, in part, to an expected reduction in failures, yet the cost for hardening is more than doubling. Materials and supply inventory is another cost category in the rate case filing impacted by storm hardening. In response to OPC's Eleventh Set of Interrogatories, Interrogatory No. 264, the Company has indicated the increase in materials and supplies was due, in part, to the acceleration of the transmission and distribution storm hardening activities. This raises a concern regarding what the cost impact of the acceleration will be in the test year.

Again, the relationship between the Plan and base rate costs related to storm hardening amplifies why there is a concern with addressing the Company's requested approval of the Plan in one set of testimony and the costs of the Plan in another set of testimony in the rate case. Any decision with regard to the approval of the Plan should be deferred or remain open until decisions are made on related Plan cost issues in Docket No. 160021-EI so that all the impacts of the requested Plan can be evaluated together at one time.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes, it does at this time. However, given the separate testimony filing dates for this docket, Docket No. 160061-EI, and the rate case docket, Docket No. 160021-EI, I reserve the right to supplement my testimony. I am still in the process of reviewing additional information and discovery responses recently received, and there are still outstanding discovery requests that specifically address differences identified between testimony, the Plan, and responses.

ERRATA SHEET

WITNESS: HELMUTH SCHULTZ III – DIRECT TESTIMONY AND EXHIBITS

Testimony Errata

PAGE #	LINE #	CHANGE
8	21	Change $17.743 to $15.899
8	21	Change $17.166 to $15.381
10	15	Change $28.216 to $35.616
10	15	Change $27.298 to $34.458
12	1	Change $34.407 to $33.336
12	1	Change $47.627 to $46.556
24	20	Change $60.807 to $79.130
24	21	Change $24.323 to $35.616
24	23	Change $36.484 to $47.478
25	1	Change $36.484 to $47.478
25	3	Change $42.565 to $55.391
25	3	Change $24.323 to $35.616
25	4	Change $18.242 to $23.739
25	6	Change 66.29% to 64.30%
25	6	Change "'s response to Staff Interrogatory 21" to "witness_Slattery's rebuttal testimony"
25	7	Change $28.216 to $35.616
25	7	Change $27.298 to $34.458
26	8	Change $2.681 to $2.395
26	8	Change $2.595 to $2.319
26	17	Change $2.681 to $2.395
26	17	Change $2.595 to $2.319
27	5	Change $1.152 to $1.032
27	5	Change $1.136 to $1.018

27	8	Change $1.775 to $2.240
27	8	Change $1.751 to $2.210
27	15	Change $17.743 to $15.899
27	16	Change $1.152 to $1.032
27	16	Change $1.136 to $1.018
25	20	Change $28.216 to $35.616
27	21	Change $1.775 to $2.240
27	21	Change $1.751 to $2.210
37	22	Change "a blended rate as recommended by Citizen's Witness Pous" to "the Company's blended depreciation rate"
37	22	Change $856,000 to $950,000
37	23	Change $1,231,000 to $1,365,000
38	2	Change $428,000 to $475,000
37	23	Change $615,000 to $683,000

Exhibits Errata

SCHEDULE	**LINE #**	**CHANGE**
HWS-2, Page 1	Header	Add: "Revised 8/26/16"
	11	Change 66.29% to 59.40%; and "Testimony" to "(d)"
	12	Change (17,743) to (15,899)
	14	Change (17,166) to (15,381)
	Source	Add: "(d) Slattery Rebuttal, page 9."

DIRECT TESTIMONY

OF

Helmuth Schultz III

On Behalf of the Office of Public Counsel

Before the

Florida Public Service Commission

Docket No. 160021-EI, et al (consolidated)

I. STATEMENT OF QUALIFICATIONS

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Helmuth W. Schultz III. My business address is 15728 Farmington Road, Livonia, Michigan 48154.

Q. BY WHOM ARE YOU EMPLOYED?

A. I am a Senior Regulatory Analyst with Larkin & Associates, P.L.L.C.

Q. PLEASE DESCRIBE THE FIRM LARKIN & ASSOCIATES, P.L.L.C.

A. Larkin & Associates, P.L.L.C., performs independent regulatory consulting primarily for public service/utility commission staffs and consumer interest groups (public counsels, public advocates, consumer counsels, attorney generals, etc.). Larkin & Associates, P.L.L.C., has extensive experience in the utility regulatory field as expert witnesses in over 600 regulatory proceedings, including water and sewer, gas, electric and telephone utilities.

Q. HAVE YOU PREPARED AN EXHIBIT WHICH DESCRIBES YOUR EDUCATIONAL BACKGROUND AND PROFESSIONAL EXPERIENCE?

A. Yes. Attached as Exhibit No.__(HWS-1), is a summary of my background, experience and qualifications.

Q. BY WHOM WERE YOU RETAINED, AND WHAT IS THE PURPOSE OF YOUR TESTIMONY?

A. Larkin & Associates, P.L.L.C., was retained by the Florida Office of Public Counsel ("OPC") to review certain components of the rate increase requested by Florida Power & Light Company (the "Company" or "FPL"). Accordingly, I am appearing on behalf of the citizens of Florida ("Citizens") who are customers of FPL.

II. BACKGROUND

Q. PLEASE BRIEFLY DESCRIBE THE ISSUES YOU WILL BE ADDRESSING IN THIS PROCEEDING.

A. I am addressing the appropriateness of the Company's proposed recovery of costs related to payroll, incentive compensation, benefits other than pensions and post-retirement benefits ("OPEB"), payroll taxes, tree trimming, pole inspections and Directors and Officers Liability ("DOL") Insurance premiums. I will also be addressing the level of the depreciation reserve surplus available in 2017 based on recommendations regarding cost estimates to be utilized in 2015 and 2016 that are considered excessive. I am also addressing the rate base impact from the change in the depreciation reserve surplus. Finally, I will address the Company's request regarding the continuation of the automatic storm recovery mechanism contained in the 2010 settlement agreement among parties that the Commission approved in Order No PSC-11-0089-S-EI and the 2013 settlement approved in Order No. PSC-13-0023-S-EI.

III. PAYROLL

Q. WHAT ISSUES DID YOU IDENTIFY DURING YOUR REVIEW THAT IMPACTED YOUR RECOMMENDATIONS REGARDING THE AMOUNT OF PAYROLL COST INCLUDED IN FPL'S 2017 PROJECTED TEST YEAR?

A. The Company has projected its payroll based on an increased number of employees using justification similar to its past two base rate filings. Based on what actually occurred subsequent to those filings, I determined that the Company's support for the amount of payroll included in O&M expense is insufficient.

Q. WHAT DID YOU REVIEW IN THE FILING THAT LED TO YOUR CONCERN RELATED TO THE LEVEL OF PAYROLL REQUESTED BY FPL IN THE TEST YEAR AND THE PROJECTED INCREASE IN EMPLOYEES?

A. I reviewed the Company testimony, Minimum Filing Requirement ("MFR") Schedule C-35 and responses to discovery. In my review of the testimony of FPL's witness Slattery, I noted that the witness addresses a perceived need for additional employees with similar justification to the justification offered in Docket No. 120015-EI. I became concerned that the projected employee complement would be excessive just as it has been in past rate filings. As shown on Company MFR Schedule C-35, the average number of employees for the historic years 2015 and 2014 was 8,836 and 8,847, respectively. The 2014 average of 8,847 was a decline from the average employee complement for 2013 of 9,506. This decline was reminiscent to the decline that was observed during and in the aftermath of, FPL's last rate case proceeding, Docket No. 120015-EI.

Here, in the Company's 2016 request, as shown on MFR Schedule C-35, payroll is based on an average of 9,087 employees in 2016, an average of 9,091 employees in 2017 and an average of 9,067 employees in 2018. The request for a significant increase of 255 employees from 2015 to 2017 follows the familiar path of this same issue in Docket No. 120015-EI. The similarities prompted a more in-depth review of what transpired after Docket No. 120015-EI ended with respect to employee levels to determine the reasonableness of the Company's request.

Q. DID YOU FIND THAT YOUR CONCERN WAS JUSTIFIED?

A. Yes. The Company's filing in Docket No. 120015-EI (MFR Schedule C-35), claimed that there would be an employee complement of 10,311 employees in 2012 and 10,147 employees in 2013. We now know that the actual average employee complement as shown on Exhibit No. HWS-2, Page 2, for 2013 was 9,506. That is a difference of 641 employees or a reduction of 6.32%. That is a material difference, corresponding to tens of millions of dollars in over-collected payroll costs. I then went back further and reviewed the Order PSC-10-0153-FOF-EI (page 143) in Docket No. 080677-EI, and saw the same pattern of conduct. There the Company requested 11,111 employees for the 2010 projected test year. We now know the average actual employee complement for 2010 was 10,195, a difference of 916 employees. FPL has established a pattern of conduct in which FPL requests far more employees than they really need and then reduces the employee complement or does not fill positions soon after the rate case order is final. Based on the Company's propensity to ask for significantly more employee positions than what it needs to operate efficiently, it is only appropriate to view the current request with skepticism. The Company did confirm in its response to OPC Interrogatory No. 1 in the current docket that 2017 employee positions were based on actual year-to-date 2015 figures adjusted for <u>forecasted</u> positions. As shown on Exhibit No. HWS-2, Page 2, the Company has established a pattern of not filling a significant number of its authorized positions. Specifically of concern, is the recent trend that variances between authorized and filled positions have noticeably widened. Based on the information included in the filing and the responses to discovery, it is obvious that once again the Company has significantly overstated the projected number of employees in its rate request. This overstatement will in turn again result in an excessive revenue requirement if the Commission accepts it.

Q. DID THE COMPANY ATTEMPT TO PROVIDE ANY JUSTIFICATION FOR THE INCREASE IN EMPLOYEES IN ITS REQUEST?

A. The Company provided testimony attempting to explain why they believe an increase in employees is required. In her direct testimony on pages 9-11, FPL Witness Slattery once again claims that the industry continues to face a severe shortage of skilled workers. She adds this is due to an aging workforce, skill gaps in the talent pool, and emerging technologies, with special emphasis on the nuclear employees. She further makes reference to some statistics indicating that 47% of the workforce will be eligible to retire in five years (this figure was 40% in Docket No. 120015-EI). She also suggests that the number of generation and power delivery employees eligible to retire in 5 years are slightly higher at 50%. These are the same claims that Witness Slattery provided in Docket No. 120015-EI, on the eve of FPL cutting its workforce by 6.42%.

Q. DO THE WORKFORCE DEMOGRAPHICS CONCERNS PUT FORTH BY THE COMPANY JUSTIFY INCREASING THE NUMBER OF EMPLOYEES IN THE COMPANY'S REQUEST?

A. No. As discussed earlier the Company made similar arguments in both Docket No. 080677-EI and Docket No. 120015-EI. Obviously, when exposed to the test of time, as I have shown above, these arguments fail to hold up.

Q. WHAT PRIMARY FACTOR SHOULD THE COMMISSION CONSIDER WHEN MAKING A DETERMINATION AS TO THE COMPANY'S PAYROLL REQUEST IN THIS FILING?

A. The primary factor the Commission should consider is the Company's history of making requests for an increased number of employees and the fact that in actuality the number of FPL employees has decreased every year since 2008. Also, as shown on Exhibit No. HWS-2, Page 2, when a comparison is made of FPL's number of actual employees to its authorized number, the Company has consistently shown that it does not hire at or near the level the Commission has authorized and upon which customer rates are established.

Another factor to be considered is that the Company has, when it filed its past two rate requests, consistently asked for more positions than was ultimately implicitly authorized. For example, the Company in Docket No. 080677-EI requested 11,111 employees for 2010 and 11,157 for 2011. As shown on Exhibit No. HWS-2, Page 2, the number of authorized employees for 2010 and 2011 was 10,627 and 10,250, respectively. The differences are significant (a reduction of 484 positions for2010 and a reduction of 907 positions for 2011) and would represent an excess revenue requirement of approximately $32.25 million based on the 2010 test year payroll expense. Furthermore, in Docket No. 120015-EI, the Company requested 10,147 positions for the projected 2013 test year, the actual average was 9,506 (a reduction of 641).

Q. HOW MANY OF THE REQUESTED 11,111 POSITIONS DID THE COMMISSION ALLOW IN DOCKET NO. 080677-EI?

A. The number was not specifically identified in the order. However, in Order No. PSC-10-0153-FOF-EI, the Commission referenced variance history based on actual to target. The Commission then elected to apply the 2007 variance of 2.08% in determining a disallowance to payroll expense. If one reduces the FPL requested 11,111 positions by 2.08% (or 231 positions), the result is an allowance of 10,880 positions for 2010, yet the actual 2010 average achieved was only 10,195. The Company, in essence collected from ratepayers compensation for 685 non-existent employees. Using the Commission adjustment in Docket No. 080677-EI, that would equate to an annual, excess revenue requirement of $45.6 million. In Docket No.

120015-EI, I recommended an employee complement of 9,766 for 2013. Even my estimate turned out to be overly optimistic as the actual average was 9,506. (Since that case was ultimately resolved through a contested stipulation, there is not a number specifically authorized by the Commission.) I believe it is very important that, when a decision is made in this case with respect to payroll, thc Commission should recognize what the Company has historically claimed would occur, as opposed to what actually transpired. At least for its past two rate cases, FPL testimony has not come close to hitting the mark in its filed request for purposes of establishing its actual payroll. Therefore, an adjustment reducing the projected number of employees reflected in the current rate request is essential.

Q. WHAT ADJUSTMENT ARE YOU PROPOSING TO THE COMPANY'S REQUEST?

A. As shown on Exhibit No. HWS-2, Page 1 of 2, I am conservatively recommending that the number of estimated positions in the 2017 projected test year be reduced from 9,091 to 8,835. The figure of 8,835 is the 2015 average employee complement, although the December 2015 employee count was only 8,801. I consider this adjustment to be conservative (e.g. giving the company the benefit of the doubt) based on history. This reduction in employees reduces total payroll, excluding incentive compensation, by \$26.766 million. Based on the Company's O&M allocation factor, this equates to a reduction in payroll expense of \$17.743 million (\$17.166 million jurisdictional).

Q. WHY DID YOU EXCLUDE INCENTIVE COMPENSATION FROM YOUR ADJUSTMENT?

A. Even though the Company has made an adjustment for executive incentive compensation removing at least some of the executive incentive compensation on a basis unrelated to the excessive staffing proposal, I am proposing a separate adjustment for employee incentive compensation. Including incentive compensation in the above payroll adjustment would result in an improper double counting of the dollars being adjusted.

IV. INCENTIVE COMPENSATION

Q. WHAT ANALYSIS DID YOU PERFORM TO EVALUATE THE COMPANY'S INCENTIVE COMPENSATION IN THIS CASE?

A. I analyzed FPL's testimony on this issue, relevant and available incentive plan information, the Commission's Order No. PSC-10-0153-FOF-EI from FPL's rate case in Docket No. 080677-EI, and the responses to discovery regarding payroll and incentive compensation in this current docket. In this case, FPL Witness Slattery stated on page 12 of her direct testimony that "FPL has excluded from its expense request the portions of executive and non-executive incentive compensation that were excluded by the 2010 Rate Order, Order No. PSC-10-0153-FOF." She explained that, even though FPL believes the expense is reasonable and properly recoverable in rates, this adjustment was made in an effort to narrow the items at issue in this rate case. This aspect of her testimony is essentially identical to the testimony provided in Docket No. 120015-EI.

Q. DID YOU HAVE AN ISSUE WITH THE COMPANY'S POSITION IN DOCKET NO. 120015-EI?

A. Yes. The issue was whether the Company followed Order No. PSC-10-0153-FOF-EI in Docket No. 080677-EI as it was written or as the adjustment to incentive compensation was calculated and intended to be implemented. I also had concerns with the purported goals that were incorporated in the incentive compensation process.

Q. DID THE COMPANY ADJUSTMENT TO REMOVE THE INCENTIVE COMPENSATION BASED ON THE ORDER IN DOCKET NO. 080677-EI NARROW THE ISSUES IN THIS RATE CASE?

A. Yes, but not sufficiently. To some degree, the issue was narrowed with respect to executive incentive compensation. However, a gap remains and I am recommending an adjustment be made for the employee incentive compensation. As shown on Exhibit No. HWS-3, I am recommending that the Company's 2017 O&M expense be reduced by $28.216 million ($27.298 million jurisdictional).

Q. HAVE YOU REVIEWED THE ADJUSTMENT MADE BY THE COMPANY?

A. Yes. FPL, has represented, in determining the revenue requirement for the 2017 projected test year and for the subsequent projected test year 2018, that $26.080 million and $26.644 million, respectively, were removed on a jurisdictional basis for executive incentive compensation.

Q. WHY DID YOU STATE THAT FPL "REPRESENTED" THAT AN EXECUTIVE INCENTIVE COMPENSATION ADJUSTMENT WAS MADE?

A. I am not convinced the amount identified is totally accurate. In response to OPC Interrogatory No. 139, the Company indicated the amount adjusted and stated that this adjustment was consistent with Order No. PSC-10-0153-FOF-EI in Docket No. 080677-EI. The response indicates the total Executive Incentive Compensation for 2017 and 2018 is $36.550 million and $37.112 million, respectively. In Docket No. 120015-EI, I questioned the O&M amounts represented to be the projected incentive compensation because the percentage allocated to O&M was significantly different from one year to the next. In Docket No. 120015-EI, the executive incentive compensation amounts identified for 2012 and 2013 were $55.111 million and $57.320 million, respectively. I have been analyzing rate filings for a long time and find the difference in the total amount to be significant. The Company did not provide an explanation as to how the number in this year's filing is so much lower than in the previous case. Without more explanation, the information provided by FPL would suggest that company executives took a material pay cut or that more of their compensation was shifted from incentive to base pay.

Q. IS THERE ANY OTHER INFORMATION THAT YOU REVIEWED THAT WOULD ADD TO YOUR CONCERN?

A. Yes. The response to OPC Production of Documents Request No. 3 provides the detailed work papers supporting the MFRs. The payroll detail for MFR Schedule C-35 indicates that for the projected test year 2017 the executive incentives amount is

$13.220 million and stock based compensation is $34.407 million for a total of $47.627 million. This is different from the executive incentive amount of $36.550 million as represented in the adjustment made by the Company in this case to comply with the Commission's prior order. I would also note that in the previous (2012) filing, the Company's executive incentive compensation also included what was identified as "Performance Incentive." I have not seen a reference to that in this filing, however I did observe in the Schedule C-35 detail for the MFR that in the years 2013 to 2015 there was a Performance Dollar award. I would further note that in reviewing the MFR detail for C-35 that the amount for Employee Incentives was listed as $80.282 million for 2017. The Company response to Staff Interrogatory No. 21 identifies total expensed and capitalized employee incentives to be $60.807 million. The Company did not provide an explanation for this discrepancy.

Q. IS IT POSSIBLE THAT THE INCENTIVE COMPENSATIONS PLANS HAVE CHANGED SIGNIFICANTLY FROM THOSE THAT EXISTED IN DOCKET NO. 120015-EI?

A. Based on my experience and my review of the information that was supplied, I do not believe they have changed significantly. The plan information I was able to review appears to be basically the same. The plan names and the limited documents provided in response to OPC Production of Document Request No. 7 appear to be similar, if not the same as what was provided in Docket No. 120015-EI. In fact, some of the limited plan information provided for this case is dated 2011 and 2012. The point is that the disclosed level of executive compensation is significantly less when compared to the last (2012) rate case filing and such a decline is something I have not seen before, at least to that level of significance. This is counterintuitive and should have been explained by FPL in its initial filing as it suggests that either there is executive compensation in the filing that has not been identified or that FPL executives have taken a massive pay cut which seems to run counter to FPL's position that it needs tools such as incentive compensation to attract certain qualifications in their employees.

Q. EARLIER YOU INDICATED THAT YOU SAW SOME OF THE INCENTIVE PLANS AND YOU JUST DISCUSSED SOME OF THE LIMITED PLAN INFORMATION PROVIDED. DID YOU REQUEST AND RECEIVE COPIES OF ALL THE PLAN DOCUMENTS?

A. Yes, I requested the complete plan documents; however I did not initially receive them all in my office. The Company's response to OPC Production of Document Request No. 7 provided 7 documents and indicated that another 10 documents that were considered "highly sensitive" would be made available for review at the law offices of the Radey Law Firm in Tallahassee. This response, in my experience, is highly unusual. On occasion a company has claimed confidentiality with respect to an incentive plan, yet I do not recall the plans being so *highly sensitive* that they had to be reviewed at the company's legal counsel's office. In conjunction with my review in 2012, I reviewed some, but not all, of the documents listed as highly sensitive and I did not have to travel to Florida to do an on-site review.

Q. DID YOU REVIEW ANY OF THE HIGHLY SENSITIVE DOCUMENTS IN THIS CASE?

A. Yes. OPC counsel went to the Radey Law offices and reviewed the documents and communicated to me the plan title and the basics of the plan. Some of the plans were redacted and provided for review.

Q. DID YOUR REVIEW OF THE VARIOUS HIGHLY SENSITIVE PLANS CHANGE YOUR POSITION WITH RESPECT TO THE QUALITY OF THE GOALS OR THE APPROPRIATENESS OF THE PLAN COSTS?

A. No. The information that was reviewed did not provide any support that the customer's reliability and/or safety was the primary focus of plan achievement.

Q. DID THE COMPANY ADJUST FOR NON-EXECUTIVE INCENTIVE COMPENSATION, AS PART OF ITS COMPLIANCE WITH ORDER NO. PSC-10-0153-FOF?

A. FPL, as part of what it presents as its compliance adjustment, reduced O&M expense $679,000 ($657,000 jurisdictional) in 2017 and $679,000 ($657,000 jurisdictional) in 2018, and represents that this is consistent with the Commission adjustment in Order No. PSC-10-0153-FOF. To put this in perspective, even assuming there is not an issue with what the order said and what the order did (discussed below), the adjustment for non-executive incentive compensation in Docket Nos. 086077-EI and 090130-EI (the 2008 rate case) was $5.661 million. This dramatic difference between the proposed adjustment and the 2008 rate case adjustment is counterintuitive and should have been explained by the Company in its initial filing as it suggests that there is non-executive compensation in the filing that has not been identified.

Q. IS THERE AN ISSUE WITH WHAT THE 2010 ORDER SAID AND WHAT THE ORDER DID IN DOCKET NOS. 086077-EI AND 090130-EI?

A. Yes. First, I would note that the adjustment made in the 2010 rate order from the 2008 rate case, Order No. PSC-10-0153-FOF, and the adjustment made by the Company in the current filing, after accounting for the omission (the exclusion or non-removal of the total non-executive dollars), appear to be consistent with the mechanics of the Commission's determination, with the noted exception to the level of dollars involved. As I pointed out in Docket No. 120015-EI, there is nevertheless a problem with the treatment of non-executive compensation. The problem is that, based upon my review of testimony and the Commission's prior decision, I believe there was an inadvertent oversight reflected in the Commission's 2010 order regarding what should have been included as part of the adjustment in that proceeding. The OPC witness' testimony on that issue was entitled "Non-Executive Incentive Compensation" and the questions discussed issues related to "Non-Executive Incentive Compensation"; however, the testimony dealt only with the non-executive long term incentive compensation. This was a different plan than the more costly, general non-executive type compensation plan. The Commission order also refers repeatedly to non-executive incentive compensation, which suggests the Commission was also under the impression that the OPC witness' recommended adjustment was similar to the executive incentive compensation cost adjustment recommendation that consisted of both cash-based incentives as well as stock-based incentives. Therefore, the non-executive compensation adjustment in Docket No. 080677-EI appears to have inadvertently omitted the cash-based portion of the non-executive incentive compensation when the decision was made with respect to what should have been adjusted. There was no explanation or rationale contained in the order as to why one component would be excluded from rates while the other would be included. That is why a significant difference exists in this filing when compared to the mechanics of the overall executive incentive compensation adjustment. The difference on a total Company basis in Docket No. 080677-EI amounted to approximately $52.966 million. Thus, the amount of non-executive incentive compensation at issue in this docket based on the intended adjustment in the 2010 order is, according to the response to Staff Interrogatory 21, is $60.807 million (O&M component of $40.309 million and Capital component of $20.498 million).

Q. HOW DOES ORDER NO. PSC-10-0153-FOF-EI FACTOR INTO YOUR RECOMMENDATION IN THIS CASE?

A. The Commission in Order PSC-10-0153-FOF decided that 100% of executive incentive compensation should be excluded from rates and "that 50 percent of the *non-executive incentive* compensation" should be excluded from O&M expense as "unreasonable". The justification for disallowing 50% (instead of the 100% disallowed for executives) was that the Commission was "hesitant to conclude that one hundred percent of the non-executive incentive compensation benefited only shareholders." I would concur with the Commission, provided the goals are set at a level that creates a true incentive to enhance performance. It should be noted, however, that in the Commission's Order in Docket Nos. 090079-EI, 090144-EI and 090145-EI (Progress Energy Florida's rate case – now Duke – and decided only 12 days before the FPL case) stated that 100% of all the incentive compensation (both executive and non-executive) should be disallowed. The adjustment I am proposing in the current docket is consistent with the Commission's Order in Docket No. 080677-EI as it applies to customer-related goals. The only difference between FPL's 2008 rate case and this case is that I have identified the portion of non-executive incentive compensation that was addressed and disallowed at the 50% level, but not explicitly identified in Docket No. 080677-EI. I think FPL's adjustment to remove only the non-cash portion of the non-executive incentive compensation is an erroneous implementation of the true intent of the 2010 rate order from Docket No. 080677-EI.

Q. WHEN IS ALLOWING SOME INCENTIVE COMPENSATION REASONABLE?

A. If goals are established that require improved customer service and performance as well as create cost savings as a condition of receiving payment, then justification exists for allowing a 50/50 sharing of the costs that will be incurred in achieving those stretch goals. It is important to distinguish between goals that require improvement and goals that simply allow incentive payments for performing at a level that is expected in day-to-day performance and/or a level that has previously been achieved. "Incentive" means to stimulate into action. There is no stimulation if goals are set at a level that does not require an effort to improve on past performance. For example, in the Progress

Energy Florida (PEF) rate case (Docket No. 090079-EI), I recommended full disallowance based on the fact that the plans were not designed to provide a quantifiable and/or tangible benefit to rate payers. Basically, the incentive plan was focused on paying added compensation for goals that were shareholder-oriented. As I noted earlier, the Commission agreed with my recommendation and disallowed the entire amount requested. Typically, if an employee plan is designed in a manner that would enhance performance that benefited ratepayers, I would recommend a 50/50 split. A properly designed employee incentive compensation plan will provide enhanced performance that benefits shareholders and ratepayers equally. The cost of such a plan then should be shared equally by shareholders and ratepayers.

Q. HOW DOES THAT DIFFER FROM THE EXCLUSION OF EXECUTIVE INCENTIVE COMPENSATION PLANS?

A. Executive plans are more focused on earnings. Therefore, more scrutiny has to be placed on executive compensation. Since executives are already highly compensated and the goals that are included in the executive plan are more focused on shareholder returns than customers, saddling the customers with these costs is not appropriate. In addition, the main purpose for an incentive plan for executives is to provide a means of deducting, for tax purposes, compensation that may not be deductible if paid strictly as base pay. More compensation is at issue and the bar should be set higher for any executive compensation to be included in rates.

Q. DID YOU REVIEW THE GOALS FOR THE FPL NON-EXECUTIVE INCENTIVE COMPENSATION PLAN?

A. I reviewed the goals and achievements over the past five years in an attempt to determine whether the goals are realistic and would stimulate improved performance. The information supplied on the goals and achievements in response to Staff Interrogatory No. 20 are in some cases generic, vague, very limited or otherwise inadequate. For example, the customer satisfaction goal, for residential and business components alike, for each of the five plan years was listed as "aggressive goal." That description is not very informative and does not provide any way to measure performance. With the exception of the 2015 residential component, the achievement was "beat goal." Again that identified achievement provides no measurement value. The exception for the 2015 residential satisfaction simply stated "Slightly missed goal." Measurement of satisfaction is generally based on surveys and should require that, as a level of satisfaction is achieved the applicable goal is increased the following year to a higher level. This would add an incentive for improvement. For FPL, there does not appear to be this process of "moving the goal posts" each year to incent additional improvement for the benefit of customers.

Another example of inadequate goal-setting is in the area of safety. In 2011, the Company achieved a .97 rating. This represents a ratio of recordable incidents per a set number of hours. In FPL's case, they are using 200,000 hours for measurement purposes. The lower the achieved number, the better. The goal for 2012 was set lower at .9 which creates an incentive to improve. The Company achieved that goal in 2012, and then set the next year's goal at a level that required improvement until goals were reset in 2015. The Company failed to achieve its 2014 goal and, instead of holding that goal at that level, the Company increased the allowable incident rate and made the goal easier to achieve. This suggests that, when compensation dollars are involved the Company is willing to relax the requirements to allow a better opportunity for achieving an incentive payout.

The service reliability component reflected similar results. In 2011, the Company failed to achieve the 13.4 goal for momentary interruptions with a 13.8 rating. However, instead of maintaining the goal at 13.4, the goal was relaxed to 13.9, a rating that would have been achieved if that were the goal in 2011. Here the lower the number the better for customer service. In 2012 the actual rating was 11.9 and the goal for 2013 was set at 12.3. Again the target for improvement was reduced instead of being advanced and set for improvement. It is interesting to note that in 2011 the goal for an incentive indicator labeled "Completion of base rate proceeding" was "fair outcome for customers and shareholders" and the Company indicated that the goal was achieved. To determine the payment of extra compensation to employees (a cost the Company is seeking from ratepayers) based on how the Company perceives the outcome of a base rate filing – in part for its shareholders – is not only insulting to ratepayers but also disingenuously subjective. While there is no explicit goal of this type provided in the documents I have reviewed, the mentality seems to pervade that goals are more often subjective and neither objectively established nor systematically and objectively enforced to yield customer benefits.

Finally, the Company's goals include financial metrics that if achieved are designed primarily to benefit shareholders. Reducing O&M means more income for shareholders and capital spending provides investors with more of a basis on which to earn a return. For example, budgeting $62.2 million for vegetation maintenance and only spending $58.5 million allows the Company to earn more. In my opinion, the goals, as depicted in the Company response to Staff Interrogatory 20, are limited at best. Likewise, easing the requirement, as discussed above, because a goal was not achieved does not provide an incentive for improvement. Instead, it suggests that the decision makers will do what is necessary to provide some assurance that the so-called at-risk pay is not really at risk. Based on the 2015 weighting of goals, the 40% financial metric should be assigned to shareholders and the remaining performance and so called customer goals should be split at best 50/50 between shareholders and ratepayers. The Company should be put on notice through ratemaking disallowances that, unless the goals are real goals that create an incentive to improve performance for the benefit of customers that the cost of the incentive plan(s) will be borne by shareholders.

Q. ARE YOU CONCERNED WITH THE GOALS THAT WERE NOT QUANTIFIED?

A. Yes. The determination of the success of goals is increased if the goal and the achievement are stated in numeric terms. This eliminates discretion and/or judgment as long as the goal is adhered to at the payout time. Measuring achievement without defined goals cannot be performed with precision, and the practice of not defining goals in numeric terms makes it impossible to track progress. For example, the goal of "aggressive" is subject to the evaluators' opinion as to what is aggressive and what is not.

Q. DOES YOUR RECOMMENDATION FOR SHARING THE NON-EXECUTIVE INCENTIVE COMPENSATION DIFFER FROM THE COMMISSION'S DETERMINATION IN ORDER NO. PSC-10-0153-EI-FOF?

A. No. In fact it is consistent with the determination in that order. The decision, as I read it, is focused on the sharing of benefits. The Commission stated it was hesitant to conclude that the plan benefitted only shareholders. That, in my opinion, means it was evaluating the flow of benefits when the decision was made to share the cost of non-executive incentive compensation equally. As I discussed earlier, for that sharing to take place, the evidence must establish that the goals used to determine whether payment will be made must be set at a level that creates a true incentive to perform at a higher level than previously achieved. FPL has consistently failed to set true incentive goals, which could serve as a basis for recommending a total disallowance.

Q. IS IT POSSIBLE THAT, BECAUSE SOME OR ALL OF INCENTIVE COMPENSATION IS DISALLOWED FOR RATEMAKING PURPOSES, COMPANIES WILL SIMPLY ELIMINATE THE PLAN AND INCREASE BASE PAY TO ACCOUNT FOR THE DIFFERENCE?

A. Some may say it is possible, however based on my experience I say it is improbable. In my four decades of analyzing rate cases, this has been a fairly common response by companies. I have never seen it happen. In fact, FPL Witness Slattery was asked this very question in the rebuttal phase of Docket No. 080677-EI[1]:

[1] Docket No. 080677-EI, Rebuttal Testimony & Exhibits of Kathleen Slattery; Page 21; filed August 6, 2009.

> Q. Would FPL need to reconsider restructuring its total compensation package *if any* incentive compensation expenses were excluded?
>
> A. Yes. FPL would need to consider reallocating total compensation and benefits so as to reduce performance-based compensation programs while raising base salaries and/or other traditional fixed-cost programs. This would raise costs to customers in the long run. Doing so would also negatively affect the Company's performance and impede the ability to compete in attracting and retaining the talent needed to deliver on commitments to customers. Penalizing utilities that shift from traditional fixed-cost programs to more flexible, performance-based programs would encourage inefficient program design that would negatively affect performance and harm customers.
>
> (Emphasis added)

It has been over six years since the decision in Docket No. 080677-EI, and FPL still has an incentive compensation plan.

Q. IS IT POSSIBLE THAT BY DISALLOWING COSTS RELATED TO INCENTIVE PLANS, THE COMPANY WILL SHIFT COMPENSATION TO BASE PAY?

A. I do not believe it is likely. First, I am not aware of any utility that does not have some form of incentive compensation plan. Incentive compensation is typically an issue in a proceeding. In some cases, like Docket No. 090079-EI, the entire amount has been disallowed and the Company continues to pay incentive compensation. Incentive compensation from its inception was not pay that was put at risk by shifting it from a base pay to a variable pay plan. Instead it was, in effect, just another form of compensation offered to employees, in addition to the employees' base pay.

Q. WILL THE DISALLOWANCE OF INCENTIVE COMPENSATION PUT THE COMPANY AT RISK BECAUSE ITS COMPENSATION PLAN IS NOT COMPETITIVE WITH OTHER UTILITIES?

A. No. It is a universal argument that a company measures the reasonableness of its compensation by comparing its employees' compensation with other operating entities. Companies typically argue that by disallowing the plan there is a risk that total compensation will not be competitive and they will not be able to attract and retain competent employees. In my experience, I have not observed any utility eliminate its incentive compensation plan despite having some or all of it disallowed for ratemaking purposes. Furthermore, compensation studies used by companies to justify the employee compensation are focused on total compensation. These studies may justify the total compensation paid to employees; however, to date I have not seen a study that makes a comparison of the various jurisdiction-specific allowance levels for incentive compensation as such is included in total compensation. Basically, the studies may provide some basis for paying employees, but the studies do not make any determination as to what is reasonable with regard to incentive compensation for purposes of establishing rates. Therefore, I believe this claim has no merit.

Q. HOW DID YOU DETERMINE YOUR ADJUSTMENT?

A. As shown on Exhibit No. HWS-3, I began with the $60.807 million identified by the Company as employee incentive compensation. I excluded $24.323 million or 40% of the incentive compensation that is projected to be paid out based on the financial-related goals. That resulted in $36.484 million in incentive compensation that is projected to be paid out and it is associated with alleged customer goals. That $36.484 million was allocated 50/50 for an equal sharing of the supposed customer-related goals. The $42.565 million on line 7 ($24.323 million associated with financial goals plus $18.242 million representing the shareholders' half of the customer-related goal component) thc total assigned to shareholders. To determine my adjustment, I applied the O&M allocation of 66.29% that was based on the Company's response to Staff Interrogatory 21. The result is an adjustment of $28.216 million ($27.298 million jurisdictional).

Q. IF YOU ARE CONCERNED ABOUT THE QUALITY OF THE GOALS, WHY DIDN'T YOU EXCLUDE MORE OR EVEN ALL OF THE INCENTIVE COMPENSATION?

A. I am attempting to align my adjustment as close as possible with the intent of Order No. PSC-10-0153-FOF. The financial goal adjustment is one change and, because some customer goals do exist, I am giving that some consideration as part of my overall recommendation. One <u>*limited*</u> example of a customer goal is the employee safety goal. The employee safety goal was achieved in 2012 with an OSHHA recordable of .75. The 2013 goal was then set at .73. In 2013 the .73 goal was achieved with an incident rate of .62 and the Company responded by setting the 2014 goal at .59. That is how the process should work. Unfortunately, when the Company failed to achieve the .59 goal in 2014, it went backwards and lowered the goal progress of the incentive process by easing the requirement in 2015 to .61. Based on what I have provided as evidence, the Commission could exclude all of the incentive compensation as was done in the Order in Docket Nos. 090079-EI, 090144-EI, and 090145-El.

V. EMPLOYEE BENEFITS

Q. ARE YOU MAKING ANY RECOMMENDATION WITH RESPECT TO EMPLOYEE BENEFITS?

A. Yes. I am recommending that employee benefit expense (excluding pensions and OPEB expense) be reduced by $2.681 million ($2.595 million jurisdictional). This calculation is shown on Exhibit HWS-4. My recommendation reflects the impact of my recommended payroll adjustment for the Company's excessive employee complement request.

Q. HAVE YOU MADE THE ADJUSTMENT SIMILAR TO YOUR PAYROLL ADJUSTMENT, WHERE YOU REDUCED THE BENEFITS ON A PER EMPLOYEE BASIS?

A. Yes. The adjustment for excess employees is shown on Exhibit No. HWS-4. My recommendation is a reduction to Account 926 of $2.681 million ($2.595 million on a jurisdictional basis) consistent with the benefit costs associated with the Company-projected 256 added positions that I have recommended be disallowed from the Company's projected employee complement, as discussed earlier.

VI. PAYROLL TAX EXPENSE

Q. WITH YOUR ADJUSTING PAYROLL IS THERE A FLOW THROUGH ADJUSTMENT TO PAYROLL TAX EXPENSE?

A. Yes. To the extent payroll is reduced, there is an associated reduction to payroll taxes that must be reflected. Thus, I am recommending a reduction of $1.152 million ($1.136 million jurisdictional) to payroll taxes to correspond with my payroll adjustment associated with the reduction in employees. I am also recommending a separate reduction of $1.775 million ($1.751 million jurisdictional) to payroll taxes to correspond with my adjustment to employee incentive compensation.

Q. HOW DID YOU DETERMINE YOUR PAYROLL TAX ADJUSTMENT?

A. Based on the Company's projected 2017 payroll tax dollars and payroll dollars as shown on MFR Schedule C-35, I calculated an effective payroll tax rate. The effective tax rate as calculated on Exhibit HWS-5 is 6.49%. I then applied that effective tax rate to my recommended adjustment to payroll expense of $17.743 million. The result is a payroll tax adjustment of $1.152 million ($1.136 million jurisdictional).

The second adjustment only factors in the FICA effective rate in my adjustment because the unemployment taxes would be factored into any general pay. The effective tax rate as calculated on Exhibit HWS-5 is 6.29%. I then applied that effective tax rate to my recommended adjustment to incentive compensation expense of $28.216 million. The result is a payroll tax adjustment of $1.775 million ($1.751 million jurisdictional).

VII. VEGETATION MANAGEMENT/HARDENING PLAN

Q. ARE YOU COMBINING THE DESCRIPTION OF VEGETATION MANAGEMENT WITH STORM HARDENING?

A. Yes. My identification of the vegetation management discussion is being linked with storm hardening because they are inextricably interrelated. FPL Witness Miranda in discussing the Company's storm hardening references vegetation management. When hardening of the system is being performed it encompasses not only poles and conductors, but it also includes vegetation, which is a primary cause of system damage. The Company in Docket No. 160061-EI (the Storm Docket), filed its storm hardening plan for approval contemporaneously with its base rate filing. In that filing, FPL witness Miranda attached as an Exhibit MBM-1(Storm), the FPL 2016-2018 Electric Infrastructure Storm Hardening Plan ("Plan"). Within the Plan, reference is made as to how the initiatives of storm hardening, vegetation management and pole inspections, can be reasonably expected to reduce future storm restoration costs compared to what they would be without those initiatives.

Q. PLEASE EXPLAIN HOW VEGETATION MANAGEMENT IS INTER-RELATED WITH STORM HARDENING.

A. The storm hardening that is discussed by the Company focuses on upgrading the system to be more storm-resilient. In conjunction with any effort to harden the system structurally, a utility must also address what causes damage to the system. Vegetation is a primary contributor to the damages to the utilities' transmission and distribution infrastructure that results from severe weather. In recent years, the east coast of the country has seen significant storm damage from hurricanes, tropical storms, lightning, wind (i.e. derecho type) and snow. Infrastructure can be directly impacted not only by wind and storms but it can also be indirectly impacted by broken tree limbs and falling trees. A number of utilities specifically include vegetation management as a major discussion piece of their storm hardening plan. This vegetation management plan includes cycle trimming but not the removal of danger and/or hazard trees. The classification as a "danger or hazard tree" is a term used by utilities for a purpose, that purpose is the trees are a danger and/or a hazard to the utilities infrastructure.

Q. WHAT ARE DANGER AND/OR HAZARD TREES?

A. A danger tree is a tree within and just outside the right of way that if it were to fall it could strike the line or pole within the right of way. A hazard tree is a danger tree but it is also either a diseased or damaged tree making it more susceptible to causing damage to infrastructure.

Q. WHAT DID YOU REVIEW IN DETERMINING WHETHER THE VEGETATION MAINTENANCE IS APPROPRIATE?

A. I reviewed Company storm and rate case testimony, its Plan and responses to discovery.

Q. ARE YOU RECOMMENDING AN ADJUSTMENT TO THE 2017 PROJECTED TEST YEAR AND THE PROJECTED 2018 VEGETATION MANAGEMENT/HARDENING PLAN COSTS?

A. Yes. In reviewing the Company response to OPC Interrogatory No. 10, I noted that the Company has budgeted 15,100 miles of vegetation trimming for 2017 and 2018, the same number of miles budgeted for 2015. That suggests the Company is not anticipating increasing its trimming efforts. The response also indicates that the system, as of 2015, had 36,256 miles subject to trimming. That equates to a trim cycle of 2.4 years. Another important factor noted was the level of spending from both a budgeted and historical actual basis as shown in FPL's response to OPC Interrogatory No. 9. The information is summarized on Exhibit HWS-6 and it shows that over the past three years the Company did not expend what was budgeted for tree trimming. To the Company's credit, the miles actually trimmed exceeded the miles budgeted despite spending less than what was budgeted. Therefore, based on the current trim cycle, it is not unexpected that the cost could be less than anticipated and the miles trimmed more than anticipated. My analysis shows that it is appropriate to make an adjustment to reflect the expected and normal level of vegetation management/hardening expense.

Q. WHAT ADJUSTMENT ARE YOU PROPOSING TO THE COMPANY'S "PROJECTED COSTS?"

A. As shown on Exhibit No. HWS-6, I am recommending spending of $60.953 million, a reduction of $4.647 million ($4.647 million jurisdictional) to the Company's projected 2017 spending. This adjustment was determined by multiplying FPL's 2015 budgeted spending of $63.100 million by the budget-to-actual variance of 96.6% for the years 2013 through 2015. I then subtracted the result from the amount requested.

For 2018, I used the same process to calculate my projected spending but then escalated that by 2%. This resulted in a recommended spending of $62.172 million and a reduction of $7.428 million ($7.428 million jurisdictional) to the Company's projected 2018 spending.

Q. SHOULD THE COMMISSION BE CONCERNED THAT YOUR REDUCTION COULD IMPACT THE RELIABILITY OF THE SYSTEM SINCE YOUR RECOMMENDATION IS LESS THAN WHAT WAS EXPENDED IN 2015?

A. No. The Company spending for 2015 was based on 15,244 miles of trimming. The Company is budgeting based on 15,100 miles. The average cost per mile, with the exception of 2015, has declined from year to year and rightfully so. As I discussed earlier, the Company is on an approximate 2.4-year trim cycle. The benefit of being on an accelerated cycle is that it does not require the same level of aggressive trimming previously implemented. The declining average cost per mile is evidence of that. Company Witness Miranda states that FPL's approved vegetation plan is a three-year and six-year cycle[2]. The Company is ahead of the game and even with my recommended spending should be able to continue with that success.

Another factor to consider is that spending for vegetation management can vary from year to year, depending on the condition of the planned area for trimming, contractual pricing, and the actual miles trimmed. My projected cost is based on the historical average cost variance between what the Company budgeted and what was actually spent for trimming. The currently budgeted miles are essentially the same as

[2] Testimony of Manuel Miranda at page 11, lines 5-10.

the budgeted miles for the three years in my average and in my adjustment. I used the Company's 2015 budget for the same number of miles and simply applied the actual variance. The Company projection ignores the historical variance.

VIII. POLE INSPECTIONS/HARDENING PLAN

Q. **ARE YOU RECOMMENDING A REDUCTION TO THE 2017 PROJECTED TEST YEAR POLE INSPECTION COSTS FOR THE SAME REASON THAT YOU RECOMMENDED THE VEGETATION MANAGEMENT/ HARDENING PLAN COST BE REDUCED?**

A. Yes. In my review of the Company response to OPC Interrogatory No. 13, I noted that actual pole inspections expenses were below budget during the period 2012 through 2015, and this was despite the fact that the actual number of inspections exceeded the planned number of inspections. Similar to my position on the vegetation management issue, adjustments are appropriate for 2017 and 2018 O&M expense to reflect the historical budget to actual differences.

Q. **WHAT ADJUSTMENT ARE YOU PROPOSING TO THE COMPANY'S PROJECTED POLE INSPECTION EXPENSE?**

A. As shown on Exhibit No. HWS-7, I am recommending a reduction of $1.664 million ($1.663 million jurisdictional) to FPL's projected 2017 test year expense of $5.800 million. I calculated the adjustment by multiplying the Company request of $5.800 million by the budget-to-actual variance of 71.3% for the years 2013 through 2015 and subtracting the result from the amount requested by the Company.

A similar adjustment was made to reduce the Company's requested 2018 inspection cost of $5.900 million. The 2018 adjustment is a reduction of $1.693 million ($1.692 million jurisdictional).

IX. DIRECTORS AND OFFICERS LIABILITY INSURANCE

Q. ARE YOU RECOMMENDING AN ADJUSTMENT TO THE COST OF DIRECTORS AND OFFICERS LIABILITY INSURANCE PREMIUMS?

A. Yes. Directors and Officers Liability ("DOL") insurance protects shareholders from the decisions they made when they hired the Company's Board of Directors and the Board of Directors in turn hired the officers of the Company. There is no question that DOL insurance, which FPL has elected to purchase, is primarily for the benefit of shareholders. Since shareholders are the primary beneficiary, they should be responsible for the costs associated with acquiring this coverage. The Company will inevitably argue that the cost is a necessary expense which protects ratepayers. Nevertheless, the cost of the premiums associated with acquiring DOL insurance, while considered to be a necessary business expense by many, is in reality a necessary business expense designed to protect shareholders from their past decisions. Notwithstanding that shareholders are the primary beneficiary, I am recommending that this business expense be shared equally between shareholders and rate payers.

Q. WHAT ADJUSTMENT ARE YOU RECOMMENDING?

A. As shown on Exhibit HWS-8, I am recommending an estimated reduction to Account 925 of $1.391 million ($1.369 million jurisdictional) for the projected test year 2017 and an adjustment of $1.391 million ($1.346 million jurisdictional) for the subsequent projected test year 2018.

Q. WHY ARE YOU ESTIMATING THE COST FOR THE 2017 PROJECTED TEST YEAR AND THE SUBSEQUENT PROJECTED TEST YEAR of 2018?

A. In Interrogatory No. 37, Staff requested the Company to itemize each component of insurance expense for the test year, and provide comparative information for the years 2011-2015 and 2016 year to date. This request was verbatim, the same as OPC Interrogatory 60 in Docket No. 120015-EI. In Docket No. 120015-EI, I took exception to the DOL cost identified in the response and recommended an equal sharing of the cost. According to the response to OPC Interrogatory No. 60 in Docket No. 120015-EI, FPL had included $2,781,173 of expense in account 925 for DOL insurance (DOL) in the 2013 projected test year. Conveniently, the Company in the response to Staff Interrogatory No. 37 in the current docket lumped the DOL insurance in with "Liability Insurance Other." In addition, the Company failed to provide the test year insurance amounts as requested.

Q. HOW DO YOU KNOW THE DOL INSURANCE IS INCLUDED IN THE LIABILITY OTHER –INSURANCE AMOUNT?

A. By comparing the 2011 expense in the response to OPC Interrogatory 60 in Docket No. 120015-EI to the 2011 expense in the response to Staff Interrogatory No. 37 in Docket No. 160021-EI, I found costs to be the same or very close to being the same.

Q. HAVE YOU ADDRESSED THIS ISSUE IN PREVIOUS RATE CASES IN FLORIDA?

A. Yes. This issue was addressed in the Gulf Power Company rate case Docket No. 110138-EI. In that case, the Commission determined that the cost for DOL insurance should be shared equally between shareholders and ratepayers. In the PEF case (Docket No. 090079-EI[3]), the Commission allowed PEF to place one half the cost of DOL insurance in test year expenses noting that other jurisdictions make an adjustment for DOL insurance and that the Commission has disallowed DOL insurance in wastewater cases.

Q. WHAT IF THE COMMISSION HAD NOT DISALLOWED HALF THE COST IN THE GULF AND PEF DOCKETS, WHAT WOULD YOU THEN RECOMMEND IN THIS CASE?

A. I would still be recommending to the Commission that there be either a complete disallowance or at the very least an equal sharing, because the cost associated with DOL insurance benefits shareholders first and foremost. Unlike an unregulated entity, criteria exist for recovery of costs, such as prudence and benefit. The benefit of DOL insurance is the protection shareholders receive from directors' and officers' imprudent decision making. The benefit of this insurance clearly inures primarily to shareholders; some of whom generally are the parties initiating any suit against the directors and

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[3] See, Order No. PSC-10-0131-FOF-EI, issued March 5, 2010, in Docket No. 090079-EI, In re: Petition for increase in rates by Progress Energy Florida, Inc.

officers. The Commission's decisions on this question in the Gulf Power and PEF rate case dockets were fair, and those decisions should be followed in this Docket.

X. CAPITAL STORM HARDENING

Q. ARE YOU RECOMMENDING AN ADJUSTMENT TO THE COMPANY'S CAPITAL STORM HARDENING COST?

A. Yes. As shown on my Exhibit HWS-9, I am recommending a reduction of $31.546 million to the projected test year 2017 and $45.335 million to the subsequent projected test year 2018. The Company has made significant strides in hardening the system and has expended more than planned during the years 2012 through 2015, however, I believe the projected increase in spending for 2016 through 2018 is overly optimistic.

Q. IF THE HISTORICAL SPENDING WAS TRADITIONALLY HIGHER THAN PLANNED WHY WOULD THE PLANNED SPENDING FOR 2016 THROUGH 2018 BE OVERLY OPTIMISTIC?

A. The cumulative capital spending in this area for the four years 2012 through 2015 that coincided with FPL's Stipulation and base rate freeze, totaled $1.001 billion. The proposed spending for just the two years 2016 and 2017 is projected to be $1.075 billion. That is $74 million more spending in half the time. The total spending for 2016 through 2018 of $1.943 billion is almost double the spending for the previous four years. That is significant and I do not share the Company's optimism for its capital storm spending levels.

Q. **ARE YOU AWARE OF ANY INFORMATION THAT WOULD SUPPORT YOUR SKEPTICISM?**

A. Yes. The Company's response to OPC Interrogatory No. 363 provided year to date capital expenditures through May 2016 along with forecasted 2016 and 2017 capital spending for storm hardening. The year to date May 2016 amount totaled $186 million, which when annualized totals $446 million. That $446 million is $25 million less than the 2016 forecasted capital spending of $471 million. It is also appropriate to keep in mind that with the storm season approaching that completing any makeup of the underspent amount in the second half of the year would be difficult.

Q. **HOW DID YOU DETERMINE YOUR RECOMMENDED ADJUSTMENTS FOR 2017 AND 2018?**

A. I utilized the ratio of the annualized May 2016 to the forecasted 2016, and applied that to the Company's forecasted 2017 and 2018 storm hardening capital costs. This calculation is shown on Exhibit No. HWS-9.

Q. **DOES THIS ADJUSTMENT TO THE STORM HARDENING IMPACT ANY OTHER COSTS IN THE COMPANY'S REQUEST?**

A. Yes. As shown on Exhibit No. HWS-9, I have calculated an adjustment to depreciation expense using a blended rate as recommended by Citizens Witness Pous and accordingly adjusted accumulated depreciation for the depreciation expense adjustment for the year. The adjustment to depreciation expense is a reduction of $856,000 and $1,231,000 for the years 2017 and 2018, respectively. The accumulated depreciation was one half of the annual expense to reflect an average for the year. The adjustment to accumulated depreciation is a reduction, increasing rate base, by $428,000 and $615,000 for the years 2017 and 2018, respectively.

XI. DEPRECIATION RESERVE SURPLUS

Q. ARE YOU RECOMMENDING AN ADJUSTMENT FOR THE HISTORIC DEPRECIATION RESERVE SURPLUS THAT THE COMPANY APPLIED ENTIRELY TO THE 2016 YEAR?

A. Yes, to some extent I am making a recommendation. The Company has assumed that a 2015 unamortized amount of approximately $202 million will be utilized in 2016.[4] The amount included in 2016 is an estimate based on the projected cost of service for 2016. Based on the response to OPC Interrogatory No. 274, the actual December 2015 balance is $263 million. That leaves at least $61 million unaccounted for. The issue is the same as it was in Docket No. 120015-EI where the Company estimated that the reserve surplus would be fully utilized and not available to offset expenses in the projected test year. The response to OPC Interrogatory No. 108, in this docket, shows that the January 1, 2013 surplus reserve starting balance was $400 million. The surplus did not get utilized as the Company claimed it would be. As it was in Docket No. 120015-EI, the key word here is *estimated* and the assumption was it would be fully utilized. Clearly, since there is a balance remaining as of December 2015, the Company's assumption was wrong. The circumstances are very similar today. The amount for 2016 is not known and measurable, and is subject to change based on

[4] FPL Witness Barrett at page 34, lines 2-5.

changes in facts and/or assumptions that were employed in the forecasting of rate base, revenue and expenses for 2016. To simply assume the Company is correct could result in rates being set for 2017 with no means for accounting for an inaccurate estimate in 2016.

Q. HAVE YOU REQUESTED ANY 2016 INFORMATION TO SEE IF THE COMPANY ESTIMATE MAY BE REASONABLE?

A. Yes. In response to OPC Interrogatory No. 109, the Company indicated that it flowed back (credited depreciation expense) $176.409 million of the surplus reserve through March 2016. In reviewing the historical information for 2013 through 2015, the Company flowed back approximately $100,000,000 or more in the first quarter of each year. However, by the end of the respective years, the flow back changed. In 2013 the Company flowed back $155 million, in 2014 the Company reversed that flowback and restored $33 million to the surplus reserve because earnings did not allow for a flow back. In 2015 the Company flowed back only 15 million. In my opinion, the Company has overestimated the depreciation reserve surplus amortization requirement for 2016 by overstating expenses. Based on the response to OPC Interrogatory No. 108, the Company planned a flow back of $184 million for 2013 yet it only flowed back $155 million. For 2014, the Company estimated a $16 million reversal of the flow back and it actually was $33 million. Finally, the 2015 estimate was a flow back of $81 million while the actual flow back was $15 million. Similar results occurred during the years 2010 through 2012. The use of estimates will present issues and the fact remains that the Company estimate for 2016 is not known and measurable.

Q. DIDN'T THE STIPULATION IN DOCKET NO. 120015-EI CONTEMPLATE THE COMPLETE AMORTIZATION OF THE RESERVE SURPLUS BY 2016?

A. Yes. However, the Stipulation also stated that FPL may not amortize an amount that would result in FPL achieving a return on equity greater than 11.50%. The Company achieved a return on equity of 11.50% in two of the last three years. It is probable based on those results that the Company could achieve an 11.50% return on equity in 2016. This is especially true if some of the projected costs that are being adjusted in the 2017 projected test year are also adjusted in 2016.

Q. ARE THERE SOME SPECIFIC COSTS THAT YOU BELIEVE WOULD IMPACT THE AMOUNT OF THE DEPRECIATION RESERVE SURPLUS THAT WOULD BE REQUIRED IN 2016?

A. Yes. As discussed in detail, FPL has overestimated payroll because it assumed an excessive employee complement in 2017. Similarly, there are other estimated costs such as tree trimming, pole inspections, DOL insurance and incentive compensation that are overstated, as well as employee benefits and payroll taxes.

Q. HAVE YOU CALCULATED ADJUSTMENTS TO THE 2016 PROJECTED COSTS THAT WOULD RESULT IN AN INCREASED AMOUNT OF DEPRECIATION RESERVE SURPLUS AVAILABLE TO OFFSET COSTS IN 2017?

A. No specific adjustments have been determined. However, any O&M adjustment made to the 2017 projected test year could be applied to the 2016 year since the Company

2016 amount is just a projection. That said, I do not recommend that any unused depreciation reserve surplus that was initially established in Order No. PSC-10-0153-FOF-EI, be applied as a reduction to the Company's projected 2017 cost of service.

Q. WHAT DO YOU RECOMMEND WITH RESPECT TO ANY UNUSED SURPLUS?

A. The initial order establishing the $894.6 million reserve established a four-year amortization period and that was changed by the Stipulation and Order No. PSC-13-0023-S EI. That Order stated that the amount was to be amortized by the end of 2016 unless earnings exceeded 11.50%. The appropriate return of the over collection from ratepayers has dragged on well beyond a reasonable point in time. Therefore, I recommend that any unused surplus remaining as of December 31, 2016 be refunded to ratepayers over no more than a two-year period. Additionally, I recommend that because there is $61 million more in the reserve as of January 1, 2016 than the Company estimated and given the fact that since the reserve was established the amortization over a six year period has averaged $105.267 million, the 2016 earnings and surplus requirement be the subject of a review to assure that ratepayers receive what they are entitled to. Hypothetically, with a $263 million balance at the beginning of the year and based on the historical trend, there could be over $150 million of unused surplus reserve. Given the fact that ratepayers have waited beyond the initial time frame set for the return of funds they advanced to the Company, ratepayers should be entitled to some verification of how the remaining $263 million was used or remains unused and subject to refund.

XII. STORM RECOVERY MECHANISM

Q. HAVE YOU REVIEWED THE TESTIMONY OF COMPANY WITNESS DEWHURST REGARDING STORM COST RECOVERY?

A. Yes. Company Witness Dewhurst states that, while the Company preferred the recovery method that allows for an annual accrual to provide for a storm reserve level that would accommodate most storms and still allow the Company to seek recovery of storm costs that exceed the storm reserve, however, the Company is willing to continue to recover prudently incurred storm costs under the framework prescribed by the 2010 Rate Settlement and continued by the 2012 Rate Settlement.

Q. WHAT IS YOUR RESPONSE TO THE COMPANY'S TESTIMONY?

A. The current framework prescribed by the 2010 Rate Settlement and continued by the 2012 Rate Settlement is sufficient with some exceptions. As for the previous recovery system, I am of the opinion it also would work, as long as safeguards are in place.

Q. WOULD YOU EXPLAIN WHAT EXCEPTIONS YOU HAVE WITH THE CURRENT FRAMEWORK?

A. Yes. The Order approving the stipulation states that "FPL would not be precluded from petitioning the Commission to seek recovery of costs associated with any storms."[5] That, in my opinion, could be what is referred to as a Pandora's Box. The reference to "any storm" is a concern. Storms happen and are common to all companies and to ratepayers. No one reimburses ratepayers for storm costs by means of a Commission

[5] Order No. PSC-13-0023-S-EI at page 3.

order, the ratepayers must incur a cost for insurance to protect their homes and ratepayers are responsible for costs not covered by insurance. The Company should have the recovery subject to a level that is set for major storms and not just any storm. I am aware that the OPC has agreed to similar language for all 5 investor-owned electric utilities and that the intent in the negotiated agreements is that the recovery under the provision is limited to major, named storms as defined by the National Hurricane Center. If this is the first occasion where the Commission will be adopting the provision as its own, I would recommend that the language in the final order clarify that recovery is so limited.

Q. ARE THERE OTHER CONCERNS WITH THE CURRENT STORM RECOVERY FRAMEWORK?

A. Yes. In Attachment A to the Order approving the 2012 Settlement Agreement, at page 5, it states "The Parties expressly agree that any proceeding to recover costs associated with any storm shall not be a vehicle for a "rate case" type inquiry concerning the expenses, investment, or financial results of operations of the Company and shall not apply <u>any</u> form of earnings test or measure or consider previous or current base rate earnings or level of theoretical depreciation reserve."[6] The word "any" concerns me. I understand that the intent is that "rate case" type inquiries were intended to preclude earnings based limitations on full recovery of costs and reserve replenishment. Likewise the parties would be precluded from suggesting other cost savings (unrelated to the storm damage) offsets to limit full recovery. The intent was not and should not

[6] Order No. PSC-13-0023-S-EI, Attachment A at page 5, subpart (c).

be memorialized by the language in the proposal to limit legitimate inquiry into the reasonableness and prudence of the costs that the company claims to have incurred in storm damage repair and restoration activities. By itself, the plain wording of the proposal suggests the Company has a blank check and what FPL says is storm related gets classified as such without any questions asked. I urge the Commission to ensure that the going-forward understanding is that a full opportunity to test and challenge costs will be provided in the time that is needed since the company will be allowed to receive expedited interim recovery of costs.

Q. WHAT SAFEGUARDS SHOULD EXIST IF THE COMPANY WERE TO RETURN THE PREVIOUS RECOVERY SYSTEM?

A. If annual accrual is to be used, those accruals should be based on historical information specific to the Company. Some of the storm analysis done for the companies, in the past used a model that evaluates storms over a set period of time and included a very wide geographic area. Factoring in a geographic area that is outside of the company's specific customer service area is not appropriate. Factoring in hurricanes that did not impact the company's service territory is not appropriate. Also a major consideration is the Company's intensive storm hardening program. This should be factored in because ratepayers have paid for this hardening and not factoring the hardening in would be like paying for insurance to mitigate storm costs but not being able to collect on it. Another major factor that should be factored in is establishing a threshold for what is a major storm and that threshold should be the shareholders responsibility. If a change were to be implemented these are suggestions that should be considered, I would also suggest that all parties be involved in a dialogue that would make sure that when the unforeseen storms that have a major impact do occur that shareholders and ratepayers receive a fair consideration as to what costs should be borne by whom. Ratepayers should not be the sole source of funding for storm costs, as shareholders are aware that there is a risk in making an investment and unlike non-regulated companies utility shareholders have been compensated for that risk in the established return on equity.

Q. DOES THAT CONCLUDE YOUR TESTIMONY?

A. Yes it does.

BY MR. REHWINKEL:

Q Mr. Shultz, did you also cause to be prepared nine exhibits entitled HWS-1 through HWS-9?

A Yes, sir.

Q Okay. And with the corrections shown on your errata that are listed in Exhibit 715, is that -- are those exhibits true and correct?

A Yes, sir.

MR. REHWINKEL: Okay. Madam Chairman, these exhibit have been given the numbers 180 through 188 --

CHAIRMAN BROWN: So noted.

MR. REHWINKEL: -- for identification.

BY MR. REHWINKEL:

Q Mr. Smith -- Mr. Shultz, do you have a summary of your testimony to give?

A Yes, I do.

Q Could you give that now.

A Good afternoon, Commission. One of the issues that I have identified in my testimony is the company's request for 9,091 employees in 2017. This represents an increase of 256 positions over the historic 2015 test year.

As discussed in my testimony, this is reminiscent of the company's previous two rate filings where the company claimed a shortage of skilled workers, and that they would be required to add employees. Yet, subsequent to each of the past two rate filings, the company, instead of increasing the employee -- employee complement, decreased the number of employees.

The Commission has in front of it to make a decision: Is the company going to continue on with the past of what they have done or will they actually fulfill -- fill those positions.

History speaks volumes, I believe. In my experience, I have found that to be something to rely on. And I am recommending the company's request to add the 256 positions be rejected.

Incentive compensation is also a major factor in this case. Incentive compensation is supposed to be pay for performance. The company, in its filing, has removed almost 100 percent of the equity incentive compensation of executives and a portion of the nonexecutive equity compensation.

This is purportedly based on the decision in Docket 080677-EI, which, on my review, was intended to remove both 50 percent of the equity portion and the nonexecutive incentive compensation.

Regardless of whether my opinion is right or wrong, the allowance in rates for nonexecutive compensation should be based on the merits of the plan. This means that the plan should be properly designed and should reflect improvements in performance.

With the design, it must be determined whether the goals are established to determine the level of payment, are truly goals that create an incentive to perform at a high level, a level that is beyond what is expected to the day-to-day performance of the job and a level that's been previously achieved.

The information supplied in the response to Staff Interrogatory 20 suggests that the goals over the past five years do not truly provide for an incentive to improve, but instead are to assure achievement and payment of nonexecutive incentive pay.

The goals also include financial goals, which are generally viewed as shareholder goals. And the cost of achieving those goals should be borne by shareholders. If the customer goals are real, then the cost of nonexecutive compensation for those goals should be shared.

To justify the compensation, the company has suggested to you you have to consider whether the total compensation is competitive. A reference is made to comp- -- compensation studies and the results. The fact of the matter is the compensation studies do not make an apples-to-apples comparison of what you're deciding, as the compensation is the compensation that's going to be included in rates. And there are no studies that make a comparison of compensation included in rates.

Based on my experience, I believe the company has done an impressive job with its vegetation management and storm hardening. That said, though, I do not believe the company's performance justifies allowing a blank-check approach for future spending.

Based on the information supplied, it is effectively trimming on a 2.4-year trim cycle. The company plan trimming is equivalent to the historic 2015 and similar to 2013 and '14. Those years represent the trim cycle and the current planned number of miles to be trimmed.

In each of the years, the company underspent what was budgeted and still achieved the trim miles. Spending can vary from year to year. And the company is on -- vegetation management plan that I am recommending does not change the number of miles to be trimmed.

A similar recommendation is made for poll inspections, where I relied on a historical three-year average of underspending. I applied that factor to the company's 2017 budget. This adjustment simply reflects the history of budget to actual, and is not designed --

CHAIRMAN BROWN: 30 seconds.

A -- to change the company's poll inspection.

I also recommend an adjustment to the capital spending from storm hardening. This is not based upon a similar analysis, but this is based upon the level of spending and the level of increases that have occurred over the recent years. The increase for the 2017 year is 73.5 percent.

Thank you.

CHAIRMAN BROWN: Thank you, Mr. Shultz.

MR. REHWINKEL: Madam Chairman, Mr. Shultz is tendered for cross-examination.

CHAIRMAN BROWN: Thank you.

And welcome.

THE WITNESS: Thank you.

CHAIRMAN BROWN: FIPUG.

MR. MOYLE: Thank you, Madam Chair. Just a couple questions. This witness doesn't have any of the documents, I assume, that we've been identifying; is that right?

CHAIRMAN BROWN: Mr. Shultz, do you have Exhibit 715 in front of you?

MR. MOYLE: I -- I was just referencing?

MS. BROWNLESS: It's Exhibit 579. And, no, Mr. Shultz does not have any documents identified on the staff's comprehensive exhibit list.

MR. MOYLE: Okay.

CHAIRMAN BROWN: Oh. Oh, that's what you were getting at. Sorry.

MR. MOYLE: Yes.

EXAMINATION

BY MR. MOYLE:

Q So I just have two quick questions. Your comments with respect to a sharing of incentive/bonus payments -- are you -- are you saying that there are no -- the shareholders of NextEra are not funding any portion of the bonus payments for which FPL is seeking this commission to award them in this case?

MR. DONALDSON: Let me just object. I want to know where Mr. Moyle is going with this because this sounds like friendly cross. And I am not aware of his actual witness stating something that is totally opposite to what this witness is referring to --

CHAIRMAN BROWN: Mr. Moyle.

MR. DONALDSON: -- or taking the position opposite of that.

MR. MOYLE: Yeah. Well, we've -- we've taken the position that there shouldn't be a rate increase; that it should be a decrease. And I think all these issues, when you add them up, are revenue issues.

So I have two lines of questions; one is whether rate -- whether shareholders are paying any of the bonus incentive compensation money or whether that's all on the backs of the ratepayers.

And my other question is going to be about the call centers and whether, in his headcount analysis, he specifically looked at the number of employees in FPL's five call centers.

So those are the two questions --

CHAIRMAN BROWN: I don't have a problem with the second question. The first one, you are going to have to -- you need to rephrase because it sounds like friendly cross to me.

MR. MOYLE: Okay.

CHAIRMAN BROWN: Why don't you start with the second one.

MR. DONALDSON: Is that the call center one?

MR. MOYLE: Call center. Okay. I will do it that way.

BY MR. MOYLE:

Q Sir, as part of your review and your analysis with respect to headcount, did you specifically look at number of call centers that FPL has and, if you did, the

number of employees FPL employs in call centers in making the determinations as to whether that was appropriate, overstaffed, understaffed?

MR. DONALDSON: Again, that sounds like friendly cross.

CHAIRMAN BROWN: He added the extra stuff.

MR. DONALDSON: That was a close call, but --

CHAIRMAN BROWN: You had to add that extra stuff. How about, rephrase it again?

BY MR. MOYLE:

Q What did you do with respect to the call centers?

A I didn't look at them on a stand-alone basis.

Q Okay. And -- and with respect to the bonus incentives -- incentives, what did you do with respect to looking at those these vis-a-vis what ratepayers are paying and what shareholders are paying?

MR. DONALDSON: Again, I am going to object. This is not a position that, I believe, that FIPUG has taken a specific position on. And I don't see anything with respect to Mr. Pollock, their witness, that is contrary to what this witness is talking about. So it's clearly friendly cross, even as open-ended as that question is.

MR. MOYLE: I guess I -- you know, again, there are a lot of issues in this case and there's a lot of money in this case. And I would suggest that, to the extent I have two limited questions with respect to monetary issues, that I should be able to ask this witness about them and let -- I don't know the answer. He may tell me it's all being paid by shareholders, but I don't --

CHAIRMAN BROWN: Staff -- I mean, legal?

MR. HETRICK: Madam Chair, I certainly think you have the discretion of allowing Mr. Moyle a little bit of latitude on this, but not much.

CHAIRMAN BROWN: Okay. Objection overruled.

MR. MOYLE: Thank you.

CHAIRMAN BROWN: Can you restate it for Mr. Shultz? But be careful.

MR. MOYLE: At my -- at my risk, I will try to.

BY MR. MOYLE:

Q So, sir, I am just trying to get an understanding, your understanding, with respect to monies that ratepayers were being asked to pay for bonus/incentive money and how those incentive/bonus amounts are funded.

A With respect to -- there's -- there's basically two items that are in the incentive comp that we would be looking at and I addressed them -- as I addressed in my summary.

You have the equity compensation, which the company has removed most of that. There is some that was left in. And then you have the cash incentive plan, which the company is asking ratepayers to pay for.

Q So all the cash, the ratepayers are paying for?

A Yes, sir.

Q And you said equity sum has been left in. So that's, like, you get stock option? Is that what equity means?

A Yeah. It has to do with the stocks, yes, sir.

Q Okay. So what's the split that's left in there?

A Well, according to the testimony of the company, 50 percent of the employee portion, nonexecutives, was allowable. And then there is -- there's a very small amount which, based upon our response to a late-filed exhibit, appears to be in there for the executives.

MR. DONALDSON: I am going to object and move to strike that last portion because he is referencing a late-filed exhibit, which basically is looking at a testimony that was subsequent to his testimony, which amounts to surrebuttal. So I would move to strike that portion of his response.

CHAIRMAN BROWN: Public -- Office of Public Counsel.

MR. REHWINKEL: Yeah. Madam Chairman, the discovery process is ongoing. And I think it was asked of him, and he gave an answer based on what he knew. It was not rebuttal to any witness who asked a fact question. He is a fact witness and an expert.

I think he is entitled to -- to answer Mr. Moyle's question.

CHAIRMAN BROWN: Mr. Moyle, would you like to --

MR. MOYLE: Well, I -- I mean, this, I think, is the first time I have heard a late-filed deposition-exhibit objection. I know there has been a lot of late-filed depo exhibits flying around. So it would be interesting to hear that exhibit -- hear that.

I guess I would just say, we're at trial. He is under oath. He is being asked a question. And this is the time to get it. I mean, you all need to make hard decisions. I would suggest that having more information rather than less will help you make the -- what you think are the proper decisions.

CHAIRMAN BROWN: Thank you for that. Mr. Hetrick.

MR. HETRICK: Madam Chair, I don't understand -- I don't think FPL counsel has articulated any prejudice here. So at this point, I think you have the discretion to allow it in.

CHAIRMAN BROWN: Okay. Motion overruled -- I mean, objection overruled.

MR. MOYLE: Thank you.

BY MR. MOYLE:

Q Sir, and -- and I am tempted to have the court reporter to read it back because it was a pretty involved answer, but there were two components. One to it -- one, you said that there was still some equity contrib- -- equity contribution or equity stock options left in for executives, but you said it was a small portion; is that correct?

A Yes, sir.

Q And when -- when you say small -- you know, in a rate case, small takes on a different meaning maybe sometimes. So what -- what do you mean by "small"?

A I mean small in context to the total amount that was identified as executive equity incentive compensation.

Q Okay. So tell me those two numbers. What was the total amount identified, and then what's the amount left or the small amount?

A The small amount was in the range of about $70,000. And the large amount was in the range of millions -- oh, here, I got it. It's -- you are talking about $30 million for the amount that was removed from the filing?

Q Okay. And -- and with respect to -- same question with respect to, I guess, nonexecutive. That's all in, correct?

A No, the non- -- well, the nonexecutive equity compensation was a 50-50 split. Shareholders get 50 percent. Ratepayers get 50 percent. The cash compensation is all -- all the ratepayers.

Q And not the 50-50 split on the cash?

A No.

Q And do you know what the cash number is in the equity number?

A That was -- oh, for the equity number or the cash?

Q Well, both.

A The cash incentive that was identified as being included in rates was $5.853 million. And the amount of cash -- or the amount that's associated with stock based for employees that's included in the rate filing is $1 million.

Q One million?

A 1,073,000.

Q Okay. So you apply the 50-50 to that, it would be a $500,000, roughly, item?

A Well, I -- I -- when I reference the 50-50, I'm referencing what the company says they adjusted for. The information that I have indicates that they took out 679,000, which is less than the 50 percent.

Q Okay. And then final question: With respect to the cash-value number, if this commission said, well, the cash value is all being paid for by ratepayers, 50 million point eight, if we were going to do a 50-50 split on it, it would be a 25.4 and 25.4 divided by ratepayers and shareholders?

A Well, if you were doing a strict 50-50. That's not what I did in my testimony. What I did is I took -- in my testimony is, I said you have financial goals. Financial goals should be paid for by shareholders.

So I took 40 percent of the amount that was there that was for financial goals and says this comes out. And then the remaining 60 percent was split 50-50.

MR. MOYLE: Okay. That's all I have. Thank you.

CHAIRMAN BROWN: Okay.

Hospitals?

MR. SIQVELAND: Nothing for this witness. Thank you.

CHAIRMAN BROWN: Thank you. Retail Federation.

MR. LAVIA: No questions. Thank you.

CHAIRMAN BROWN: Thank you.

FEA?

MR. JERNIGAN: No questions.

CHAIRMAN BROWN: Sierra?

MS. CSANK: No questions.

CHAIRMAN BROWN: Thank you.

AARP?

MR. COFFMAN: No questions?

CHAIRMAN BROWN: Thank you.

FPL?

MR. DONALDSON: Just a few questions.

EXAMINATION

BY MR. DONALDSON:

Q Hi, Mr. Shultz. How are you?

A I am fine. How are you?

Q Good. Kevin Donaldson on behalf of Florida

Power & Light. I don't think we've ever met.

I have a quick question. When did you prepare this errata that is Exhibit 715?

A My errata sheet? That was done basically over the weekend. Some of it was prepared a little earlier.

Q Okay. And are there any changes that you are making with respect to things that Mr. Pous stated -- Witness Pous stated that is in your errata?

A That was on exhibit HWS-9. And what that does is --

MR. REHWINKEL: Can I ask, Counselor, are you asking about changes to his testimony or his exhibits or both?

MR. DONALDSON: I am asking about the changes that are on his errata that are the subject of any changes that needed to be made as a result of Mr. -- Witness Pous being withdrawn. That's what I am asking.

MR. REHWINKEL: Okay.

MR. DONALDSON: So I want to know those changes that you made.

CHAIRMAN BROWN: You said HWS-9?

THE WITNESS: Yes, ma'am.

CHAIRMAN BROWN: That's identified on our comprehensive exhibit list as 188. Are you saying that that needs to be modified as a result of the withdrawal of Pous?

THE WITNESS: That was modified as a result of Pous' --

CHAIRMAN BROWN: Okay.

THE WITNESS: The one that's been filed with the errata sheet is in there. There is an HWS-9 that has the new numbers.

CHAIRMAN BROWN: Okay.

BY MR. DONALDSON:

Q So that is the last page of Exhibit 715; is that correct?

A Yes, sir.

Q Okay. Now, with respect to the other changes that you made, am I correct that the rest of these changes are changes that you made after reviewing Ms. Slattery's deposition transcript and/or her rebuttal testimony?

A There were changes made as a result of her rebuttal and the deposition transcript -- well, actually the deposition transcript and the late-filed exhibits that came from the deposition.

MR. DONALDSON: Okay. Thank you.

No further questions.

I am going to object to all those changes for the record.

CHAIRMAN BROWN: Okay. Thank you. So noted.

Staff.

EXAMINATION

BY MS. BROWNLESS:

Q Hi, Mr. Shultz.

A Hello.

Q I am Suzanne Brownless. Nice to see you.

Were you provided responses to staff interrogatories and production of documents requests associated with your subject area?

A Yes.

Q And were you also provided responses associated with your subject area of FIPUG's, FEA's, South Florida's, and AARP's discovery, as they became available?

A Yes, ma'am. I basically -- anything that I saw as a response or even discovery -- I would look at the -- at them and determine whether they were applied to areas that I was focused on.

Q Okay. And did you review responses to OPC's discovery in this case?

A Yes, ma'am.

THE WITNESS: Thank you.

That's all I have. Thank you.

CHAIRMAN BROWN: Thank you.
Commissioners?
Seeing none, redirect.
MR. REHWINKEL: Thank you, Madam Chairman.

FURTHER EXAMINATION

BY MR. REHWINKEL:
Q My only redirect is with respect to Exhibit 715 and the questions of Mr. Donaldson. Do you have a copy of Exhibit 715 in front of you?
A Yes, sir.
Q Could I ask you to turn to page two, number two at the bottom, and ask you what the reference is to page 37 -- do you see those references on the left-hand side?
A I am not following where you're at. Sorry.
Q Okay. Page one at the top says errata sheet, Witness Helmuth --
A Yes.
Q Okay. So you see the page-number column at the far left?
A Yes, sir.
Q The line number is next.
A Yep.
Q And then the change.
All right. So starting with page 37 --

A Yes, sir.

Q Are those references, 37 -- there's five of them. Are those the changes to incorporate the withdrawal of Mr. Pous' testimony?

A Yes, sir.

Q Okay. And then, if I could ask you to turn back to the very last page, HWS-9, it says, revised 8/26/16. Do you see that?

A Yes, sir.

Q And lines 17 and 18 -- are those the revisions to reflect Mr. Pous' withdrawal of testimony?

A Yes, sir.

Q Okay. Now, Mr. Donaldson asked about -- he asked you about the rest of the adjustments. Would you agree that the rest of the adjustments, the non-Pous adjustments, are to incorporate the changes that -- that you perceived from the rebuttal and late-filed deposition exhibit of Ms. Slattery?

A Yes, sir. What I include -- what I -- why I did this is because of the fact that the information wasn't readily available when I prepared my testimony. And I subsequently was provided that information through the rebuttal testimony of Ms. Slattery and in responses that came -- basically came after the, you know, the initial testimony is provided.

And I felt that it was important to have the actual numbers instead of estimates because the Commission wants to work with accurate numbers as opposed to inaccurate numbers, so --

Q Can I ask you, when you say, was not available, can you tell me the timing of when you prepared your testimony for filing and when the discovery response that you reviewed came in?

A Well, the discovery response came in on July 5th.

Q Do you know what time of day?

A Basically, at the end of the day is when I was able to identify receipt of that, and the testimony was basically complete as of that time. And there would not have been time to go back and regenerate all the new information.

Q Okay. So let me ask you this with respect to the timing: All of the changes that we see here basically is taking a few numbers and flowing them through your exhibits; is that correct?

A Yes, sir.

Q So you would have had to have made all of these changes after you had put your testimony to bed. Is that what you are saying?

A Yes, sir.

Q Okay. Now, with respect to Witness Slattery's rebuttal, did you perceive her criticisms to your testimony to be accurate with the O&M factor and feel the need to incorporate them into your testimony?

MR. DONALDSON: I'm going to object. This is outside the scope of my cross. And it's going into surrebuttal as far he's given an opinion on Ms. Slattery's rebuttal. This is clearly inappropriate. He is not allowed to give surrebuttal on another witness' rebuttal.

MR. REHWINKEL: Madam Chairman, Mr. Donaldson's first question was when. And he said he was going to object to the errata. And all I am doing is asking the witness to explain the timing of his errata, which is all I am doing.

CHAIRMAN BROWN: Repeat the question, Mr. Rehwinkle.

MR. REHWINKEL: I'm going to have to ask the court reporter to read it back because I --

CHAIRMAN BROWN: Our kind court reporter, could you please read the question back?

(Whereupon, the court reporter read the requested portion of the record.)

MR. DONALDSON: That is clearly not a timing question. And I asked him when he actually prepared this errata, and he said it was over the weekend. That is a timing question.

CHAIRMAN BROWN: Objection sustained.

Mr. Rehwinkle, can you move on?

MR. REHWINKEL: Okay. So I think -- Madam Chairman, let me ask one question to correct a mistake, I believe.

BY MR. REHWINKEL:

Q On page two of your errata, 715, do you see the last page reference of 37?

A Yes, sir.

Q And I would ask you, is -- if that should be a 38.

A Yes, sir.

Q Okay. So line -- page 38, line 23.

And oh, yes, what about the line number? Should that be line three?

A That -- let me -- let me back up on this. I want to look at the schedule and make sure. I believe -- I believe what it should be is that you would be looking at line 38 [sic], two, for the change from 428 to 475, and line -- page 38, line two for the change from 615 to 683.

Q Two or three?

A Pardon?

Q Is it -- is it line three where 615 changes to 683?

A Okay. Three. I don't have it right in front of me, so --

Q Okay.

A It's going to be two or three. It's going to be one of those lines.

MR. REHWINKEL: Thank you. No further questions.

CHAIRMAN BROWN: All right. Thank you, Mr. Rehwinkle.

Getting into exhibits 180 through -- well, I guess 188 is revised, but -- Mr. Rehwinkle?

MR. REHWINKEL: Yes, the Public Counsel would move 180 through 188.

CHAIRMAN BROWN: Isn't 188, though, amended in the errata, which is marked as Exhibit 715?

MR. REHWINKEL: Yes, we would move it as revised.

CHAIRMAN BROWN: Under 715 or under 188?

MR. REHWINKEL: Well, I think the thing to do is move 180 through 188 as filed, and we will see how it goes with 715.

CHAIRMAN BROWN: Are there any objections to 180 through 188?

MR. DONALDSON: That -- that makes sense. That's fine.
CHAIRMAN BROWN: Okay.
MR. DONALDSON: No objections.
CHAIRMAN BROWN: Seeing no objections, we will move 180 through 188.
(Whereupon, Exhibit Nos. 180 through 188 were received into evidence.)
CHAIRMAN BROWN: FPL, you have 714. I don't know. I just had that marked down as 714.
MR. DONALDSON: I have 715.
CHAIRMAN BROWN: Yeah.
MS. BROWNLESS: Seven --
CHAIRMAN BROWN: 715 is the errata. Sorry. 715 is Office of Public Counsel errata to Mr. Shultz's testimony. Let's just address that right now.
MR. REHWINKEL: We would -- we would move that.
CHAIRMAN BROWN: All right. I understand that FPL has an objection.
MR. DONALDSON: Yes. Yes, Madam Chairman. First of all, Mr. Shultz went ahead and stated in his -- in his testimony that he filed this errata basically as of this weekend, this past weekend.

And it -- it is actually indicating on his errata that changes are being made as a result of reviewing Ms. Slattery's rebuttal testimony as well as her deposition transcript.

This is clearly an attempt by Mr. Shultz to put in surrebuttal testimony to Ms. Slattery's rebuttal testimony as a result of the depositions and the rebuttal that is being placed.

Your prehearing officer set out a schedule. The schedule indicated FPL was to file its direct case. Intervenors would file their -- their case. And FPL would file a rebuttal case.

There is no surrebuttal date or deadline that is being placed into the record in this prehearing officer [sic]. And by incorporating these errata changes, that essentially would be the Commission acknowledging and accepting surrebuttal testimony, which FPL has not had an opportunity to actually go out and conduct any additional type of review, discovery. And we will be prejudiced by allowing this type of information to go forward into the record.

CHAIRMAN BROWN: Mr. Rehwinkle.

MR. REHWINKEL: Yeah, Madam Chairman --

MR. MOYLE: Can I -- can I be heard as well?

CHAIRMAN BROWN: I am going to go to Office of Public Counsel first and then you.

MR. MOYLE: Okay. We have an objection, though.

CHAIRMAN BROWN: Okay.

Go ahead, Mr. Rehwinkle.

MR. REHWINKEL: Yeah. Madam Chairman, the Public Counsel is not in any way seeking to prejudice FPL. We are using the information that would have been used, had it been available at the time Mr. Shultz filed his testimony.

If -- if the Commission doesn't want the correct information, that's fine. Ms. Slattery will be back on -- on -- on rebuttal, and we will deal with it there. But I think for the -- for the sake of completeness, Mr. Shultz has been transparent with the company and the Commission.

And we would offer this in there -- I don't know. I guess the objection is to the whole exhibit or just the pieces that don't relate to Mr. Pous?

MR. DONALDSON: It's the whole exhibit where he is making the changes as a result of re-reviewing and reviewing Ms. Slattery's rebuttal and late-filed exhibits, with the exception of the

Pous portions.

CHAIRMAN BROWN: Oh, it's the last -- is that the last page?

MR. DONALDSON: As well as page two, which Mr. Shultz just stated --

CHAIRMAN BROWN: Could you do me a favor and carve out what you are not objecting to?

MR. DONALDSON: Okay. So FPL is not objecting to page two, lines 37 through 30 --

UNIDENDIFIED SPEAKER: Page two of the exhibit.

MR. DONALDSON: Right. So it's page two referring to page 37 and 38 of that exhibit.

CHAIRMAN BROWN: Okay.

MR. DONALDSON: And no objection to the last page, which is the revised HWS-9 as a result of Mr. Pous' withdrawal.

CHAIRMAN BROWN: All right. Everything else you object to --

MR. DONALDSON: Yes.

CHAIRMAN BROWN: -- in that exhibit. Okay.

FIPUG.

MR. MOYLE: I may have to take a little more time with this, but I think we want to object to everything that they do not object to, that FPL does not object to because we are not that worked up about the Slattery information.

What we are worked up about is the depreciation information that we haven't had a chance to really even look at or digest or consider or reflect upon. And it's replete. And it's really based on, you know, just not having a chance to look at it and understand what it's doing and -- and be prepared for it.

So I don't know how -- how this is going to all work out with this depreciation issue, but I would respectfully suggest that when a witness is going to take the stand and say, hi, I am here to tell you about these things, if they are going to say, I'm making changes related to the depreciation issue that, at a bare minimum, they give us a heads-up when they are on the stand.

I mean, I don't think I was able to understand this until -- you know, until questions were asked. So that's the objection. I'm going along basically on the fact that we would object because it's information that we haven't had a chance to review and understand and digest.

I am not wanting to goof things up in a way that it can't maybe be reconsidered at a particular point in time, but right now, we just have to object because we have not had a chance to --

CHAIRMAN BROWN: Okay.

MR. MOYLE: -- review the information.

CHAIRMAN BROWN: Thank you for the suggestion.

You know what, I'm going to take a moment to think about this. And I would --

MR. REHWINKEL: May -- may I be heard briefly on this?

CHAIRMAN BROWN: Sure.

MR. REHWINKEL: Madam Chairman, I understand Mr. Moyle's philosophical point. But the fact of the matter is, as a matter of law, Mr. Pous' testimony has been withdrawn. It will not be offered. And this witness testified that the adjustment was based on Mr. Pous' testimony, which is -- doesn't exist anymore. So he reverted to the company's.

It -- it's pretty straightforward, but I -- I understand you want to consider it. And we will address it when you're ready to talk about it.

CHAIRMAN BROWN: Thank you. And -- and we will address it probably somewhere around the dinner break, before or after, but we will come back to it. Okay? Objections are all noted.

MR. DONALDSON: Thank you.
CHAIRMAN BROWN: Thank you.
Would you like this witness excused?
MR. REHWINKEL: Yes, we would. And thank you, Madam Chairman.
CHAIRMAN BROWN: Thank you.
Have a great evening.
THE WITNESS: Thank you.
(Witness excused.)
CHAIRMAN BROWN: All right. We are going to call the next witness of Public Counsel, if he is here. I guess you have O'Donnell?
MS. CHRISTENSEN: Yes. Office of Public Counsel would ask that Mr. O'Donnell be called to the stand.
CHAIRMAN BROWN: All right. Mr. O'Donnell. Welcome to the fun.
THE WITNESS: Thank you. Glad to be here.
CHAIRMAN BROWN: Mr. O'Donnell, have you been sworn in?
THE WITNESS: Yes.
CHAIRMAN BROWN: All right.

EXAMINATION

BY MS. CHRISTENSEN:
Q Good evening, Mr. O'Donnell. Could you please

state your name and your business address for the record, please.

A   Kevin W. O'Donnell, 1350 Southeast Maynard Road, Suite 101, Cary, North Carolina.

Q   Okay. And did you cause to be filed prefiled direct testimony on July 7th, 2016, in this docket?

A   Yes.

Q   And do you have any corrections to your testimony?

A   No.

Q   And if I were to ask you the same questions today, would your answers be the same?

A   Yes.

MS. CHRISTENSEN: Okay. I would ask that Mr. O'Donnell's direct prefiled testimony be read into the record as though read.

CHAIRMAN BROWN: All right. We will enter Mr. O'Donnell's prefiled testimony into the record as though read.

(Prefiled direct testimony inserted into the record as though read.)

DIRECT TESTIMONY

OF

OF KEVIN W. O'DONNELL, CFA

On Behalf of the Office of Public Counsel

Before the

Florida Public Service Commission

Docket No. 160021-EI, et al (consolidated)

Q. PLEASE STATE YOUR NAME, POSITION, AND BUSINESS ADDRESS FOR THE RECORD.

A. My name is Kevin W. O'Donnell. I am President of Nova Energy Consultants, Inc. My business address is 1350 Maynard Rd., Suite 101, Cary, North Carolina 27511.

Q. ON WHOSE BEHALF ARE YOU PRESENTING TESTIMONY IN THIS PROCEEDING?

A. I am appearing on behalf of the Florida Office of Public Counsel, the representative of FPL ratepayers before the Public Service Commission of Florida.

Q. PLEASE SUMMARIZE YOUR EDUCATIONAL BACKGROUND AND RELEVANT EMPLOYMENT EXPERIENCE.

A. I have a Bachelor of Science in Civil Engineering from North Carolina State University and a Master of Business Administration from the Florida State University. I earned the designation of Chartered Financial Analyst (CFA) in 1988. I have worked in utility regulation since September 1984, when I joined the Public Staff of the North Carolina Utilities Commission (NCUC). I left the NCUC Public Staff in 1991 and have worked continuously in utility consulting since that time, first with Booth & Associates, Inc. (until 1994), then as Director of Retail Rates for the North Carolina Electric Membership Corporation (1994-1995), and since then in my own consulting firm. I have been accepted as an expert witness on rate of return, cost of capital, capital structure, cost of service, rate design, and other regulatory issues in general rate cases, fuel cost proceedings, and other proceedings. I have been engaged in cases before the North Carolina Utilities Commission, the South Carolina Public Service Commission, the Virginia State Commerce Commission, the Minnesota Public Service Commission, the Public Service Commission of Maryland, the New Jersey Board of Public Utilities, the Public Utilities Commission of Colorado, and the Florida Public Service Commission. In 1996, I testified before the U.S. House of Representatives' Committee on Commerce and Subcommittee on Energy and Power, concerning competition within the electric utility industry. Additional details regarding my education and work experience are set forth in Exhibit KWO-1 to my direct testimony.

Q. PLEASE SUMMARIZE YOUR TESTIMONY.

A. In this proceeding, FPL is asking this Commission to approve a capital structure that has an equity ratio of 59.60%. FPL's request in this case puts an unnecessary costly burden on ratepayers of Florida and should not be allowed. To be specific, FPL's requested capital structure in this case will cost the typical residential customer of FPL an extra

$40.97 per year as compared to a more normal capital structure of 50% common equity and 50% debt.

A capital structure with a 59.60% equity ratio is higher than the equity ratio that has been allowed by any state regulator in the past three years; higher than the average common equity ratio of the comparable group of FPL's rate of return witness; and much higher than the equity ratio of NextEra Energy.

My recommendation is the Commission adopt a capital structure that consists of 50% common equity and 50% debt as this capital structure is comparable to other utilities as well as the equity ratio granted by state regulators across the country.

Q. HOW IS YOUR TESTIMONY STRUCTURED?

A. I have outlined my testimony in the following manner:

I. Economic and Regulatory Policy Guidelines for a Fair Rate of Return

II. Capital Structure

A. Explanation of Capital Structure

B. FPL's Requested Capital Structure

C. Capital Structure Comparison

D. Recommendation and Impact on FPL Consumers

E. Summary

I. Economic and Regulatory Policy Guidelines for A Fair Rate of Return

Q. PLEASE DESCRIBE THE REGULATORY FRAMEWORK USED TO DEVELOP YOUR RECOMMENDATION THE FAIR RATE OF RETURN?

A. The theory of utility regulation assumes that public utilities perform functions that are natural monopolies. Historically, it was believed or assumed that it was more efficient for a single firm to provide a particular utility service rather than multiple firms. Even though deregulation for the procurement of natural gas and generation of electric power and energy is spreading, as is the development of renewable energy production, delivery of these products to end-use customers will most likely continue to be considered a natural monopoly for the foreseeable future. This is because regulatory authorities regulate the service areas in which regulated utilities provide service, particularly but not necessarily limited to distribution. On this basis, state legislatures or commissions assign exclusive franchised territories to public utilities or determine territorial boundaries where disputes arise, in order for these utilities to provide services more efficiently and at the lowest reasonable cost. In exchange for the protection within its monopoly service area, the utility is obligated to provide adequate service at a fair, regulated price.

This naturally raises the question - what constitutes a just and reasonable price? The generally accepted answer is that a prudently managed electric utility should be allowed to charge prices that allow the utility the opportunity to recover the reasonable and prudent costs of providing utility service and the opportunity to earn a fair rate of return on invested capital. This just and reasonable rate of return on capital should allow the utility, under prudent management, to provide adequate service and attract capital to meet future expansion needs in its service area. Since public utilities are capital-intensive businesses, the cost of capital is a crucial issue for utility companies, their customers, and regulators. If the allowed rate of return is set too high, then consumers are burdened with excessive costs, current investors receive a windfall, and the utility has an incentive to overinvest. If the return is set too low, adequate service is jeopardized because the utility will not be able to raise working capital on reasonable terms.

Since every equity investor faces a risk-return tradeoff, the issue of risk is an important element in determining the fair rate of return for a utility.

Regulatory law and policy recognize that utilities compete with other firms in the market for investor capital. In the often cited case of *Federal Power Commission v. Hope Natural Gas Company*, 320 U.S. 591 (1944), the U.S. Supreme Court recognized that utilities compete with other firms in the market for investor capital. Historically, this case has provided legal and policy guidance concerning the return which public utilities should be allowed to earn:

In *Hope Natural Gas*, the U.S. Supreme Court stated that the return to equity owners (or shareholders) of a regulated public utility should be "commensurate" to returns on investments in *other* enterprises whose "*risks* correspond" to those of the utility being examined:

> the return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital. (320 U.S. at 603)

Q. PLEASE EXPLAIN THE RELATIONSHIP BETWEEN THESE COURT RULING AND ECONOMIC PRINCIPLES RELATING TO THE CAPITAL STRUCTURE ISSUE NOW BEFORE THIS COMMISSION?

A. As this Commission is aware, every equity investor faces a risk-return tradeoff. The more risk the investor assumes, the higher the return the investor demands. The risks that a regulated utility incurs can be stated as financial risk and business risk. As the amount of debt relative to equity capital increases, the amount of money necessary to pay the interest on debt increases, and financial risk increases. Similarly, as the amount of debt relative to equity capital decreases, financial risk decreases. Thus, as the utility assumes more debt or less debt, the risk of repayment of the debt increases or decreases accordingly.

Business risk is a measure of a company's ability to operate at a profit within its industry. Given that FPL operates in a monopoly industry with no retail competition, its business risk is relatively small.

One of the responsibilities of the utility is to employ prudent and reasonable levels of debt and equity. Utility finance personnel will often attempt to employ different levels of debt and equity in the Company's capital structure in order to maximize the return allowed by state regulators. The related task of the regulator is to assess these levels of debt and equity presented in general rate case proceedings to determine if the levels reflect the actual, corresponding financial and business risks to the utility. Further, the regulator should review the utility's capital structure and adjust, when necessary, the requested levels of equity and debt, for ratemaking purposes, to prevent customers from paying rates that are unreasonably high. Moreover, the relative amounts of equity and debt in the total capital raised by the utility bear directly on the risk perceived by investors, and thus to the rate of return that is commensurate with that risk.

II. Capital Structure

A. Explanation of Capital Structure

Q. WHAT IS A CAPITAL STRUCTURE AND HOW WILL IT IMPACT THE REVENUES THAT THE UTILITY IS SEEKING IN A RATE CASE?

A. The term "capital structure" refers to the relative percentage of debt, equity, and other financial components that are used to finance a company's investments. For simplicity, there are three financing methods that involve investor funds. The first method is to finance an investment with common equity, which essentially represents ownership in a company and its investments. Returns on common equity, which in part take the form of dividends to stockholders, are not tax deductible. This feature makes equity financing about 40% more expensive than debt financing on a pre-tax basis alone due to the gross-up for taxes required to pay back this type of shareholder financing. The second form of corporate financing is preferred stock, which is normally used to a much smaller degree in capital structures. Dividend payments associated with preferred stock are also not tax deductible.

Corporate debt is the third major form of financing used in the corporate world. There are two basic types of corporate debt: long-term and short-term. Long-term debt is generally understood to be debt that matures in a period of more than one year. Short-term debt is debt that matures in a year or less. Both long-term debt and short-term debt represents liabilities on the company's books that must be repaid prior to any common stockholders or preferred stockholders receiving a return on their investment.

Q. HOW IS A UTILITY'S TOTAL RETURN CALCULATED?

A. The utility's return is developed in a two-step process. First, the weighted cost of all capital is developed. A utility's total return is developed by multiplying the percentage of each component of the capital structure relative to the total financing on the company's rate base, by the cost rates associated with each form of capital. For each component, the mathematical product is referred to as a weighted average. The sum of the components' weighted averages represents the weighted average overall cost of capital, sometimes called the "WACC."

Second, the cost of capital is grossed-up for taxes, developing the revenue requirement for capital. When the percentage ratios are applied to various cost rates, a total after-tax rate of return is developed. An example of this cost allocation is shown later in this testimony. Since the utility must pay dividends associated with common equity and preferred stock with after-tax funds, the post-tax returns are then converted to pre-tax returns by grossing up the common equity and preferred stock dividends for taxes. The final pre-tax return is then multiplied by the Company's rate base in order to develop the amount of money that customers must pay to the utility for its return on investment and tax payments associated with that investment.

Q. HOW DOES CAPITAL STRUCTURE IMPACT THIS CALCULATION?

A. Costs to consumers are greater when the utility finances a higher proportion of its rate base investment with common equity and preferred stock instead of less expensive long-term debt. However, long-term debt, which is first in line for repayment, imposes a contractual obligation to make fixed payments on a pre-established schedule, as opposed to common equity where no similar obligations exist.

Q. WHY SHOULD THE COMMISSION BE CONCERNED ABOUT HOW FPL FINANCES ITS RATE BASE INVESTMENTS?

A. There are two reasons that the Commission should be concerned about how FPL finances its rate base investments. The first reason is that the cost of common equity is higher and more expensive than the cost of long-term debt. A higher equity percentage, above an optimal level, will translate into higher costs to FPL's customers but without any corresponding improvement in quality of service for customers. Long-term debt is a financial promise made by the company and is carried as a liability on the company's books. Common stock is ownership in the company. Due to the nature of this investment, common stockholders require higher rates of return to compensate them for the extra risk involved in owning part of the company versus having a more senior claim against the company's assets in the form of debt.

The second reason the Commission should be concerned about FPL's capital structure is due to the tax treatment of debt versus common equity. Public corporations, such as FPL, can expense interest payments associated with debt financing. Corporations are not, however, allowed to deduct common stock dividend payments for tax purposes. All dividend payments must be made with after-tax funds, which are more expensive than pre-tax funds. Since the regulatory process allows utilities to recover reasonable and prudent expenses, including taxes, customer rates must be set so that the utility pays all its taxes and has enough left over to pay its common stock dividend. If a utility is allowed to use a capital structure for ratemaking purposes that is top-heavy in common stock, customers will be forced to pay the associated income tax burden, resulting in unjust, unreasonable, and unnecessarily high rates. Setting rates through the use of capital structure that is top-heavy in common equity violates the fundamental principles of utility regulation that rates must be fair, but only high enough, to support the utility's provision of safe, adequate, and reliable service at a fair price.

Q. HOW IS SETTING A CAPITAL STRUCTURE FOR A REGULATED ELECTRIC UTILITY COMPANY DIFFERENT THAN SETTING A CAPITAL STRUCTURE FOR A NON-REGULATED COMPANY THAT OPERATES IN A COMPETITIVE ENVIRONMENT?

A. Unregulated companies in competitive markets must carefully weigh the risk of using lower cost debt that can be used to leverage profits versus the use of the more expensive common equity that dilutes profits (i.e. company issues additional stock so there are more shares of stock which will share in any profits). Such capital sourcing decisions are based, in large part, on the competitive nature of the business in which the entity operates.

In the case of a regulated electric utility with a licensed service territory that has little-to-no retail competition in its service territory, there is actually a strong incentive for a company to use common equity to build assets that can be placed in rate base. The utility is guaranteed the opportunity to earn its allowed rate of return on plant investment and, as such, can maximize profits by building plant and receiving favorable regulatory treatment from state regulators.

For example, unregulated companies in competitive markets work to lower capital costs through efficient capital cost decisions (i.e., profit motives that limits the Company's desire to issue additional stock) whereas electric utility rate regulation can act as an incentive for additional plant investment (i.e., profits are maximized through the issuance of common equity).

Q. PLEASE EXPLAIN HOW ONGOING CONSTRUCTION NEEDS ARE IMPACTING UTILITIES AND THEIR CUSTOMERS.

A. Utilities finance construction with three primary sources of capital: retained earnings; common equity issuances; and long-term debt issuances. Financing construction with retained earnings is preferable to the utility because using funds from ongoing operations does not dilute common equity, as would an equity issuance, nor does it add debt leverage to the utility's balance sheet. However, in most cases, financing a large asset with only retained earnings may not be possible due to the sheer size of the plant investment. As a result, utilities undergoing large construction projects often issue common equity or long-term debt to finance these projects. Therefore, selecting the ratio of equity and debt is important. Entities in unregulated, competitive markets have a profit motive that provides an incentive for such entities to select the most efficient capitalization ratio. However, franchised electric utilities operating in a regulated, noncompetitive market have an incentive to maximize the amount of common equity in their capital structure so as to increase rates and, correspondingly, the utility's profit. Franchised electric utilities should only be allowed to recover in rates a revenue requirement derived from a capitalization ratio that allows the utility to provide reliable service at the least cost. Thus, finding the right balance between debt and equity is critical, especially if the franchised electric utility is a subsidiary of a larger holding company.

Q. PLEASE EXPLAIN THE RAMIFICATIONS OF RATES BEING SET AT AN UNBALANCED DEBT/EQUITY LEVEL.

A. If a utility issues too much common equity and not enough debt for a certain project, the customer pays higher rates to support a capital structure that is neither prudent nor reasonable. It is also important to recognize how utility rate levels affect economic development. A utility with high rates will, all else being equal, cause its service territory to lose out on economic development opportunities.

If, on the other hand, the utility incurs too much debt, the utility's capitalization ratios present excess financial risk to the capital markets, thereby driving up the costs required by the markets to compensate them for the added risk. In this case, the customer would also lose since the cost it must pay the utility for accessing the capital markets is higher than it would pay using a less debt-leveraged capital structure.

One role of regulation is to balance the needs of the capital markets, including utility stockholders, with the needs of ratepayers. Too much equity or too much debt can harm both the stockholders of the corporation as well as the public. Careful study of the risks and costs of various capitalization ratios is important.

B. FPL Requested Capital Structure

Q. MR. O'DONNELL, HAVE YOU REVIEWED THE CAPITAL STRUCTURE REQUESTED BY THE COMPANY IN THIS PROCEEDING?

A. Yes, I have.

Q. WHAT CAPITAL STRUCTURE IS FPL SEEKING IN THIS CASE?

A. Based on Schedule D-1A of the minimum filing requirements (MFRs), FPL is asking for the following capital structure:

Table 1: FPL Requested All Capital Sources
Capital Structure and Cost Rates

Source of Capital	Amount ($)	Ratio (%)
	(000's)	
Long-Term Debt	$9,358,417	28.76%
Preferred Stock	$0	0.00%
Customer Deposits	$407,328	1.25%
Common Equity	$14,682,574	45.13%
Short-Term Debt	$612,939	1.88%
Def. Income Taxes	$7,368,582	22.65%
Inv. Tax Credits	$106,275	0.33%
Total	$32,536,115	100.00%

The above capital structure, however, includes all sources of capital for use by FPL to finance rate base operations. When only investor-sources of capital are included, the above capital structure translates into the following:

Table 2: FPL Requested Investor-Only Sources
Capital Structure and Cost Rates

Source of Capital	Amount ($)	Ratio (%)
Long-Term Debt	$9,358,417	37.96%
Common Equity	$14,682,574	59.55%
Short-Term Debt	$612,939	2.49%
Total	$24,653,930	100.00%

Q. DO YOU AGREE THAT REVENUE REQUIREMENTS IN THIS CASE SHOULD BE SET USING A 59.6% COMMON EQUITY RATIO?

A. No. I believe FPL's requested equity ratio is excessively high and should not be allowed by the Commission for the following reasons:

1. The requested equity ratio of 59.60% is out-of-line with other electric utilities; with allowed equity ratios from state regulators around the United States; as compared to non-regulated subsidiaries of NextEra Energy; and as compared to NextEra Energy;

2. The cost to support a 59.60% equity ratio represents a grossly unfair financial burden to FPL consumers especially when compared with the equity ratio of its parent NextEra Energy.

C. Capital Structure Comparison

Q. HOW DOES THE EQUITY RATIO REQUESTED BY FPL IN THIS CASE COMPARE TO THE COMPARABLE GROUP OF THE COMPANY'S RATE OF RETURN WITNESS, ROBERT HEVERT?

A. The 59.60% equity ratio requested in this case is much higher than any company in Mr. Hevert's comparable group and, as such, FPL has much less financial risk than Mr. Hevert's comparable group. Table 3 below compares the requested FPL equity ratio to Mr. Hevert's comparable group.

Table 3: Hevert Comparable
Group Equity Ratios

Allete	53.7%
Alliant Energy	51.4%
Ameren	49.7%
AEP	50.2%
Avista	50.0%
CMS Energy	31.4%
Dominion	34.9%
DTE Energy	49.8%
Great Plains Energy	49.1%
IDACORP	54.4%
NorthWestern Corp.	46.9%
OGE Energy	55.7%
Otter Tail	57.6%
Pinnacle West	57.0%
PNM Resources	45.6%
Portland General	52.2%
SCANA	48.1%
Westar Energy	52.5%
Xcel Energy	45.9%
Average	49.3%
Requested FPL Equity Ratio	59.6%

Q. HOW DOES THE 59.60% EQUITY RATIO REQUESTED BY FPL COMPARE TO THE EQUITY RATIO OF NEXTERA ENERGY?

A. According to data obtained from Schedule D-2, p. 1 of the MFRs filed in this case, NextEra Energy has a consolidated common equity ratio of 43.8%.

Q. HOW DOES THE FPL REQUESTED EQUITY RATIO COMPARE TO NON-REGULATED SUBSIDIARIES OF NEXTERA ENERGY?

A. The unregulated companies of NextEra Energy have an average equity ratio of 27.8% (Schedule D-2, p. 1 of MFRs) which is, obviously, much lower than the excessively high equity ratio requested by FPL.

Q. WHY IS THE COMMON EQUITY RATIO OF NEXTERA'S UNREGULATED SUBSIDIARIES SO MUCH LOWER THAN THE EQUITY RATIO OF FPL?

A. The unregulated sister companies of FPL are leveraging their operations to the maximum extent possible knowing that its parent company, NextEra Energy, has a strong cash flow stream from the regulated operations of FPL which is protected from retail competition due to regulation here in Florida. These strong cash flow payments go to the parent company from FPL, in turn, support the unregulated operations of NextEra Energy.

Q. CAN YOU PROVIDE THIS COMMISSION ANY EVIDENCE TO SUPPORT YOUR CLAIM THAT INVESTORS EXPECT THE PARENT HOLDING COMPANY, NEXTERA ENERGY, TO GUARANTEE THE PAYMENTS OF ITS UNREGULATED SUBSIDIARIES?

A. The following three statements can be found in the NextEra Energy Capital Holdings, Inc. prospectus for $325,000,000 Series H Junior Subordinated Debentures due June 15, 2072:

> NEE Capital owns and provides funding for all of NEE's operating subsidiaries other than Florida Power & Light Company ("FPL") and its subsidiaries. NEE Capital was incorporated in 1985 as a Florida corporation and is a wholly owned subsidiary of NEE. (p. S-1) NEE has two principal operating subsidiaries, FPL and, indirectly through NEE Capital, NextEra Energy Resources, LLC ("NEER"). FPL is a rate regulated electric utility engaged primarily in the generation, transmission, distribution and sale of electric energy in Florida. NEER is NEE's competitive energy subsidiary which produces the majority of its

> electricity from clean and renewable sources. NEE is a holding company incorporated in 1984 as a Florida corporation. (p. S-1)
>
> **NEE Capital's corporate parent, NEE, has agreed to unconditionally and irrevocably guarantee the payment of principal, interest and premium, if any, on the Junior Subordinated Debentures.** The Junior Subordinated Debentures will be issued in denominations of $25 and integral multiples thereof. (p. S-2, emphasis added)

Q: IS THE CAPITAL STRUCTURE REQUESTED BY FPL IN THIS CASE DRIVEN BY THE MARKETPLACE OR IS IT A HYPOTHETICAL?

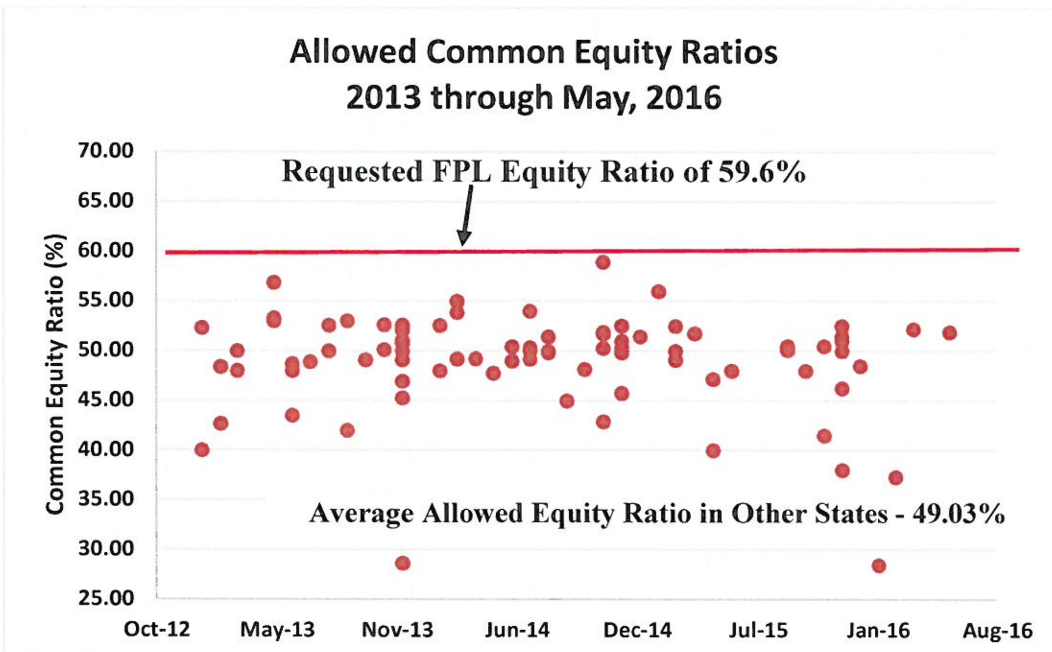
A: Any capital structure for a regulated utility in a parent/subsidiary structure is hypothetical because NextEra Energy has pre-determined the capital structure ratios. Indeed, in his prefiled testimony, Company Witness Dewhurst states the capital structure on which the Company wants revenue requirements to be determined in this case is one with a 59.6% equity ratio.

If the marketplace was driving the capital structures of the NextEra subsidiaries, the unregulated subsidiaries would have an equity ratio much higher than 27.8% and FPL would have an equity ratio much lower than the 59.6% requested in this case.

Q. MR. O'DONNELL, HOW DOES THE FPL REQUESTED EQUITY RATIO IN THIS CASE COMPARE TO THE AVERAGE COMMON EQUITY RATIO GRANTED BY STATE REGULATORS ACROSS THE COUNTRY?

A. According to data obtained from SNL Financial[1] (now known as S&P Global Market Intelligence, a division of S&P Global), there have been 92 electric utility rate cases decided since January, 2013. No other state regulatory body has allowed an equity ratio over 59% and the average equity ratio of all these 92 cases is 49.03%. This equity ratio comparison can be seen in Chart No. 1 below.

Chart 1: Allowed Common Equity Ratios from 2013 through Present



Q. PLEASE SUMMARIZE YOUR FINDINGS AS TO HOW FPL'S REQUESTED EQUITY RATIO IN THIS CASE COMPARES TO THE EQUITY RATIOS OF OTHER ELECTRIC UTILITIES, NEXTERA ENERGY AND SISTER SUBSIDIARIES, AND THE NATIONAL AVERAGE ALLOWED COMMON EQUITY RATIO IN RATE CASE PROCEEDINGS.

[1] SNL.com

A. Table 4 below provides this comparison and shows, without a doubt, that FPL's requested equity ratio in this case is grossly out-of-line with comparable utilities and what other state regulator bodies have granted in rate case proceedings across the United States:

Table 4: Summary of Common Equity Ratio Comparisons

Entity for Comparison	Equity Ratio
FPL Requested Equity Ratio	**59.6%**
Hevert Comparable Group	49.3%
NextEra Energy	43.8%
Unregulated Subsidiaries of NextEra Energy	27.8%
National Average Allowed Equity Ratio	49.0%

D. Recommendation and Impact on Consumers

Q. WHAT CAPITAL STRUCTURE DO YOU RECOMMEND THIS COMMISSION ADOPT FOR PURPOSES OF CALCULATING THE REVENUE REQURIEMENT IN THIS CASE?

A. The task of this Commission is to balance the interests of stockholders and ratepayers in order to allow the Company to operate efficiently and earn a reasonable return for shareholders. As can be seen in Table 4 above, the Company's common equity ratio request of 59.6% is simply and grossly out-of-touch with reality in utility regulation. In the past four years, no regulatory commission in the United States has allowed rates to be set on a capital structure with over 59% common equity.

In this case, however, FPL is asking this Commission to split from regulators across the country and allow the Company to charge ratepayers for the most expensive capital structure in the U.S. FPL's request in this case is simply unreasonable and will place an unfair burden on consumers.

My recommendation is this Commission employ a capital structure that is comparable to other electric utilities and is also comparable to what other state commissions across the country have deemed to be fair and reasonable. I would recommend a 50% equity ratio, which is slightly above the 49.03% average allowed by other regulatory commissions since 2013. My specific recommendation, along with OPC Witness Woolridge's 8.75% ROE recommendation, can be seen in Table 5 below:

Table 5: OPC Recommended Capital Structure

Capital Component	Ratio %)	Cost Rates (%)
Long-Term Debt	46.93%	4.62%
Short-Term Debt	3.07%	1.85%
Common Equity	50.00%	8.75%
Total	100.00%	

Q. IS YOUR RECOMMENDED CAPITAL STRUCTURE A HYPOTHETICAL CAPITAL STRUCTURE?

A. Yes. However, the capital structure requested by FPL is also a hypothetical in that it, too, is not market driven. NextEra has set the FPL capital structure in the same manner that I have set my recommended capital structure with a 50% equity ratio as stated above.

Q. WHO ARE THE WINNERS AND LOSERS IF THE COMMNISSION ALLOWS FPL TO USE A 59.6% EQUITY RATIO IN ITS CAPITAL STRUCTURE FOR RATEMAKING PURPOSES?

A. The big winners are the shareholders. If rates are set with a capital structure at 59.6% instead of a more reasonable 50% equity ratio, FPL shareholders will receive an additional $337 million annually. The customers lose because they will then be required to support an unnecessarily expensive capital structure.

Q. WHAT IS THE SIGNIFICANCE OF THE FACT THAT FPL'S REQUESTED EQUITY RATIO IS SO MUCH MORE EXPENSIVE THAN OTHER REGULATED UTILITIES?

A. As stated previously, common equity is much more expensive than is long-term debt. As such, captive ratepayers of FPL are being asked to support an equity ratio that cannot be justified or explained based on any operational reason. The ratepayers of other utilities are not being forced to support an excessively high equity ratio. In fact, in its pre-filed testimony, no Company witness attempted to demonstrate a need for such an excessive equity ratio or that any other regulatory commission has supported an equity ratio above 59%.

Q. CAN YOU QUANTIFY THE INCREASED COST TO RATEPAYERS FOR SUPPORTING THE EXCESSIVELY HIGH 59.60% COMMON EQUITY RATIO REQUESTED BY FPL IN THIS PROCEEDING?

A. Yes. The common equity ratio of NextEra Energy is a reasonable alternative to excessively high common equity ratio requested by FPL. If FPL had used the 43.8% common equity ratio of NextEra Energy in its application in this proceeding, the revenue requirement in this case would be $324 million instead of the $866 million requested to be effective January 2017 (Silagy pre-filed testimony, p. 26, l.9).

Q. WHAT WOULD BE THE IMPACT ON RATES IF THE COMMISSION EMPLOYS A REASONABLE CAPITAL STRUCTURE FOR RATEMAKING PURPOSES THAT IS COMPARABLE TO FPL PEERS, SUCH AS COMPANY WITNESS HEVERT'S COMPARABLE GROUP OF COMPANIES, AND IN-LINE WITH THE NATIONAL AVERAGE ALLOWED EQUITY RATIO?

A. If FPL utilized a capital structure that consisted of 50% common equity, the revenue requirement in this case would be approximately $529 million instead of the requested $866 million.

Q. CAN YOU QUANTIFY THIS IMPACT TO THE TYPICAL RESIDENTIAL CONSUMER?

A. Yes. Under the Company's current proposal, a residential consumer that uses 1,000 kWhs per month will see a rate increase of $8.78 per month (Schedule A-2, p. 1), which equates to an additional $105.36 per year. If FPL had used a capital structure that was reasonable and comparable to the utilities utilized by FPL witness Hevert for his testimony, and to equity ratios allowed by other regulatory commissions in other rate cases, the monthly rate increase would have been $40.97 per year lower than what FPL is herein requesting.

Table 6 below provides a summary of the impact to residential consumers of varying usage in using a 50% common equity ratio in this case.

Table 6: Impact to Residential Consumers with 59.60% Equity Ratio

Monthly Usage	Monthly Increase ($) with 59.60% Equity Ratio	Annual Increase ($) with 59.60% Equity Ratio	Annual Savings with 50.00% Equity Ratio
[1]	[1]		
500	$5.48	$65.76	$25.57
1000	$8.78	$105.36	$40.97
1500	$11.44	$137.28	$53.39
2000	$14.09	$169.08	$65.76
2500	$16.75	$201.00	$78.17
3000	$19.40	$232.80	$90.54

Notes: 1. Source is MFR, Schedule A-2, p. 1 of 6

Florida has many senior citizens that live on fixed incomes as well as low income customers. A savings of $40.97 per year would go a long way to helping seniors and low income customers make ends meet.

Q. WHAT WOULD BE THE IMPACT OF USING A CAPITAL STRUCTURE OF 50% COMMON EQUITY TO A LARGE INDUSTRIAL CONSUMER?

A. Table 7 below shows the impact to an industrial consumer (2,000) kW load) at various usages of using a 50% common equity ratio to set rates in this proceeding as opposed to FPL's excessively high common equity ratio.

Table 7: Cost Impact of Using 50% Common Equity Ratio

Load	Usage	Monthly Increase ($) with 59.60% Equity Ratio	Annual Increase ($) with 59.60% Equity Ratio	Annual Savings with 50.00% Equity Ratio
[1]	[1]	[1]		
2,000	548,000	$8,285	$99,420	$38,665
2,000	876,000	$9,417	$113,004	$43,948
2,000	1,095,000	$10,257	$123,084	$47,868
2,000	1,314,000	$11,115	$133,380	$51,872

Notes: 1. Source is MFR, Schedule A-2, p. 5 of 6

Q. HOW DO YOU THINK FPL WILL RESPOND TO THE ABOVE TABLES AND YOUR ARGUMENT THAT ITS REQUESTED EQUITY RATIO IS UNFAIR AND TOO EXPENSIVE FOR CAPTIVE CONSUMERS IN FLORIDA?

A. I expect FPL to argue that its bond ratings will be negatively impacted by this Commission's decision to use a reasonable equity ratio (50%) for calculating revenue requirements in this case.

Q. DO YOU BELIEVE FPL'S CREDIT RATING WILL BE DOWNGRADED IF THIS COMMISSION DOES NOT GRANT THE COMPANY'S REQUESTED EQUITY RATIO OF 59.60% IN THIS PROCEEDING?

A. No, I do not. The rating agencies are used to analyzing utilities with reasonable equity ratios, if anything, FPL's requested excessive equity ratio is an outlier.

While the market will definitely pay attention to the overall revenue change granted by the Commission in this case, the capital structure used for calculating the revenue requirement will have little bearing on FPL's credit rating. Instead, the credit markets are going to primarily examine the actual capital structures of NextEra Energy and FPL as opposed to how this Commission determines this matter in calculating the revenue requirement in this case.

Furthermore, it is important to understand and quantify the impacts of a hypothetical and speculative rating downgrade relative to the request for excessively high equity ratio. According to published reports, FPL intends to invest $16 billion in capital expenditures in the near future. If FPL finances this CAPEX using a capital structure of 50%, the amount it will finance with debt will be $8 billion. Assuming arguendo that FPL's bonds were downgraded, consumers may be asked to pay an additional 25 basis points in higher interest expense associated with the hypothetical downgrade. When applied to the $8 billion, the downgrade would cost consumers approximately $20 million per year in higher debt service costs. However, FPL's request in this case for a 59.60% equity ratio will cost consumers $314 million annually in higher costs. When given the choice, I am quite confident consumers would choose to pay an annual interest expense of $20 million that may result from a hypothetical and speculative ratings downgrade instead of paying an extra $337 million annually to maintain FPL's excessively high equity ratio.

E. Summary

Q. MR. O'DONNELL, PLEASE SUMMARIZE YOUR TESTIMONY IN THIS PROCEEDING

A. FPL's requested capital structure with a 59.6% common equity ratio in this proceeding is grossly excessive relative to any standard. In fact, the Company's requested equity ratio is:

- Higher and more expensive than any other common equity ratio granted by any other state regulator in the United States over the past 4 years;
- Higher than the average common equity ratio of the comparable group of companies relied upon by FPL witness Hevert, the Company's rate of return witness;
- More than double the common equity ratio of NextEra's unregulated subsidiaries;
- Higher than the common equity ratio of NextEra Energy;
- Will cost the average residential consumer in Florida who uses 1,000 kWh per month an extra $40.97 per year as opposed to a capital structure more in-line with national averages and the average of FPL witness Hevert's comparable group; and
- Will result in the typical industrial consumer paying higher rates in the range of $39,000 to $52,000 per year.

To balance the interests of stockholders and consumers, I recommend the Commission employ a fair, just, and reasonable capital structure that consists of 50% common equity and 50% debt from investor sources of capital.

Q. DOES THIS COMPLETE YOUR TESTIMONY?

A. Yes, it does.

BY MS. CHRISTENSEN:

Q And Mr. O'Donnell, did you prefile -- did your prefiled testimony have an exhibit labeled as KWO-1?

A Yes.

Q Do you have any corrections to that exhibit?

A No.

MS. CHRISTENSEN: Okay. I would ask at this time if Mr. O'Donnell be allowed to summarize his testimony.

CHAIRMAN BROWN: One moment.

Staff?

MS. BROWNLESS: We have questions.

CHAIRMAN BROWN: Okay. I'm --

MS. BROWNLESS: I am sorry. We have questions of Mr. O'Donnell, please.

CHAIRMAN BROWN: Thank you. Just a few authentication questions before he goes.

Go ahead, please.

MS. BROWNLESS: Thank you.

EXAMINATION

BY MS. BROWNLESS:

Q Mr. O'Donnell, did you review comprehensive exhibit list, which has been marked as Exhibit 579?

A Yes.

Q Okay. And with regard to Exhibit No. 530, did

you prepare that exhibit or was it prepared under your direct supervision and control?

A Yes.

Q If I were to ask you the same questions as are contained in that exhibit, would your answers be the same today?

A Yes.

Q Are they true and correct, to the best of your knowledge and belief?

A Yes, they are.

Q And are any portions of your exhibit confidential?

A No, not that I am aware of.

MS. BROWNLESS: Thank you, sir.

CHAIRMAN BROWN: Ms. Christensen?

MS. CHRISTENSEN: I would ask that the witness be allowed to summarize his testimony now.

CHAIRMAN BROWN: Thank you.

Welcome.

THE WITNESS: Thank you. It's good to be back in Tallahassee.

The purpose of my testimony in this proceeding is to present to the Commission my findings as to the proper capital structure to employ in determining revenue requirements for Florida Power

& Light.

In its filing, FPL has requested this commission grant it a capital structure that consists of 59.6 percent common equity ratio, when considering only investor-supplied funds.

This requested equity ratio of 59.6 is incredibly high by any standard. In my analysis in this case, I determined that the requested equity ratio of 59.6 is higher than any equity ratio granted by any state regulator in any major rate case heard in the United State over the past three-and-a-half years.

It's higher than the average equity ratio as found in company Witness Hevert's comparable group. It's much higher than the equity ratio of NextEra Energy.

It's approximately double the equity ratio of the NextEra unregulated affiliates; represents an additional $337 million in higher revenue requirements in this case as compared to my recommended capital structure; will cause a typical Florida residential customer to pay an additional $41 per year to support this higher equity ratio; and will cause the commercial customer with a 2000-kW load to pay anywhere from roughly $39,000 per year to $52,000 per year in higher operating costs for electricity.

The fact that the unregulated subsidiaries of NextEra have an equity ratio of less than half that of FPL's indicative strategy, whereby the unregulated affiliates are highly leveraging their operations, knowing that the parent company, NextEra, can tap the stated cash flow of its monopoly utility, FPL.

My recommendation is that the Commission deny the company's request to set rates with an equity ratio from investor sources of 59.6. Instead, I recommend the Commission set revenues based on the capital structure that consists of 50-percent debt and 50-percent equity.

In my testimony, I examine the monetary impact of a hypothetical bond rating downgrade as compared to the higher operating -- higher cost of supporting 59.6 percent equity ratio in this case.

As I explained in my testimony, if given the chance, I am confident the ratepayers would rather take the risk of paying $20 million in higher interest rates due to a credit downgrade than pay the 337 million in this case that is associated with FPL's request to have rates set at a 59.6

equity ratio.

The revenue requirement impacts of my recommendation in this case is $337 million. As stated above, there is a human element behind this $337 million figure. The $40.97 per year for the typical residential customer can go a long way in helping elderly on fixed incomes make ends meet.

The 39,000 and 52,000 annual impact to 2,000-kW industrial load is equivalent to the wages of one to two full-time employees.

This completes my summary.

MS. CHRISTENSEN: We tender the witness for cross.

CHAIRMAN BROWN: Thank you.

FIPUG.

MR. MOYLE: Thank you, Madam Chair.

EXAMINATION

BY MR. MOYLE:

Q Good afternoon, sir.

A Good afternoon.

Q You said that -- I had asked Mr. Dewhurst if -- if he could tell me for each percentage points in the equity structure whether he could assign a dollar value to each hundred basis points or one percentage point. He told me he couldn't.

So I am asking you if you can do that. And I guess -- I heard you say 337 million in savings if you don't do 60 and you do 50. Would that mean that it's $33.7 million for each hundred basis points or 1 percentage point?

A I think that's --

MR. DONALDSON: I am going to object. That sounds like friendly cross.

CHAIRMAN BROWN: I'm going to allow it.

THE WITNESS: I think that's roughly accurate. I would have to go back and recalculate the numbers because you're going to have to gross those equity ratios up from posttax to pretax, but I think that's roughly accurate.

BY MR. MOYLE:

Q Okay. And then, the second and final question I have is, is equity -- equity ratio and ROE kind of interrelate together, as I understand it; is that right?

A Yes.

Q And how -- how do they do that? I mean, if you move one, you move the other? Can you explain that, please?

A Yes. Typically, what you have is the higher the equity ratio, the lower the financial risk; the lower the financial risk, the lower the return on equity, and vice-versa. So with less risk, you demand a lower return.

Q Okay. So if it's a high -- high-equity ratio, that's a -- you would argue that puts more pressure down on the ROE, to go lower on the ROE; is that right?

MR. DONALDSON: Object, Madam Chair. Again, this is friendly cross. And your prehearing order specifically says that any party conducting --

CHAIRMAN BROWN: I'm aware of what the prehearing order says.

MR. DONALDSON: Sorry.

MR. MOYLE: I'm just asking to -- if I understood his last answer.

CHAIRMAN BROWN: He already answered the question. Asked and answered. And I believe that was your last question.

MR. MOYLE: It was. I get them wrong sometimes when they answer. But I will leave it at that. Thank you.

CHAIRMAN BROWN: Thank you, Mr. Moyle.

All right. Moving on to Hospitals.

MR. SIQVELAND: No questions for this witness. Thank you.

CHAIRMAN BROWN: Thank you.

Retail Federation.

MR. LAVIA: No questions. Thank you.

CHAIRMAN BROWN: Thank you.

FEA.

UNIDENDIFIED SPEAKER: No questions, ma'am.

CHAIRMAN BROWN: Thank you.

Sierra Club.

MS. CSANK: No questions.

CHAIRMAN BROWN: Thank you.

AARP.

MR. COFFMAN: No questions?

CHAIRMAN BROWN: Thank you.

FPL.

MR. DONALDSON: Just a couple of questions -- well, maybe a few, a couple is two.

CHAIRMAN BROWN: Although, we heard from another witness that a couple is more than two.

MR. DONALDSON: That's very true. That's very true.

EXAMINATION

BY MR. DONALDSON:

Q Good afternoon.

A Good afternoon.

Q Mr. O'Donnell, correct?

A Yes.

Q Okay. Can we agree that FPL rates are lower

on average to other electric utilities nationwide?

MR. MOYLE: I'm going to object to -- it's irrelevant.

CHAIRMAN BROWN: Overruled.

THE WITNESS: I haven't looked at that EIA data. I have heard that suggested here in this proceeding, but I do a lot of work in the wholesale market. And I can tell you right now that, if you're as heavy 70-percent natural gas, you are going to have low rates. That -- that is abundantly clear.

BY MR. DONALDSON:

Q Do you have your depo?

A No, not with me.

Q You don't have a copy of it?

A No.

Q I can share a copy of my depo, or if Public Counsel has her depo, she can potentially share it with you.

CHAIRMAN BROWN: Ms. Christensen?

MS. CHRISTENSEN: No, I don't have it.

BY MR. DONALDSON:

Q Okay. I'll -- I will walk down and share a copy of my -- of your depo with you.

The question is --

MS. CHRISTENSEN: I would object to improper impeachment. I'm not sure whether or not he is saying that the witness has responded differently than he had in his deposition.

CHAIRMAN BROWN: I haven't even heard a question yet, so I think it's a premature objection.

MR. DONALDSON: Right. Well, he definitely did answer it differently, so --

CHAIRMAN BROWN: Do you want to pose the question or do you want to --

MR. DONALDSON: Sure. It was the question I just asked: Whether or not we can agree that FPL rates are, on average, lower than other utilities on the national average.

CHAIRMAN BROWN: Okay.

MR. DONALDSON: That was the question.

CHAIRMAN BROWN: Okay. And I allowed it.

THE WITNESS: In a prior answer in the deposition that I think they are lower, again, that's what I have heard, but I have not gone into the EIA reports, as -- and checked that. I mean, EIA reports are what they are.

You can definitely sort utilities -- and I have done a lot -- from highest to lowest. And I have heard that they are lower than national average, but I haven't looked at the EIA reports.

BY MR. DONALDSON:

Q Okay. Thank you.

Can we also agree that increasing the amount of debt a company takes on also increases its financial risk?

A Yes.

Q Would you agree that, if FPL's equity ratio was reduced, FPL would have to pull out equity out of the company?

A No.

Q Okay. Am I correct that you don't know, as a general rule, whether equity ratio of a parent holding company's are lower than the equity ratio of their electric operating subsidiaries?

A As a general rule, I don't know. I mean, I know in the case of NextEra, it certainly is. In the case of Dominion, I know that it is, but I also know in the case of -- I think it was West Star, that their operating ratio is higher than that of their subsidiaries. It -- It may very well be a mix.

Q All right.

A But I know that, in terms of the equity ratios of the holding companies that I looked up, Mr. Hevert's group, it was about 50 percent. And I didn't notice that much of a difference between the equity ratios in his Exhibit 12 of 14.

Q I think you answered my question already, but thank you. Yeah.

So you didn't compare an actual operating company to another operating company as far as capital structure; is that correct?

A I think I did. I looked at Mr. Hevert's testimony.

Q But once you -- aren't you aware that Mr. Hevert's testimony used the holding company as and for ROE evaluation? You're aware of that, right?

A I think he used -- he had two exhibits --

Q You can say yes or no and then you can give an explanation, sir.

A I'm aware of that, yes. But he also had two exhibits; one for holding company, one for operating company.

Q Okay. And within your specific testimony, you did not do a comparison with respect to a operating company just like FPL and what those capital structure rates are?

A I don't think --

Q Correct, yes or no?

A No.

Q Okay.

A No, that's not accurate because, if you look at my testimony in chart one, to the extent that these are operating companies that are regulated by PSCs, that comparison is there.

Q You didn't have any compensation with any analysts from Moody's or S&P or Value Line regarding this case, correct?

A No.

Q All right. And isn't it true that you don't speak for any credit rating agencies?

A That's correct.

Q And you don't have any specific knowledge of whether a credit rating agency will downgrade FPL if its equity ratio is lowered to 50 percent, true?

A I can't speak for them --

MR. MOYLE: Speculation.

BY MR. DONALDSON:

Q Okay. Again, you have never worked for a credit rating agency; is that correct?

A No, I have never worked for S&P or Moody's. No, I have not.

MR. DONALDSON: Okay. Hold on one second. That's all I have. Thank you.

CHAIRMAN BROWN: Okay. Staff.

EXAMINATION

BY MS. BROWNLESS:

Q Good afternoon.

A Good afternoon.

Q We're going to start out with the standard questions I have asked everybody. Were you provided responses to staff's interrogatories and POD requests associated with your subject area as they became available?

A Yes.

Q And were you also provided in responses associated with your subject area responses to FIPUG's, FEA's, South Florida's, AARP's discovery requests as they became available?

A Yes.

Q And during the course of the -- your engagement in this proceeding, did you review the responses to OPC's interrogatories and PODs as they became available?

A As they pertain to my area, yes.

Q Thank you.

And I assume that, to the extent you prepared any questions that OPC subsequently asked, you reviewed the responses to the questions you asked.

A Yes.

Q All right. If we can turn to page 12 of your testimony. And on line 14, can you review your testimony from line 14 to line 20.

A Yes.

Q Okay. Do you know how FP&L's customer growth compares to the customer growth of similar utilities nationwide?

A Recently, no.

Q When you say recently, what time period are you talking about?

A Over the past few years. I mean, obviously back in the -- prior to 2010, I think there was very strong growth in South Florida. Since then, because of the housing market and whatnot, I -- I simply have not followed the kind of growth that FPL has had.

Q Okay. So in the last six years you haven't followed it.

A Not extensively, no.

Q Assume for the purposes of this question that FPL's customer growth rate is higher than the average nationwide. Would that mean that FP&L and its customers are not experiencing the ramifications of the unbalanced debt equity level which you discussed in the testimony I referred to?

A No, I am sorry. I -- I don't see that. I don't agree with that. I don't see the link that you're referring to there.

Q Okay. Do you know how housing starts in FPL's service territory compared to those nationwide?

A No, I don't.

Q Do you know how the unemployment rate in FP&L's service territory compares to that of the nation?

A No, I don't.

Q Do you know how FP&L's rates compare to other Florida electric utilities?

A I have heard that their rates are lower than other Florida utilities. And I think I have already opined as to why they seem to be lower than the other utilities.

Q And do you know how FP&L's rates compare to other electric utilities nationwide?

A From what I heard earlier today, just a few minutes ago, it appears that they are going to be lower than other electric utilities across the country. And that is exactly what I would expect when 70 percent of your energy supply is coming from natural gas.

If I can give you a quantification here --

Q Sure.

A I do a fair amount of work in the wholesale market. Wholesale market is on the natural -- or natural gas is on the margin in the wholesale market right now. And you're looking at prices between $35 and $45 a megawatt hour --

Q Yes, sir.

A -- in the open market; whereas, if you look at most regulated utilities, at least here in the southeast, they are at better cost between $60 and $80 a megawatt hour. So if you have a heavy portfolio of natural gas generation, you are going to have lower rates.

And that's indicative of also the fact that I am doing wholesale deals right now. And I do anticipate cutting my rates for my -- my towns, my clients very significantly once our oil contract rolls off and we enter into the new contracts.

Q Would you agree that because FP&L's rates are as low, that FP&L and its customers are not experiencing the ramifications of an unbalanced debt equity level as you discussed in your testimony?

A No, I cannot agree with that. Again, I think the reason why their rates are lower is due to the fact that they have such a heavy reliance on natural gas.

Q Okay. Can you state today that FPL's credit rating will not be negatively impacted if the Commission

reduces their equity ratio to the 50-50 you have suggested?

A I feel confident that it will not be.

Q And what are you basing that on?

A My 32 years of experience in the industry. The fact that, also, I think Mr. Lawton comes up behind me, and he has done an extensive analysis on that.

Q Okay. And just out of curiosity -- this is for me -- have you had any discussions with Moody's or Standard & Poor's or any of the rating agencies with regard to this issues?

A In my days working for the North Carolina commission, yes, but that's a couple decades ago. But in this particular case, no.

Q Thank you.

A And quite frankly, that may be considered insider trading in some form or fashion. So I really wouldn't want to.

Q Well, I certainly don't want you to do anything that's inappropriate, sir.

Can you turn to page 26 of your testimony, please. And can you review lines one through six.

A Yes.

Q Okay. Do you believe that the markets will pay attention to any revenue change granted by this

commission with regard to your equity ratio recommendation, but that rating agencies will not pay attention to that same change?

A I think all of that kind of rolls together. I think that the credit agencies are going to be looking at the results of this rate case. But I don't believe they are going to drill down into the fact that, well, this commission, instead of granting a 59.6, we are granting them 50 percent. I think they will be looking at the overall dollars.

MS. BROWNLESS: Thank you so much.

That concludes our cross.

CHAIRMAN BROWN: Thank you.

Commissioners, any questions?

Seeing none, redirect?

MS. CHRISTENSEN: Thank you.

FURTHER EXAMINATION

BY MS. CHRISTENSEN:

Q And good evening, Mr. O'Donnell. I think you were asked several times probably by staff and FPL regarding your use of Standard & Poor's and Moody's. How do you use Standard & Poor's and Moody's in your line of work as an expert?

A Well, obviously we look at the credit ratings and -- and we see what we are going to be recommending relative to these various benchmarks. And then we also look at the details of how Standard & Poor's and Moody's review -- how they do the various ratings.

I think Dr. Woolridge adequately said earlier today about Standard & Poor's will look more towards the parent company and the groups of companies within the -- all of the companies within -- under FPL. They are going to look at -- or excuse me, under NextEra.

They're going to look at NextEra. They are going to look at the unregulated subsidiaries. And they are going to look at FPL. And so those are all the things that I'm going to look at and they're going to be all the things that I'm going to factor into when I look at my recommendations in these cases.

Q Okay. And you utilize the Standard -- or do you utilize the Standard & Poor's and Moody's reports to inform your recommendations regarding equity ratios?

A Yes.

Q Okay. And in this case, did you review the equity ratios of holding companies that were used as part of the -- or Mr. Hevert's -- or Hevert's, excuse me -- proxy group?

A Yes, that is a -- Table 3 in my testimony.

Q Okay. And can you explain to us why, as part of your example, you refer to the holding companies and

not, generally speaking, operating companies in trying to determine and establish what an appropriate equity ratio would be?

A Well, because there is a link between the price that someone is going to pay for that -- for that particular stock and the equity ratio that they may see.

These numbers in Table 3 came from Value Line. So when investors are going to pop up on Value Line, they are going to look at these numbers and they are going to say, oh, okay. Well, I think I may want to pay a little bit more for AEP than -- I think that's -- excuse me -- yeah, AEP versus CMS because, you know, they have a little bit higher equity ratio.

So in that -- price is going to be reflected in your DCF model. That's going to be capturing your return on equity. So all of these factors flow together. The equity ratio flows together with your return on equity.

Q Okay. And can you explain, I think -- I think some -- there was some inference in the questioning from FPL's attorneys that you were comparing -- you were comparing apples to oranges by comparing holding companies to operating companies.

Can you explain why you look at both holding companies and operating companies in coming up with your equity-ratio recommendation for the Commission?

A Well, really, my chart one, which looks at what other states have done, I looked at this in terms of holistically. I wanted to look at what has the company's witness done in this particular case; then, what have other state commissions given those operating companies.

So it -- again, it's looking at both aspects of it: This is what other state commissions have done, and then this is how your stock price will compare to your equity ratio. And those two are linked.

But I thought it was important to present both of these facts to the Commission, in particularly the chart one that shows what other operating companies are being granted for equity ratios across the country.

Q Okay. And if you know, are there any operating companies and parent companies that you reviewed in your preparation of testimony that have the same equity ratio?

A I am certain that there are some. I can't remember what they may be at this point in time. I think maybe, if I remember correctly, South Carolina Electric and Gas, SCANA, may be one.

MS. CHRISTENSEN: Okay. And -- okay. I have no further questions on redirect. Thank you very much.

CHAIRMAN BROWN: Thank you. Thank you for your testimony.

Exhibits -- there is just one associated with this witness.

MS. CHRISTENSEN: Yes. I would ask to have Mr. O'Donnell's exhibit -- and if you give me a moment, I --

CHAIRMAN BROWN: 179.

MS. CHRISTENSEN: 179 moved into the record.

CHAIRMAN BROWN: Okay. Well, seeing no objection --

MR. DONALDSON: No objection.

CHAIRMAN BROWN: -- we will move 179 into the record.

(Whereupon, Exhibit No. 179 was received into evidence.)

CHAIRMAN BROWN: OPC, you still have an outstanding one with Woolridge, 711. Would you like to move that into the record at this time? It's the errata.

MS. CHRISTENSEN: Yes, I would ask to have that moved into the record at this time. I think we finally got a completed errata sheet from Mr. Woolridge.

CHAIRMAN BROWN: Any objection?

MR. BUTLER: Madam Chair?

CHAIRMAN BROWN: Yes?

MR. BUTLER: We don't know whether we do or don't have an objection. We would like to have the opportunity for Mr. Hevert to review this before he we take a position on it. He won't be available until tomorrow evening. So, if we can defer this --

CHAIRMAN BROWN: I will.

MR. BUTLER: -- would appreciate it.

CHAIRMAN BROWN: Sure. We will not take that up.

MR. BUTLER: Thank you.

CHAIRMAN BROWN: Would you like this witness dismissed?

MS. CHRISTENSEN: Yes. I would ask that this witness be excused, please.

CHAIRMAN BROWN: Excused, not dismissed.

THE WITNESS: Thank you --

CHAIRMAN BROWN: Have a good night. Safe travels.

THE WITNESS: Thank you.

(Witness excused.)

CHAIRMAN BROWN: Thank you.

At this time, we will call -- we will have office of Public Counsel, would you like to call Lawton or Smith?

MS. CHRISTENSEN: I believe Mr. Lawton is here. And I am not sure if Mr. Smith has arrived yet. So if we could just call Mr. Lawton and then we'll see where we are with Mr. Smith after that, please.

CHAIRMAN BROWN: Okay. Great.

Mr. Lawton?

MS. BROWNLESS: Madam Chair, while Mr. Lawton is coming up to the witness stand, with regard to Exhibit 178, Mr. Woolridge's exhibit -- did that get moved into the record?

CHAIRMAN BROWN: Yes, 178 got moved into the record.

MS. BROWNLESS: Thank you, ma'am.

CHAIRMAN BROWN: You're welcome.

All right.

MR. SAYLER: Madam Chair, there is an errata for Mr. Lawton's testimony to pass out.

CHAIRMAN BROWN: Okay. We are on 716.

And just to give the parties an idea of timeframe, I'm hoping to -- if this goes 30, 45 minutes, I'm hoping to take a dinner break after this witness.

Mr. Lawton, were you sworn in?

THE WITNESS: Yes, Madam Chairman. I was sworn in at the beginning of the proceedings today.

CHAIRMAN BROWN: Thank you.

MR. MOYLE: Madam Chair, while they're -- while they're passing out this errata, you know, we have also put witnesses on the stand and said, do you have any changes, and they say, oh, yes, I have this change and they do it verbally. So I assume it's six in one, half a dozen of another; is that right?

CHAIRMAN BROWN: Yes, it's Office of Public Counsel's preference --

MR. MOYLE: Okay.

CHAIRMAN BROWN: -- to have it marked as an exhibit. So, we'll do -- I am entertaining that.

MR. MOYLE: Okay. I may have another preference tomorrow with my witness. All part of the record.

MR. JERNIGAN: Ma'am?

CHAIRMAN BROWN: Yes.

MR. JERNIGAN: Just as we're moving along, since we are having a dinner break, are we anticipating getting to witnesses today or you think --

CHAIRMAN BROWN: Yes. Yes. I would like to get to the FEA witnesses after dinner.

MR. JERNIGAN: You are thinking all three?

CHAIRMAN BROWN: Yeah.

MR. JERNIGAN: Okay. Thank you.

CHAIR BROWN: All right. Mr. Sayler, you would like this marked as an exhibit?

MR. SAYLER: Yes, ma'am. I would like the errata to the direct testimony of Daniel J. Lawton marked as an exhibit.

CHAIRMAN BROWN: 716.

(Whereupon, Exhibit No. 716 was marked for identification.)

MR. SAYLER: Thank you.

CHAIRMAN BROWN: You're welcome.

You have the floor.

MR. SAYLER: Thank you, Madam Chair.

EXAMINATION

BY MR. SAYLER:

Q Good evening, Mr. Lawton. How are you tonight?

A Oh, very well. Thank you.

Q All right. You have been previously sworn; is that correct?

A That is correct.

Q All right. Would you please state your name and business address for the record.

A Sure. My name is Daniel Lawton. My business address is 12600 Hill Country Boulevard, Suite R-275 Austin, Texas.

Q And you have prepared and caused to be filed 30 pages of direct testimony in this proceeding; is that correct?

A I have.

Q And on August 28th -- yesterday -- Office of Public Counsel filed an errata sheet for your direct testimony; is that correct?

A Yes.

Q And that's been identified as Exhibit 716.

Beyond the filed errata, do you have any further changes or revisions to your prepared testimony?

A Not that I am aware of. Thank you.

Q All right. With the changes in your errata, if I asked you the same questions contained in your direct testimony, would your answers be the same?

A They would, indeed.

MR. SAYLER: All right. Madam Chair, I would ask that the testimony of Mr. Lawton be inserted into the record as though read.

CHAIRMAN BROWN: We will insert Mr. Lawton's prefiled testimony into the record as though read.

MR. SAYLER: All right.

(Prefiled direct testimony inserted into the record as though read.)

ERRATA SHEET

WITNESS: **DAN LAWTON – DIRECT TESTIMONY AND EXHIBITS**

Testimony Errata

PAGE #	LINE #	CHANGE
27	10	Delete "three" and replace with "two"
27	16-18	Delete "A third S&P financial metric is Debt to Capital (Debt/Capital) and is the same indicator of financial leverage employed by Moody's as discussed earlier."
29	15	Delete "Debt/Capital" from the third row, under the column entitled "S&P"

Exhibit Errata

Exhibit DJL-5 Financial Metric Evaluation (Page 1 of 1)

Replace the following second table from DJL-5:

ALTERNATIVE CAPITAL STRUCTURE, COST RATES, AND RETURN ON EQUITY@ 8.75%

DESCRIPTION	CAPITAL	RATIO	COST RATE	WEIGHTED COST	RETURN
LONG TERM DEBT	$11,636,598	35.56%	4.62%	1.643%	$537,611
CUSTOMER DEPOSITS	$409,700	1.25%	2.050%	0.026%	$8,399
COMMON EQUITY	$12,398,749	37.89%	8.750%	3.315%	$1,084,891
SHORT TERM DEBT	$762,151	2.33%	1.850%	0.043%	$14,100
DEFERRED INCOME TAX	$7,411,492	22.65%	0.000%	0.000%	$0
INVESTMENT TAX CREDITS	$106,894	0.33%	6.750%	0.022%	$7,215
TOTAL CAPITAL	$32,725,584	100.00%		5.049%	$1,652,215
RATE BASE			$32,725,584		($497,703)

PER COMPANY FILING SCHEDULES B-1, ADJUSTED PER OPC TESTIMONY OF RALPH SMITH EXHIBIT RCS-2 P. 15.

With the following table (Revised 8/27/2016):

ALTERNATIVE CAPITAL STRUCTURE, COST RATES, AND RETURN ON EQUITY@ 8.75%

DESCRIPTION	CAPITAL	RATIO	COST RATE	WEIGHTED COST	RETURN
LONG TERM DEBT	$11,553,623	35.56%	4.62%	1.643%	$533,777
CUSTOMER DEPOSITS	$406,779	1.25%	2.050%	0.026%	$8,338.97
COMMON EQUITY	$12,310,339	37.89%	8.750%	3.315%	$1,077,154.73
SHORT TERM DEBT	$756,716	2.33%	1.850%	0.043%	$13,999
DEFERRED INCOME TAX	$7,358,644	22.65%	0.000%	0.000%	$0
INVESTMENT TAX CREDITS	$106,132	0.33%	6.750%	0.022%	$7,164
TOTAL CAPITAL	$32,492,233	100.00%		5.049%	$1,640,434
RATE BASE			$32,492,235		($509,484)

PER COMPANY FILING SCHEDULES B-1, ADJUSTED PER OPC TESTIMONY OF RALPH SMITH EXHIBIT RCS-2 P. 15.

DJL-5 BOTTOM TABLE

LINE #	CHANGE	
1	Change	$32,725,584 to $32,492,235
3	Change	$1,652,215 to $1,640,434; and ($497,703) to ($509,484)
4	Change	$1,140,564 to $1,641,771; and ($525,361) to ($950)
5	Change	$2,792,779 to $3,282,205; and ($1,023,064) to ($510,434)
6	Change	$12,398,749 to $12,310,339; and $2,427,393 to $2,338,983
7	Change	$551,711 to $547,777; and "blank" to $104,078
8	Change	5.1 to 6.0
9	Change	22.52% to 26.66%

DIRECT TESTIMONY

Of

Daniel J. Lawton

On Behalf of the Office of Public Counsel

Before the

Florida Public Service Commission

Docket No. 160021-EI, et al (consolidated)

I. INTRODUCTION/BACKGROUND/SUMMARY

Q. PLEASE STATE YOUR NAME AND BUSINESS ADDRESS.

A. My name is Daniel J. Lawton. My business address is 12600 Hill Country Boulevard, Suite R-275 Austin, Texas 78738.

Q. PLEASE DESCRIBE YOUR EDUCATIONAL BACKGROUND AND WORK EXPERIENCE.

A. I have been working in the utility consulting business as an economist since 1983. Consulting engagements have included electric utility load and revenue forecasting, cost of capital analyses, financial analyses, revenue requirements/cost of service reviews, regulatory policy issues, and rate design and cost allocation analyses in litigated rate proceedings before federal, state and local regulatory authorities. I have worked with municipal utilities developing electric rate cost of service studies for reviewing and setting rates. In addition, I have a law practice based in Austin, Texas. My main areas of legal practice include administrative law representing municipalities in electric and gas rate proceedings and other litigation and contract matters. I have included a brief description of my relevant educational background and professional work experience in Schedule (DJL-1).

Q. HAVE YOU PREVIOUSLY FILED TESTIMONY IN RATE PROCEEDINGS?

A. Yes. A list of cases in which I previously filed testimony is included in Schedule (DJL-1).

Q. ON WHOSE BEHALF ARE YOU FILING TESTIMONY IN THIS PROCEEDING?

A. I am testifying on behalf of the Florida Office of Public Counsel ("OPC").

Q. WHAT IS THE PURPOSE OF YOUR TESTIMONY IN THIS PROCEEDING?

A. The purpose of my testimony is to address two issues in this case. First, I address Florida Power & Light's ("FPL's" or "Company's") requested surplus equity return inflator in excess of the already inflated market cost of equity requested by FPL. In this case, as part of the proposed four-year rate plan, the Company requests a return on shareholder equity of 11.00%[1] and then further requests an additional upward adjustment or inflator of 50 basis points for an 11.50% total equity return for rate-setting.[2] OPC witness Dr. Woolridge addresses FPL's 11.00% shareholder return on equity ("ROE") request in light of current capital market costs recommended by FPL witness Hevert, while I address the incremental 50 basis point surplus return on equity request recommended by FPL witness Dewhurst.

[1] See Direct Testimony Moray Dewhurst at p. 5 lines 10-13, citing witness Hevert's ROE recommendation.
[2] See Direct Testimony Moray Dewhurst at p. 5 lines 13-16.

The second issue I address is FPL's cash flow and financial integrity metrics. Specifically, I address the impact of the OPC's recommended return and revenue requirement recommendations on FPL's financial metrics and financial integrity.

II. SURPLUS EQUITY RETURN INFLATOR REQUEST

Q. WHAT ISSUE DO YOU ADDRESS IN THIS SECTION OF YOUR TESTIMONY?

A. In this section of my testimony, I address the Company's proposed surplus equity return inflator request. As discussed below, the Company has requested that its equity return or shareholder profit be inflated from the requested 11.00% to 11.50%. Under FPL's proposal, the 50 basis point surplus return would be added to shareholder profit, and paid by customers.

Q. PLEASE DESCRIBE THE COMPANY'S PROPOSED RATE INCREASE PLAN?

A. The Company has proposed a series of three base rate increases to be implemented over a proposed four-year rate plan covering the period January 2017 through December 31, 2020 with no other base rate increase requests until 2021.[3] All three of the proposed rate increases in the four-year rate plan are based on the requested equity return of 11.50%, which includes the 50 basis point surplus ROE inflator.[4] It is important to note that FPL's current authorized ROE is 10.50% based on the Commission's approval of the 2012 Rate Settlement.[5]

[3] Direct Testimony Eric Silagy at p. 20 lines 6-11.
[4] Direct Testimony Eric Silagy at p. 23 lines 19-23.
[5] Direct Testimony Eric Silagy at p, 23, lines 7-8.

The Company's first increase, or 2017 base rate increase proposal, requests an $866 million annual increase to be effective in January 2017.[6] The claimed cost driver for the 2017 base rate increase is "… driven in large part by the significant investment during 2014-2017 …"[7] The requested ROE with surplus inflator would be 11.50% and the associated revenue and income tax factors, when applied to the Company's requested investment level, drives the size of the base rate increase.

The second base rate increase request under the Company's four-year rate plan is the 2018 Subsequent Year Adjustment.[8] This subsequent year request assumes that the Commission will approve the 11.50% inflated ROE requested by FPL. The Company asserts that even if the entire 2017 request is granted the FPL authorized equity return will fall below the bottom of the proposed ROE range in calendar year 2018. Thus, rather than file for another base rate increase case in 2018, the Company is requesting a Subsequent Year Adjustment to increase rates effective January 2018 by approximately $262 million annually.[9] The Company claims the primary cost drivers for the $262 million Subsequent Year Adjustment 2018 rate increase are the continued investments in system infrastructure to address system growth and provide long-term economic and/or reliability benefits to customers.[10] A review of the FPL filed Schedule A-1 for the 2017 base rate case and the 2018 Subsequent Year Adjustment shows that claimed rate base investment levels increase from $32,536,116,000 to $33,870,897,000

[6] Direct Testimony Eric Silagy at p, 26, line 9.
[7] Direct Testimony Eric Silagy at p, 21, lines 13-14.
[8] Direct Testimony Eric Silagy at p, 24, line 22
[9] Direct Testimony Eric Silagy at p, 26, line 10.
[10] Direct Testimony Eric Silagy at p, 25, lines 1-3.

or by $1,334,781,000. Thus, the Subsequent Year Adjustment $262 million rate increase request is driven in large part by the requested 11.50% ROE which includes the surplus inflator.

The third rate increase addresses the cost of FPL's Okeechobee facility which is expected to be implemented on or about June 2019 when the Okeechobee facility begins commercial operation.[11] The Company estimates a rate base investment increase of $1.063 billion for the Okeechobee facility 2019 adjustment.[12] The resulting annualized rate increase for the 2019 Okeechobee facility adjustment is $209.024 million.[13] This additional increase in investment is applied to the requested 11.0% equity return plus the requested 50 basis point surplus equity return inflator requested by FPL. Again, this Okeechobee increase is to be implemented on or about June 1, 2019, more than two and one half years after the Commission hears FPL's current rate case. No further rate increases are proposed in 2020.

Q. PLEASE SUMMARIZE THE PROPOSED RATE INCREASES EXPECTED OVER FPL'S PROPOSED FOUR-YEAR RATE PLAN?

A. If approved by the Commission, the Company's proposed four-year rate plan will result in an $866.354 million annual increase in 2017. This will be followed by a $262.292 million annual increase in 2018, followed by an additional $209.024 million annual increase beginning in June 2019. Thus, under the Company's rate plan, customer rates

[11] Direct Testimony Eric Silagy at p, 25, lines 6-8. Also see Schedule A-1 Okeechobee Limited Scope 2019.
[12] See Schedule A-1 Okeechobee Limited Scope 2019.
[13] See Schedule A-1 Okeechobee Limited Scope 2019.

will increase by about $1,337.670 million annually between January 1, 2017 and June 2019.[14]

Q. WHAT IS THE FINANCIAL IMPACT ON CUSTOMERS OF THE 50 BASIS POINT SURPLUS ROE INFLATOR ADDED BY FPL EACH YEAR AND OVER THE FOUR YEAR PROPOSED FPL RATE PLAN?

A. If approved by the Commission, the Company's proposed 50 basis point surplus ROE inflator proposal would increase customer rates approximately $502 million over the four-year life 2017 through 2020 of the proposed rate plan. I have summarized in Schedules (DJL-2) through (DJL-4) the annual impacts of the 50 basis point surplus ROE inflator proposed by FPL. The total impacts of FPL's requested surplus ROE over the life of the four-year rate plan are summarized in Table 1 below.

[14] FPL has filed three post-petition Notices of Identified Adjustments that contain relatively minor revenue requirement net reductions to the overall revenue request. I have not attempted to incorporate these adjustments into the original petition figures.

TABLE 1
ANNUAL IMPACT OF FPL'S PROPOSED 50 BASIS POINT SURPLUS EQUITY RETURN INFLATOR ON CUSTOMER REVENUE REQUIREMENTS

YEAR	INCREMENTAL IMPACT	CUMMULATIVE IMPACT OF ALL PLAN INCREASES
2017	$119.718 MILLION[15]	$119.7 MILLION
2018	$4.929 MILLION[16]	$124.7 MILLION
2019	$3.053 MILLION[17]	$127.7 MILLION
2020	$2.181 MILLION[18]	$129.9 MILLION
TOTAL		**$501.98 MILLION**

Q. PLEASE DESCRIBE HOW YOU ESTIMATED THE ANNUAL IMPACT ON REVENUE REQUIREMENTS OF THE 50 BASIS POINT SURPLUS EQUITY RETURN INFLATOR?

A. To calculate the annual revenue requirement impact of FPL's proposed 50 basis point surplus equity return inflator on annual revenue requirements, I recalculated the overall cost of capital for each year of the rate plan employing a cost of equity capital of 11.0% which excludes the requested 50 basis point surplus equity return inflator. The point of this analysis is to isolate and identify the substantial impact that the 50 basis point surplus equity return inflator will have on customer rates. Dr. Woolridge, OPC's cost of capital witness, will be reviewing the FPL requested 11.0% equity return presented by FPL witness Hevert. OPC witness Dr. Woolridge will recommend the appropriate

[15] The calculation details are shown in Schedule (DJL-2)
[16] The calculation details are shown in Schedule (DJL-3)
[17] The total incremental increase estimated for 2019 is $5.234 million which is reduced for an expected June 1, 2019 start date or ((7/12)*$5.234 mm)=$3.053 million. The revenue requirement impact of removing the 50 basis point surplus ROE inflator calculation details are shown in Schedule (DJL-4)
[18] The 2020 amount is adjusted upwards for the incremental change for five months of January through May 31, 2020 for the incremental 2019 Okeechobee increase.

equity return without consideration of a surplus equity return inflator that the Commission should authorize in this proceeding.

As shown in Schedule (DJL-2), the first step in the analysis is to duplicate the FPL revenue requirement request. This is presented on lines 1 through 9 on the left half of the schedule for the year 2017. The resulting revenue requirement of $866 million for 2017 employs the capital structure and cost rates requested by FPL (including the 50 basis point equity return inflator) as presented on lines 10 through 18.

On the right side of Schedule (DJL-2), lines 1 through 9 show the result or impact of removing the 50 basis point equity return inflator from the Company's cost of capital request. The impact is substantial. Removing the 50 basis point surplus equity return inflator results in reducing the $866 million 2017 rate increase request by about $120 million as shown on line 8 of Schedule (DJL-2).

A similar type of analysis was performed on FPL's 2018 and 2019 rate requests as shown on Schedules (DJL-3) and (DJL-4) respectively. These 2018 and 2019 analyses evaluate the impact of removing FPL's proposed 50 basis points surplus equity return inflator from the requested 11.50% ROE as applied to the incremental increase in rate base investment for each year. The annualized impact of removing the 50 basis point surplus equity return inflator from the 2018 Subsequent Year request is about $4.9 million. The annualized impact of removing the 50 basis point surplus equity return inflator from the 2019 Okeechobee revenue requirement is about $5.2 million. Given that the Okeechobee facility is expected to be in service June 2019, the impact of removing FPL's proposed surplus equity return inflator for the remaining seven months of 2019 is about \$3.03 million.[19] However, the full annual impact of FPL's proposed surplus equity return inflator for the Okeechobee facility rate adjustment is approximately \$5.2 million and will occur in 2020, the last year of the four-year rate plan.

If approved by the Commission, the 50 basis point surplus equity return inflator will allow FPL to extract an extra \$502 million from customers over the four-year rate plan as proposed by the Company.

Q. HOW DOES FPL PROPOSE TO IMPLEMENT THE SURPLUS EQUITY RETURN INFLATOR?

A. If approved by the Commission, FPL's proposed surplus equity return inflator would be added to the authorized equity return and become part of the base rates. The surplus equity return inflator would remain part of base rate tariffs until modified by the Commission in some future base rate proceeding. Again, the impact of the surplus equity return 50 basis point inflator is shown year by year for the proposed four-year rate plan in Schedules (DJL-2, 3, and 4), as well as Table 1 above.

Thus, if the requested 50 basis point surplus equity return inflator proposal by FPL is approved, consumer base rates will be on average approximately \$125 million higher annually and will cost customers an extra \$502 million over the four-year rate plan.

[19] Given a June 2019 commercial operation date the rate impact is for seven months (7/12)*\$5.2 million= \$3.03 million.

Consumer base rates will remain higher until the surplus equity return inflator is removed. Consumers will pay these higher base rates whether FPL performs efficiently or inefficiently. The surplus equity return inflator proposal is not symmetric. For example, poor FPL performance in the future when these rates are in effect does not result in a lower equity return. Moreover, poor performance does not impact the level of the surplus equity return inflator and consumer revenue requirements once included in base rates.

The bottom line is that, based on the evidence provided in its filing, FPL's proposed surplus equity return inflator is quite expensive in that it would raise consumer rates on average approximately $125 million annually, and would cost customers an extra $502 million over the four-year period it would be in effect. Further, the surplus equity return inflator proposal would continue to inflate rates even if FPL's future performance is poor.

Q. WHAT IS FPL'S CLAIMED REASON FOR REQUESTING THE SURPLUS EQUITY RETURN INFLATOR?

A. FPL's rationale and specific reasons for the surplus equity return inflator request is outlined and described in the direct testimony of FPL witness Dewhurst. Mr. Dewhurst states:

> "FPL is asking the Commission to increase the authorized ROE established in this case by 50 bps, ***both to reflect what FPL has already accomplished*** **in its efforts to deliver superior value to its customers** ***and as an incentive*** **to promote further efforts to improve the customer value proposition.**"[20] (emphasis added)

[20] Direct Testimony Mr. Dewhurst at p. 27, lines 7-10.

Thus, FPL provides two general reasons as the basis for the surplus equity return inflator in this proceeding. First, FPL claims that efforts in historical (past) performance have led to the delivery of superior value to customers and should be rewarded. Second, FPL claims that the granting of a surplus equity return inflator will be an incentive to promote additional and further efforts to improve customer value.

Q. DO YOU AGREE WITH FPL'S REASONING FOR CLAIMING THE NEED OR JUSTIFICATION FOR AN EQUITY RETURN INFLATOR FOR PAST ACCOMPLISHMENTS IN THIS CASE?

A. No, I do not. I will address below the seven specific categories of service, accomplishments, and related efforts that FPL claims are worthy of the surplus equity return inflator. However, even accepting as accurate, for the sake of argument, FPL's claim that its quality of service is exceptional, this does not justify a surplus equity return inflator for past service and efforts. First, customers paid historical Commission authorized tariff rates for electricity and electric service, and the Company was authorized to, and did, earn a return through those rates. There are no terms and conditions in the historical or existing tariffs that historical performance, or exceptional performance, by the Company can or will lead to higher profit levels in the future. However, FPL is now requesting a retroactive review of historical performance to justify higher future profits for shareholders. Such retroactive ratemaking is not appropriate. It would be equally impermissible for consumers to review FPL's past excess profit levels (if such excesses existed) and set future rates to earn lower shareholder profits in an effort to recapture past excesses.[21]

It should also be noted that the current base rates were approved by the Commission as part of an overall non-unanimous settlement of the last FPL rate case. None of the settlement terms or any provisions of the Commission's final order approving rates consistent with the non-unanimous settlement set forth any provisions suggesting historical FPL performance would form the basis of added shareholder profits in future rate proceedings. Instead, rates and tariffs were established for consumers to pay for electric service, and FPL was provided an opportunity to earn a midpoint profit level of 10.50% on shareholder equity. FPL's management performance, like any other regulated utility, is always expected to be prudent in (1) seeking the lowest reasonable costs to consumers, while maintaining the highest reasonable level of reliability; (2) maintaining the lowest reasonable level of emissions from power plants; (3) maintaining the highest reasonable level of consumer service; (4) maintaining the highest level of efficiency and reliability in generating plants; and (5) seeking the lowest reasonable non-fuel O&M costs for consumers. If FPL's management has adequately satisfied those performance expectations on an historical basis, that was presumed because such prudent management behavior was certainly an expectation of the regulatory bargain. However, prudent management and historical success in keeping costs down, improving generation efficiency, and electric reliability are

[21] There is a limited exception, allowing the Commission to look back and penalize a company being guilty of mismanagement due to various instances of misconduct by an executive management official. *See Gulf Power Co. v Wilson*, 597 So. 2d 270, 272 (Fla. 1992). A penalty involving managerial misconduct is not retroactive ratemaking.

reasonable consumer expectations and do not form the basis for additional future profits.

In terms of FPL's second point, that granting the gratuitous equity return performance "bonus" or inflator will be an incentive to promote additional and further efforts to improve customer value, I do not agree such incentives are necessary.

The Company takes the position that positive economic incentives are necessary to induce pursuit of superior customer value.[22] In my opinion, monopolies such as FPL, when granted the monopoly franchise, have a duty to provide superior performance in exchange for cost recovery plus an opportunity to earn a fair and reasonable return or profit commensurate with profits earned from similar risk ventures. Enhanced customer value includes providing service at the lowest rates consistent with good service. In other words, efforts to keep rates as low as reasonably possible are part and parcel of FPL's obligation to serve.

Further, FPL enjoys advantages that competitive enterprises must envy— the absence of competition for market share; a suite of cost recovery mechanisms that greatly reduce the risks that costs will not be recovered; the ability to seek changes in prices when necessary to have an opportunity to earn a fair return, just to name a few. In short, FPL enjoys a privileged position. No additional surplus equity inflator is necessary.

[22] Direct Testimony, Dewhurst at p. 31, lines16-18

Q. HAS THIS COMMISSION PREVIOUSLY ADJUSTED A COMPANY'S ROE?

A. Yes, as noted by Mr. Dewhurst, this Commission did award an upward adjustment of 25 basis points to Gulf Power Company's ("Gulf's") equity return.[23] In that Gulf proceeding, this Commission stated: "We find that Gulf's past performance has been superior and we expect that level of performance to continue into the future."[24] However when discussing whether to create an incentive mechanism to promote reliability of service, the Commission found that factors outside of Gulf's control should be considered, stating: ". . Gulf frequently points to its low rates as a benefit to its customers and a factor that should be considered in granting rewards. Gulf does not mention that its geographic location contributes to its low rates."[25] Similarly, FPL touts the fact that it has the lowest rates in the State while failing to mention that its lower rates are a direct result of historically low natural gas prices more than superior managerial performance.

Q. IN ADDING 25 BASIS POINTS TO GULF'S ROE, DID THE COMMISSION SHIFT THE ROE RANGE BY 25 BASIS POINTS?

A. No. In the Gulf case, the Commission set the equity return at 12.0% to reflect the determination of a 25 basis point adjustment for performance, and used 11.75% at the mid-point ROE, and established 10.75% to 12.75% as the ROE range.[26] In other words,

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[23] *Id.* at p. 28, lines 15-19. Also see Docket No. 010949-EI, Order No. PSC-02-0787-FOF-EI, p. 35 (issued June 10, 2002)

[24] See Docket No. 010949-EI, Order No. PSC-02-0787-FOF-EI, p. 35 (issued June 10, 2002) at p. 35.

[25] *Id.* at p. 34 (in declining to adopt an incentive mechanism, the Commission stated that an incentive mechanism should include rewards and penalties, something which FPL is not proposing in this case)

[26] *Id.* at p. 36.

the Commission increased Gulf's ROE for rate-setting purposes, but did not shift the ROE range upwards as well.

Q. PLEASE ADDRESS FPL'S CLAIMED BASIS SUPPORTING THE PROPOSITION THAT FPL PROVIDES SUPERIOR CUSTOMER VALUE.

A. At the outset, I do not dispute that FPL does a good job in terms of service quality and reliability. As stated earlier, FPL lists seven factors to support the claim of FPL's "superior service."[27] These seven factors that FPL claims exemplifies superior service are: low bills, high reliability, low emissions, high customer satisfaction, high fossil fleet reliability, low heat rates, and low non-fuel O&M.[28] As I discuss below, in at least one important instance, FPL's claims of superior service and customer value fall somewhat short of FPL's assertion. In some cases, FPL's characterization of superior service is not complete, or if positive results and increased service quality did occur, it was the result of investments and expenditures paid for by customers, thus no surplus equity return inflator is justified.

Q. PLEASE ADDRESS FPL'S PERFORMANCE RELATED TO LOW BILLS.

A. FPL claims that customer bills are lower today than they were 10 years ago.[29] FPL is referring to the total bill including fuel costs. Fuel costs are based on the market cost over which FPL has no control. However, FPL does generally have the opportunity to control its base rate costs. In terms of base rates, an average FPL residential customer

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[27] Direct Testimony, Dewhurst at p. 27 lines 12-23 to p. 28, lines 1-12.
[28] Direct Testimony, Dewhurst at p. 27 lines 12-23 to p. 28, lines 1-12.
[29] Direct Testimony, Dewhurst at p. 27, lines 14-16.

using 1,000 kWh a month in 2006 had a base rate bill of $38.12.[30] Today, before the rate increase request, the same base rate bill is $54.86,[31] which is 44% higher than the 2006 bill. Clearly, base rates have increased, and they have increased significantly. While overall bills may be lower today relative to 2006, that is in large measure **because the market cost of natural gas has declined dramatically** from earlier periods. FPL does not have any control or influence over the market cost of gas and certainly FPL should not receive $502 million in equity return bonuses because the market price of natural gas has declined. Likewise, one would not look to penalize FPL if the price of natural gas increases in the future.

Q. PLEASE ADDRESS FPL'S CLAIMS OF SUPERIOR PERFORMANCE AND CUSTOMER VALUE ASSOCIATED WITH THE COMPANY'S RELIABILITY METRICS.

A. FPL claims to have the highest reliability as measured by the System Average Interruption Duration Index (SAIDI) in Florida and a 44% better SAIDI measure than the national average.[32] It should be noted that FPL witness Miranda states: "[h]istorically, FPL's capital expenditures and O&M expenses result from five major cost drivers: (1) FPSC storm hardening; (2) growth; (3) reliability/grid modernization; (4) grid servicing/support; and (5) complying with other regulatory agency requirements."[33] Mr. Miranda goes on to point out the expected 2014-18 capital

[30] FPL Residential Service Tariff, January 1, 2006.
[31] FPL Residential Service Tariff, July 21, 2015.
[32] *Id.* at p. 27 lines 17-20.
[33] FPL witness Miranda Direct Testimony at p. 30 lines 20-23.

expenditures for "Reliability/Grid Modernization" is $2.21 billion.[34] Moreover, because system reliability also improves as a result of FPL's storm hardening efforts, Mr. Miranda states; "... as previously mentioned, these initiatives also provide significant day-to-day reliability benefits."[35] One reasonably expects that reliability would improve (not deteriorate) when a utility invests significantly in grid modernization and storm hardening efforts.

While reliability is improving and may be at or near the top of the industry, customers have been and will continue paying for these improvements; therefore, there is no basis or policy reason to charge customers a second time to provide shareholders an inflator on the equity return for improved reliability. Improved reliability simply means customers have received what they paid for—a reliable transmission and distribution grid.

Q. PLEASE ADDRESS FPL'S CLAIMED BASIS SUPPORTING A SURPLUS EQUITY RETURN INFLATOR FOR PROVIDING SUPERIOR CUSTOMER VALUE RELATED TO LOW EMISSIONS, HIGH FOSSIL FUEL FLEET RELIABILITY, LOW HEAT RATES, AND LOW NON-FUEL O&M.

[34] FPL witness Miranda Direct Testimony at p. 31, lines 17-23

[35] FPL witness Miranda Direct Testimony at p. 12, lines 2-3.

A. Much of the underlying supporting testimony on these measures of customer value can be found in the direct testimony of FPL witness Kennedy. Ms. Kennedy summarizes this claim at page 6, lines 4-19, where she states:

> Since 1990, as FPL transformed its fossil generating fleet, the Company substantially improved its operating performance across key indicators integral to generating electricity for its customers. The cost reductions and performance improvements achieved by FPL's fossil generating fleet provide substantial benefits to the Company's customers.

Ms. Kennedy goes on to state:

> The doubling of FPL's generating capacity over the last two decades to serve its customers' electricity needs as well as the transformation of the Company's generating technology to cleaner and highly efficient combined cycle units … are both key drivers of FPL's fossil fleet non-fuel O&M and plant maintenance/reliability CAPEX. … FPL's continued CAPEX and non-fuel O&M are essential to providing these performance benefits.[36]

The claimed customer benefits related to low emissions, high fossil fuel fleet reliability, low heat rates, and low non-fuel O&M are the result of FPL's transformation of its generating fleet to more efficient gas units and continued on-going CAPEX (capital expenditures).

Q. DO YOU AGREE THAT A PERFORMANCE EQUITY RETURN PREMIUM SHOULD BE APPROVED FOR FPL'S PERFORMANCE RELATED TO LOW EMISSIONS, HIGH FOSSIL FUEL FLEET RELIABILITY, LOW HEAT RATES, AND LOW NON-FUEL O&M?

A. No. FPL readily acknowledges that the performance metrics related to low emissions, high fossil fuel fleet reliability, low heat rates, and low non-fuel O&M are the result of FPL's transformation of its generating fleet to more efficient gas units and continued

[36] Direct Testimony FPL witness Kennedy at p. 7 lines 4-14.

on-going CAPEX. Again, one reasonably expects these performance metrics to improve (not deteriorate) when a utility invests billions of dollars to transform its generating fleet. Over the past decade, residential customer base rates have increased 44% and customers have paid and will continue to pay for these new plant investments (along with a return on this plant) through rate increases to support the fossil fuel plant transformation, as well as the continued on-going CAPEX. There is no question that the fossil fleet investments have provided benefits in lower emissions, improved heat rates, and reliability for customers; however, this does not justify a $502 million surplus equity return inflator over the duration of FPL's rate plan proposal. FPL is recovering their full investment and the shareholders are recovering an equity return. The success of these fossil fuel investments should not require additional payments to shareholders. Had the fossil plant transformation not produced the promised results or had market gas prices increased substantially, without a finding of imprudent management in FPL's investment decisions, I find it difficult to imagine a scenario where customers could recover past customer payments from FPL for failed results.

Q. IN YOUR OPINION, ARE DIFFERENCES IN RATE LEVELS ATTRIBUTABLE TO FACTORS OTHER THAN MANAGEMENT PERFORMANCE?

A. Yes. For example, the costs that a utility incurs to provide service are influenced by the geographical characteristics of its service area and the density of development in that service area, as well as customer mix, vintage of equipment, etc. A utility that has a service area in which there are twice as many customers per square mile as an adjacent utility will incur lower unit costs than its neighbor, and its rates will reflect its lower cost structure. Yet, in this example the reason for lower costs and lower rates has little to do with management performance.

Q. IN YOUR OPINION, DOES FPL REQUIRE A SURPLUS ROE INFLATOR IN ORDER TO COMPLY WITH ITS OBLIGATIONS TO SERVE CUSTOMERS?

A. No. The proposal FPL has made in this case is more akin to an excess profit booster mechanism than a performance reward mechanism. In my opinion, this proposal should be denied.

Q. PLEASE ADDRESS THE ISSUE OF WHETHER A PERFORMANCE INCENTIVE IS APPROPRIATE GIVEN THAT UTILITIES HAVE AN OBLIGATION TO SERVE.

A. The Company takes the position that positive economic incentives are necessary to "actively encourage" and mimic economic incentives of freely competitive markets "to improve customer value."[37] In my opinion, monopolies such as FPL, when granted the monopoly franchise, have a duty to provide superior performance in exchange for cost recovery plus an opportunity to earn a fair return or profit commensurate with profits earned from similar risk ventures. "Superior performance" includes providing service at the lowest rates consistent with good service. In other words, efforts to keep rates as low as possible are part and parcel of FPL's obligation to serve. It is basic that an *obligation* does not require an incentive or a bonus to fulfill.

[37] Direct Testimony, Dewhurst at p. 31, lines 16-18

As previously stated, FPL enjoys advantages that competitive enterprises must envy—absence of competition for market share; cost recovery clauses that greatly reduce the risk that costs will not be recovered; the ability to seek changes in prices when necessary to have an opportunity to earn a fair return, just to name a few. In short, FPL enjoys a privileged position. No additional bonus or reward is necessary.

Q. ARE YOU AWARE OF ANY OTHER ISSUES THE COMMISSION SHOULD CONSIDER WHEN DECIDING WHETHER TO SUPPLEMENT FPL'S ROE WITH A SURPLUS ROE INFLATOR?

A. FPL claims to have delivered superior value to its customers as the basis for seeking this surplus ROE inflator.[38] However, on June 20, 2016, FPL entered into a consent order with the Florida Department of Environmental Protection ("FDEP") related to a Notice of Violation and separate Warning Letter for adverse impacts associated with the operation of the cooling canal system for its two nuclear units at the Turkey Point Power Plant complex.[39] The consent order found that cooling canal system was "the major contributing cause to the continuing westward movement of the saline water interface, and that the discharge of the hypersaline water contributes to saltwater intrusion."[40] The consent order "requires FPL to implement a range of comprehensive solutions to improve the operation of the cooling canals, halt and retract the hypersaline plume caused by the canals, update and expand its monitoring network, perform

[38] Direct Testimony, Dewhurst p. 27, line 9.
[39] https://depnewsroom.wordpress.com/hot-topics/florida-power-light-turkey-point-facility/
[40] FDEP Consent Order OGC No. 16-0241 at p. 5 available at https://depnewsroom.wordpress.com/hot-topics/florida-power-light-turkey-point-facility/

restoration projects as well as monitor for and prevent impacts to Biscayne Bay."[41] And prior to the FDEP consent order, FPL entered into a consent agreement with Miami-Dade County to resolve a separate Notice of Violation issued by the county related to the hypersaline water leaking from the cooling canal system.[42]

The cleanup of FPL's permit violation and compliance with the consent order could cost untold millions of dollars to resolve. According to FPL spokesman Peter Robbins, cleanup costs will cost about $50 million in the first year, and FPL expects the customers to pay for their permit violation.[43] Asking customers to pay millions and millions of dollars to fix FPL's permit violation does not equate with delivering superior value to its customers. Shareholders should bear the burden of the cleanup, not the customers. This is yet another reason FPL should not be entitled to a surplus ROE inflator which will cost customers approximately $502 million over a four-year period, not to mention the untold millions for fixing FPL's permit violation.

Q. ARE YOU OPINING THAT FPL IS ENTITLED TO RECOVER THE CLEANUP COSTS FROM THE CUSTOMERS?

A. No. That is a separate legal issue, the prudence of which will be resolved in another docket. I only mentioned it here as an example to rebut FPL's claims that it has delivered superior customer value and needs additional incentives to continue doing so.

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[41] https://depnewsroom.wordpress.com/hot-topics/florida-power-light-turkey-point-facility/

[42] Consent Order at p. 5 available at https://depnewsroom.wordpress.com/hot-topics/florida-power-light-turkey-point-facility/

[43] "Florida gives FPL 10 years to clean up cooling canals," by Jenny Staletovich, published by the Miami Herald on June 21, 2016, available at http://www.miamiherald.com/news/local/environment/article85104132.html

Q. IS THE REQUESTED 50 BASIS POINT SURPLUS EQUITY RETURN INFLATOR NECESSARY FOR THE COMPANY TO HAVE AN OPPORTUNITY TO EARN A REASONABLE RETURN OR MAINTAIN FINANCIAL INTEGRITY?

A. No. The Company's own evidence and request for an 11.00% equity return establishes that the additional 50 basis point surplus equity return inflator is unnecessary for the shareholders' return nor is the 50 basis point surplus necessary for the financial integrity of the Company. I should note that OPC witness Dr. Woolridge addresses the Company's 11.00% equity return request and is proposing a lower 8.75% return on equity for this case. Implicit in the Commission's establishment of an authorized return on equity is the concept that the authorized return will provide the utility with the opportunity to earn a fair return consistent with risks faced by the enterprise, satisfying the standards set forth in *Hope* and *Bluefield*.[44] Given that the Company's claimed required return on equity does not include the added revenue associated with the 50 basis point requested surplus equity return inflator, FPL's financial integrity and associated financial metrics are not dependent on these funds.

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[44] *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*") and *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) ("*Bluefield*").

III. FINANCIAL INTEGRITY

Q. WHAT ISSUE DO YOU ADDRESS IN THIS SECTION OF YOUR TESTIMONY?

A. In this section of my testimony, I address FPL's financial integrity and the impact of the OPC revenue requirement recommendation on FPL's financial metrics.

Q. PLEASE DEFINE THE TERM FINANCIAL INTEGRITY AS YOU USE IT IN YOUR ANALYSIS.

A. The term financial integrity is a term or concept that addresses a company's ability to access capital at reasonable rates and on reasonable terms. Pursuant to the *Bluefield* and *Hope*[45] standards, financial integrity should be sufficient to attract capital on reasonable terms under a variety of market and economic conditions. The Company, the shareholders, the regulatory authority, and the customers have a stake in FPL maintaining financial integrity and access to capital markets.

Q. HAVE YOU REVIEWED CREDIT RESEARCH REPORTS FOR THE COMPANY REGARDING CREDIT QUALITY AND CORPORATE FINANCIAL METRICS?

A. Yes. The Company's credit quality is strong. It is not threatened or under significant pressure of downgrade.

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[45] *Federal Power Commission v. Hope Natural Gas Co.*, 320 U.S. 591 (1944) ("*Hope*") and *Bluefield Water Works and Improvement Co. v. Public Service Commission of West Virginia*, 262 U.S. 679 (1923) ("*Bluefield*").

Q. HAVE YOU REVIEWED RECENT CREDIT REPORTS OF FPL?

A. Yes. A recent Moody's Investor Service ("Moody's") March 31, 2016 credit research report states:

> **FPL is one of the strongest regulated electric utilities in the US.** The political and regulatory environment for Florida utilities is stable, allaying some of the uncertainties that this year's rate case will entail. Its large, mainly residential service territory is growing, and the economic recovery will result in organic growth in sales and a need for new infrastructure. To meet these needs, FPL continues to make substantial capital investments in its rate base, which will increase earnings as they are completed.[46] (emphasis added)

Moody's describes FPL's ratings outlook as stable and the current ratings assume timely cost recovery mechanisms and regular capital contributions from NextEra will maintain FPL's strong credit metrics.[47] As noted in Dr. Woolridge's testimony and Exhibit JRW-4, according to Moody's, FPL has an A1 credit rating which is higher than NextEra Energy's credit rating of Baa1. Overall, FPL has, and continues to maintain, strong credit metrics and financials based on rating agency evaluations.

Q. WHAT FINANCIAL RATIOS OR FINANCIAL METRICS SHOULD THE COMMISSION CONSIDER WHEN EVALUATING COST OF EQUITY?

A. In my opinion, the Commission should consider the financial metrics that bond rating agencies consider in evaluating credit risk to a company. Three key financial metrics involve cash flow coverage of interest, cash flow as a percentage of debt, and debt leverage ratio.

[46] Moody's Investor Services, Credit Opinion, Florida Power & Light Company (March 31, 2016) at p. 1.
[47] Moody's Investor Services, Credit Opinion, Florida Power & Light Company (March 31, 2016) at p. 2.

Q. HOW ARE THESE FINANCIAL RATIOS CONSIDERED AND CALCULATED?

A. Ratings agencies such as Moody's and Standard & Poor's ("S&P") develop rating guidelines that make explicit general ratings outcomes that are typical, or expected, given various financial and business risk combinations. A rating matrix or guideline is just that, a guideline, not a rule written in stone that guarantees a specific rating for a specifically achieved financial metric level.

Funds from a company's operations, in other words cash flow, are very critical to any rating/risk consideration. Interest and principal obligations of a company cannot be paid out of earnings if earnings are not cash. Thus, analyses of cash flow reveal debt servicing ability.

Debt and capital structure considerations are indicative of leverage and flexibility to address financial changes. The liquidity crisis that hit all markets and industries in 2008 is an example of the importance of financial flexibility. Stable and continuous cash flows provide financial flexibility.

Each of these financial ratios is calculated in my Schedule (DJL-5) employing OPC's recommendations in this proceeding. The results of my analyses indicate strong financial metrics, supporting FPL's current bond rating.

Q. WHAT KEY CREDIT METRICS ARE INDICATORS OF CREDIT QUALITY?

A. As discussed earlier, the two primary rating agencies that provide credit ratings for FPL and its parent NextEra are Moody's and S&P, and both emphasize similar credit metrics. For example, among the key financial metrics considered by Moody's are: (i) cash from operations as a percentage of debt (CFO/Debt), (ii) cash from operations plus interest divided by interest (CFO/Interest), and (iii) Debt/Capitalization. Financial metrics such as CFO/Debt and CFO/Interest are measures of cash flow, while Debt/Capitalization measures the degree to which debt leverage is used to fund operations.

S&P employs three similar financial metrics in evaluating financial integrity and ratings of a company. For example, S&P employs Funds From Operations as a percentage of Debt (FFO/Debt). This financial measure evaluates the cash flow support of debt, which is similar to Moody's CFO/Debt measure. Another S&P metric is the size of debt compared to earnings before income taxes, depreciation and amortization (Debt/EBITDA). This metric (Debt/EBITDA) is a measure of a company's ability to pay off debt and is similar to Moody's (CFO/Interest) metric. A third S&P financial metric is Debt to Capital (Debt/Capital) and is the same indicator of financial leverage employed by Moody's as discussed earlier.

Q. DOES MOODY'S PROVIDE A LIST OF BENCHMARKS OR EXPECTATIONS FOR VARIOUS FINANCIAL METRICS FOR THE DIFFERENT RISK LEVELS?

A. Yes. Moody's provides financial metric expectations as guidelines for evaluating various risk levels, as shown in the following table:

Table 2[48]
Moody's Financial Risk Benchmarks

Moody's Bond Rating	CFO/Debt	CFO/Interest	Debt/Capital
Aaa	>40%	>8.0x	<25%
Aa	30% - 50%	6.0x - 8.0x	25% - 35%
A	22% - 30%	4.5x - 6.0x	35% - 45%
Baa	13% - 22%	2.7x - 4.5x	45% - 55%
Ba	5% - 13%	1.5x - 2.7x	55% -65%
B	<5%	<1.5x	>65%

Like S&P guidelines, Moody's views these benchmarks as typical expectations for the various risk ratings levels. Again, these benchmarks are not precise guarantees of future ratings outcomes – as many factors both qualitative and quantitative go into financial ratings analyses. For this analysis I focus on the benchmark guidelines for single "A" (the current FPL rating) and Baa (the lowest grade for investment grade bonds).

Q. WHAT IS OPC'S RECOMMENDED ROE AND CAPITAL STRUCTURE THAT YOU WILL BE ASSESSING IN THIS CASE IN RELATION TO FPL'S CREDIT METRICS?

A. OPC's primary recommendation includes an 8.75% recommended return on equity and a 50% debt/50% equity capital structure. OPC witness Dr. Woolridge sponsors and supports the 8.75% equity return and OPC witness Kevin O'Donnell supports the

[48] Moody's Investor Services; "Regulated Electric and Gas Utilities Assessing Their Credit Quality and Outlook" (January 18, 2013) at p. 33.

50%/50% capital structure from investor sources. The resulting overall return to be earned on rate base investment is 5.05% as is shown in my Schedule (DJL-5).

Q. PLEASE ADDRESS WHO WILL EXPLAIN WHY THE CAPITAL STRUCTURE IN YOUR SCHEDULE (DJL-5) INCLUDES MORE DEBT THAN REQUESTED BY FPL

A. OPC witness O'Donnell will address his recommended capital structure in his testimony, including the rationale for including more debt than requested by FPL. Other ratemaking items such as customer deposits, deferred taxes and investment tax credits are also included in capitalization, and thus are addressed in Schedule (DJL-5).

Q. PLEASE EXPLAIN HOW YOU EVALUATED THE IMPACT OF OPC'S RECOMMENDATION ON FINANCIAL METRICS.

A. I examined three key financial metrics that are considered by S&P and Moody's that I described earlier. These financial metrics are as follows:

Moody's	S&P
1 CFO/Debt	FFO/Debt
2 CFO/Interest	Debt/EBITDA
3 Debt/Capital	Debt/Capital

An evaluation employing Moody's metrics can be found on my Schedule (DJL-5), utilizing the primary OPC recommendation in this case. The financial metrics for OPC's return recommendation are compared to the Moody's benchmarks to determine whether these results are consistent with maintaining financial integrity.

Q. HOW DID YOU CALCULATE CASH FLOW FROM OPERATIONS ("CFO") FOR THE MOODY'S METRIC EVALUATION?

A. I employed earnings (return on investment) after taxes plus depreciation for this calculation. These values are presented in my Schedule (DJL-5) Line 6 titled "cash flow."

Q. HOW DO THE FINANCIAL METRICS COMPARE TO THE BENCHMARKS?

A. Under OPC's recommendation of 8.75% equity return with a 50% debt/50% equity capital structure and a 5.05% overall rate of return (See Schedule (DJL-5)), the financials all fall within the benchmarks except for the 50% debt ratio compared to the Moody's benchmark. The recommended 50% debt capitalization is not out of line with the Moody's Baa debt capitalization benchmark of 55%.

Q. WHAT DO YOU CONCLUDE FROM YOUR ANALYSIS?

A. In my opinion, FPL's financial integrity will remain strong and viable under OPC's recommendations based on an evaluation of the pertinent quantitative financial metrics.

Q. DOES THIS CONCLUDE YOUR TESTIMONY?

A. Yes it does.

BY MR. SAYLER:

Q And, Mr. Lawton, did you have exhibits that were identified as DJL-1 through DJL-5 attached to your prepared direct testimony?

A I do.

Q All right. And on August 28th, OPC filed an errata for your DJL-5; is that correct?

A That is correct.

Q All right. Beyond those filed errata, do you have any further changes or revisions to your prepared exhibits?

A None that I am aware of.

Q All right. And were these exhibits prepared under your direction and supervision?

A They were, indeed.

MR. SAYLER: All right. I believe staff has a few questions for you.

CHAIRMAN BROWN: Ms. Brownless?

MS. BROWNLESS: Yes, sir.

EXAMINATION

BY MS. BROWNLESS:

Q Good evening, Mr. Lawton. How are you today?

A Good evening. I am well. Thank you for asking.

Q Did you review what's been marked as Exhibit

No. 579?

A I believe so, yes.

Q Okay. And with regard to Exhibit 530 identified there, have you had an opportunity to look at that exhibit?

A Yes, I -- I have.

Q Okay. And did you prepare it or was it prepared under your direct supervision and control?

A The answer is no. The way -- if I can clarify and make it go quick.

Q Sure.

A Under Exhibit 530, you have Lawton designated as sponsoring 46 through 51 --

Q Yes, sir.

A -- the way I read that.

Q Yes, sir.

A And -- and me, Mr. Lawton, didn't prepare or sponsor all of those, but rather, I sponsored exhibits 46 and 51.

Q Oh.

A So I don't if that's a typo, that hyphen, but I read it as inclusive of 46 through 51.

Q Well, thank you.

With that clarification, did you prepare responses to 46 and 51?

A I did.

Q Okay. And are those true and correct, to the best of your knowledge and belief?

A They are.

Q And if you were to ask [sic] the same questions today as you were previously asked, would your answers be the same?

A Yes, they would.

Q Are any portions of your listed exhibits confidential?

A Are any portions of my exhibits confidential?

Q Yes.

A No -- not that I am aware of.

MS. BROWNLESS: Thank so much.

CHAIRMAN BROWN: Mr. Sayler?

FURTHER EXAMINATION

BY MR. SAYLER:

Q Mr. Lawton, did you prepare a summary of your testimony?

A I did.

MR. SAYLER: All right. Madam Chair, may he give the summary?

CHAIRMAN BROWN: Yes.

THE WITNESS: Well, good evening, Commissioners. Good to be back.

And I prepared a five-minute summary, which I've -- given the time I've had, I have shortened and shortened, so -- my name is Dan -- Daniel Lawton. And I represent OPC in this case on two specific issues; one, the first issue is the 50-basis-point request for a return-on-equity adder or, I think I call it throughout my testimony, an inflater; and the second issue, I address financial integrity as a result of all of OPC's adjustments, what's that going to do to some specific financial metrics that are reviewed by rating agencies.

To the first issue, the company in this case has requested 50-basis-points adder to the rate of return, and you have heard testimony throughout the last week about that topic.

Basically the company is requesting the 50 basis points for two reasons; one, they are asking that the Commission recognize the -- historically the -- the work they have done and the performance they have achieved on a historical basis; and, two, they want the 50 basis points as an incentive to promote more efficiency and more good works.

And let me say from the outset -- and I said it in my testimony -- I don't dispute and I don't think anybody in this case disputes that FPL has done a great job in certain areas in efficiency and -- and so forth. The question is should they get a 50-basis-point award.

Now, the first question I asked myself in this case is, how much is 50 basis points going to cost customers. And I address in my testimony, it's roughly $502 million over the four-year rate plan. Each 50 basis points is worth roughly $120 million given the size of the rate base in this case.

Now, in terms of the reasons the company -- the achievements the company has -- has proposed to should give them this award -- one is low rates. And we just heard about low rates this afternoon.

Well, rates are lower than the average utility or rates are lower than they were in 2006, as FPL says. And that is true, but that's the total rate, or the total bill.

If you look at base rates, the base rates are the costs the company controls. They have increased 44 percent, which you would expect because companies are making numerous investments in technology and storm hardening and reliability. And that's -- that's what caused that rate increase.

So in large measure, the declining historical costs in the gas markets has caused and resulted in rates being low.

Now, in terms of efficiency, the plants have been changed over time to very good gas plants. And the company is much more efficient, and it's much more reliable with storm-hardening investment. But these are investments customers have paid for. Because FPL has done what it said it was going to do, make it more efficient with these investments, it doesn't need a reward of $500 million.

With regards to five -- financial integrity, a review is presented in my testimony. And I do not believe that the OPC revenue requirement will result in financial harm.

Thank you.

CHAIRMAN BROWN: Thank you.

MR. SAYLER: Thank you, Mr. Lawton.

Office of Public Counsel would tender this witness for cross-examination.

CHAIRMAN BROWN: Thank you.

FIPUG.

MR. MOYLE: Thank you.

CHAIRMAN BROWN: Remember, no friendly cross.

MR. DONALDSON: I have my button ready.

CHAIRMAN BROWN: Preemptive -- I mean, it's --

EXAMINATION

BY MR. MOYLE:

Q Hello, Mr. Lawton. How are you?

A I'm great, Mr. Moyle. Good to see you.

Q Good. Good. Are you still practicing law in Texas?

A I am trying.

MR. DONALDSON: It sounds really friendly.

MR. MOYLE: At least he didn't object on the "good afternoon" part, right?

BY MR. MOYLE:

Q All right. So I want to ask you about the exhibits that you went over with staff. Okay?

A Yes, sir.

Q What's 46?

A Hold on a second and I will find it here.

Q And, for the record, it was like Exhibit 579 and then 530, and then there were --

A Right. 46, I think, is OPC's response to staff's fourth set of discovery.

Q Is there any hearsay in there, based on your review?

A No.

Q No?

A Not in my opinion.

Q Same -- same question with respect to 51?
A Give me a moment to find it and I will tell you more clearly.
MR. SAYLER: Madam Chair, we will locate a copy of the response.
CHAIRMAN BROWN: Okay.
BY MR. MOYLE:
Q It might be easier for you to say what it is, tell us what it is.
A That's why I am trying to find -- I had -- I brought the discovery up here with me because I knew those questions --
Q So I should ask you, just to prove it's not friendly cross to say, well, sir, you just affirmed this. What -- what is it?
A Okay. First of all, in answer to your earlier question, these are discovery requests in response to -- it is staff's fourth set of interrogatories. And question -- you asked about 51, what is it?
Q Right. 51 is a question asking me to identify any studies, reviews, or assessments that have been done by utilities in the area of reliability, bill or rate comparison, efficiency operation, and efficiency of generation.
Q And did you do that?

A Yes, I -- I answered it by -- there was an objection by OPC and -- and without waiving the objection, I answered the question by pointing out various studies I have looked at over time addressing those issues.

Q Okay. And did you attach those studies or produce them in a POD response?

A No.

Q Okay. Did you identify the studies -- I mean, you're not -- I assume, as I understand how experts use studies is they use them -- in hearsay, they use them to inform their opinion; is that right?

A No, these were studies that --

MS. BROWNLESS: Objection. I believe that Mr. Moyle's question assumes that the studies are hearsay. So perhaps he could rephrase that.

MR. MOYLE: Okay.

CHAIRMAN BROWN: Okay. Mr. Moyle.

BY MR. MOYLE:

Q Did you rely on any of these studies for the basis of forming your opinion in this case?

A In this case? No. The -- they were not directly related. The question asked had I done studies. And over the years I have conducted the studies.

Q Okay. But you didn't attach any. You are not relying on the studies in this case.

A No, sir.

Q Okay. All right. Thank you.

That -- the other -- the other point I wanted to make sure I understood is how you calculated -- you said that the adder is a cost of 502 million. We have been talking about a number of, I think, 120. How did you come up with 502?

A Sure. The $120-million number that's been talked about in this case is the value of 100 basis points on return on equity, gross -- grossed up for income taxes in the first year of the four-year rate plan.

If you -- you have my testimony, Mr. Moyle that the -- the --

COMMISSIONER BRISE: Page seven.

THE WITNESS: Page what?

COMMISSIONER BRISE: Seven.

THE WITNESS: Thank you.

On page seven, I happen to have a table that outlines the impact by year. And the reason it's not 120 million per annum is because we have a second rate increase, which is called the subsequent-year adjustment. So, rate base changes on the value of a hundred basis points on -- rate base is now slightly different.

And then in the third year, you have the Okeechobee -- I hope I am pronounce -- pronouncing that correctly -- gas plant, which would be added. And so that adds more revenue requirement and more dollars to the hundred basis points. Overall, I think I have done it correct. And it's about 502 million.

BY MR. MOYLE:

Q Okay. So the 822 in year one, under your formulaic approach, you would multiply it by four to get 3.2 billion or whatever that number comes out to be?

MR. DONALDSON: I'm going to object to friendly cross. I don't those how this is adverse to Mr. Moyle's position or his clients.

CHAIRMAN BROWN: Mr. Moyle?

MR. MOYLE: That -- that -- I'm trying to confirm his calculation with respect to another matter in the -- in the case to make sure I got it right. If it's yes or no, I am done.

MR. DONALDSON: Still doesn't make it not friendly cross.

CHAIRMAN BROWN: Objection sustained.

Mr. Moyle, any further questions?

MR. MOYLE: I have another line. No, I'm --

CHAIRMAN BROWN: All right. Hospitals.

UNIDENDIFIED SPEAKER: Nothing, Madam Chairman. Thank you.

CHAIRMAN BROWN: Retail?

MR. LAVIA: No questions. Thank you.

CHAIRMAN BROWN: FEA.

mr. jern: No questions.

CHAIRMAN BROWN: Sierra.

MS. CSANK: No questions.

CHAIRMAN BROWN: AARP.

MR. COFFMAN: No questions, Your Honor.

CHAIRMAN BROWN: FPL.

MR. DONALDSON: Just a few.

EXAMINATION

BY MR. DONALDSON:

Q Hello, Mr. Lawton. Kevin Donaldson, with FPL. I am all the way down here. How are you?

A Great. Great. I am very well. Thank you, sir.

Q Good. Welcome to Florida.

A Thank you, again.

Q Am I correct you are the sole witness for OPC that is discussing the ROE adder; is that correct?

A You know, I -- I don't know that anybody else discussed it in their testimony because -- I hope my client doesn't get mad -- I didn't read everybody's testimony in that detail.

Q So, that's -- that's a yes.

A Yes, sir, I believe it's -- I believe it's a yes. I was asked to look at the ROE adder issue.

Q Okay. All right.

If we can do a yes-or-no -- or yes or no or I don't know, and then you can give your explanation, and we can go a lot faster because it's getting late. And I don't want to interrupt anyone's dinner.

A But none of those answers would have answered the last one.

Q Sir, are you familiar with Florida Statute 366.02, which is entitled "general duties of a public utility"?

A I'm sure I've read it at some point and it has to do with --

Q Is that a yes?

A Yeah. I am sorry. Excuse me. You're right. Yes.

Q Okay.

A I am sure I have at some point.

Q All right.

A And it has to do with the --

Q Well, I'll ask you -- I'll ask you what it has to do with --

CHAIRMAN BROWN: Sir, if you could allow him an opportunity to finish. Just please -- I think he was trying to clarify his answer. He has that ability here to.

MR. DONALDSON: Oh, sure.

THE WITNESS: It -- it has to do with the duties and obligations of a utility.

BY MR. DONALDSON:

Q Okay. All right. I thought I said 366.03 -- is that what you heard -- which is general duties of a public utility?

A The general duties of a public utility, yes.

Q Okay. Can we agree that the Florida Legislature --

MR. SAYLER: Objection -- or just for clarity of the record, he was asking about 366.02 and now he is citing 366.03.

MR. DONALDSON: Well, I apologize. I thought I actually said 366.03.

CHAIRMAN BROWN: Okay.

BY MR. DONALDSON:

Q Okay. So are you familiar with Florida Statute 366.03, which is entitled "general duties of a

public utility"?

A   Yes, in that I have read it in -- in the past.

Q   Okay. Can we agree that the Florida Legislature prescribed that FPL, as a public utility, has a duty under this statute to furnish to each person applying therefore reasonably-sufficient, adequate, and efficient service upon terms as required by the Commission.

MR. MOYLE: I'm going to object to the extent it calls for a legal conclusion. I know this gentleman, if he took the Bar, could probably answer it more fully than he is now, but with respect to a legal conclusion, I think it's inappropriate.

CHAIRMAN BROWN: Objection overruled.

THE WITNESS: Yes, I believe that's what it states.

BY MR. DONALDSON:

Q   Okay. Can we also agree that all the other electric utilities within Florida, similarly, are held to the same statutory duty as FPL?

A   Yes.

Q   Okay. It's true -- and you can correct me if I am wrong -- that you are not suggesting to this commission that FPL should be held to a different duty

other than what's in the statute; is that correct?

A That is correct. FPL should be held to the statutory standard that applies.

Q Thank you.

All right. Now, you would also agree that this commission has the authority to adjust the company's ROE, return on equity, based on performance; is that correct?

A No.

Q Okay.

A It -- it takes clarification.

Q Well, can we turn to page 14 of your -- of your direct testimony?

CHAIRMAN BROWN: Mr. Donaldson, he is allowed the opportunity to clarify his answer, if the witness wants.

So, Mr. Lawton, you may continue to answer -- clarify your answer.

THE WITNESS: Thank you.

The reason I say no, the Commission has authority to -- to adjust ROE, but it's not unfettered authority. For example, there is one court case or appellate case out there that -- where this issue was brought up in Florida. And -- and the court, I think, reasoned that the ROE adder had to be within the range found reasonable by the Commission. It could not go outside that range.

So that's why -- the way you asked the question, that's why I responded no at the beginning. But with that clarification, I hope it helps.

BY MR. DONALDSON:

Q But you would agree that this commission still has the authority to adjust an ROE for a company based on performance, correct?

A Based on performance?

Q Yes.

A Based on management -- yes, based on performance, management. There is a whole host of issues this commission has wide-ranging authority to address.

Q Okay. And you specifically, on page 14, lines two through five -- that was a little loud -- specifically cite a prior order from the PSC in the Gulf case where that commission found that Gulf's past performance has been superior and expect that level of performance to continue in the future; isn't that correct? Isn't that what you state in your testimony?

A Yes, that's what my testimony says.

Q All right. Now, in your summary, I think I

heard you discuss about FPL's reliance on natural gas generation. Do -- do you recall that, sir?

A Yes. It's not only -- it's in the summary and in my testimony.

Q All right. Do you know what percentage of FPL's generation is produced by natural gas?

A I didn't hear you.

Q Do you know what percentage of FPL's generation is produced by natural gas?

A It's either 72 percent or 69 percent. I have heard both numbers in this case.

Q Okay. If I said it was 68 percent, would you take that, subject to check?

A I will take it, subject to check, but it seems to be dwindling.

Q That's a good thing, right?

A Well, if you want diversity --

Q All right. Do you know what percentage of Duke Energy Florida's generation is produced by natural gas?

A I don't commit these numbers to memory. So the answer will be no. I apologize.

Q Okay. If I said it was 65 percent, would you -- would you take that, subject to check?

MR. MOYLE: Objection, leading. He can't put in evidence. He just said he doesn't know.

MR. DONALDSON: This is cross-examination. You are allowed to lead.

MR. MOYLE: Yeah, but you're -- well --

CHAIRMAN BROWN: Objection sustained.

MR. DONALDSON: Okay.

BY MR. DONALDSON:

Q Are you aware that FPL's typical residential bill is about 30 percent lower than Duke-Florida?

A Than Duke-Florida? I haven't made the comparison, but I know it's lower.

Q Okay. Are you aware that FPL's typical residential bill is lower than most of the other Florida IOUs in the state?

A Yes.

Q Okay. Now, you would agree that that difference in residential bill is not typically just explained by natural gas reduction? You would agree with that, correct?

A Well, certainly. I mean, there is -- there is -- yes. And natural -- I don't say that it's all due to natural gas.

Q Okay. Have you -- you reviewed some of the direct testimony in this case; for instance, Ms. Roxane Kennedy's testimony. You've reviewed that?

A Yes, I have.

Q And you've reviewed Mr. Reed's testimony as well? He is the outside benchmarking expert.

A I reviewed a little bit of Mr. Reed, but I have reviewed Kennedy, Miranda, and three or four others who I cite in this testimony.

Q All right. Now, with respect to Ms. Kennedy, do you recall some of her exhibits where it shows the nonfuel O&M cost per kW versus the industry? Do you recall that?

A I recall that the nonfuel O&M has gone down and is lower than others by comparison.

Q And you would agree that it's significantly lower than where the industry is; is that correct?

A I don't know -- "significantly" is an ambiguous term. I would like to be a little more precise than that, but it's -- it's lower. I agree to that.

Q Thank you.

MR. MOYLE: And I'm just -- I don't think it's proper to ask one witness to comment on the testimony of another witness. I mean, if his question is, isn't it true, this, that or the other, but -- anyway.

CHAIRMAN BROWN: Thanks for that deep thought.

A few more questions?

MR. DONALDSON: Just a few more. Yes.

BY MR. DONALDSON:

Q Okay. So I want to be specific and not give you an ambiguous number. Okay. That's why I had to get my folder back there. And I apologize.

Would you agree that FPL's nonfuel O&M per -- dollars per kW is 39 percent lower than the industry? Do you recall reviewing that in this test- -- in Ms. Kennedy's exhibits?

A I do. And I may have mentioned it in my -- in my testimony as well.

Q And that's actually a good thing; isn't that correct?

A Well, sure it is. And --

Q That -- I'm sorry.

A Excuse me. Let me say, yes. You asked if it's a good thing -- yes, it is a good thing, and other -- other cost-saving measures have been taken by FPL through investments to modernize the system, computers.

And we heard one of the witnesses here -- I think she followed Mr. Reed -- was pointing out that half the labor force -- I think it was in customer service. It was -- had gone down over the recent years.

And that's investment.

Well, that's lower -- lowering costs because you don't have all those labor costs. So all those things lead to the kind of number you just pointed out, sir.

Q All right. Now, you didn't perform any kind of research to determine whether or not there were other utilities that were providing a better customer value than FPL, did you?

A No, I -- I -- I don't know how I -- actually I would do that.

Q Well, for instance, you didn't do any kind of research that said, other utilities' reliability is lower than FPL, or other utilities' customer service is better than FPL, or other utilities' nonfuel O&M is better than FPL. You didn't do any of that, did you?

MR. SAYLER: Objection. It seems like testifying. And I believe it's outside the scope of his testimony.

CHAIRMAN BROWN: I am going to allow it because he asked -- he didn't -- the witness asked for clarification, and he was giving him examples. So I will allow the question.

MR. SAYLER: All right. And if he can break it down into smaller questions, too -- he asked about four or five questions together.

CHAIRMAN BROWN: Mr. Donaldson, can you restate it?

MR. DONALDSON: Sure.

BY MR. DONALDSON:

Q You didn't perform any kind of research to show that other utilities, besides FPL, have better reliability, did you?

A No --

Q You didn't --

A -- because it was not necessary.

Q Right. And you did not perform any research which showed that other utilities have a better customer service to their customers than FPL, did you?

A No. Again, because it was not necessary.

Q All right. And you didn't perform any research that showed that other utilities had a better nonfuel O&M cost per kW than FPL, did you?

A No.

Q Okay. And I -- I believe that the reason why you are going to say that you didn't perform this is because incentives don't matter in this particular case; is that right?

A I didn't understand the question. Could you repeat it, sir?

Q Okay. You didn't -- you didn't -- you did not do any kind of analysis, despite the fact that this commission, in the prior case, for instance, that Gulf case, have found that an incentive for superior past performance was something that they would look at. You didn't do that, did you?

A No, I -- I didn't.

MR. DONALDSON: Okay. I think that's all. Thank you.

CHAIRMAN BROWN: Staff, you're up.

FURTHER EXAMINATION

BY MS. BROWNLESS:

Q Were you provided responses to staff's interrogatories in POD requests associated with your subject areas as they became available --

CHAIRMAN BROWN: Wait. That's -- that's very fast. Could you repeat that? Even for me.

THE WITNESS: Thank you, Chairman.

MS. BROWNLESS: Okay.

BY MS. BROWNLESS:

Q Were you provided responses to staff's interrogatories and POD requests associated with your subject area as they became available?

A Yes, as well as even other subject areas.

Q Okay. Were you also provided responses

associated with your subject area of FIPUG's, FEA's, and South Florida's, and AR- -- AARP's discovery requests as they became available?

A Yes, I was.

Q During the course of your engagement in this proceeding, did you prepare discovery questions in your subject area and, subsequently, review the responses to those?

A Yes.

Q Now, if you can turn to page 19 of your direct testimony, please.

A I am there.

Q And I am going to direct you to the sentence that starts on line 21 and let you read to the next page line two. If you can read that passage.

A Okay. I have read it.

Q Okay. Is it your contention that FP&L has greater economies of scale than other Florida utilities?

A They have economies of scale because of their size. So the answer is yes. I hate to say relative to other Florida utilities. I really haven't analyzed or done the comparison. But I think we discussed this in the deposition, as I recall, that FPL does have economies of scale.

Q Okay. And have you provided any evidence

regarding FPL's economies of scale?

A No, I didn't -- I didn't do an analysis. I kind of brought it out in that passage that you just asked that I -- I read.

Q Okay. What specific factors would you look at to determine FPL's economies of scale relative to other Florida electric utilities?

A Well, if -- if you want to look at those things, you want to see that the -- because of the size and -- and you know, its purchasing power is a classic example. It may have ability to cut better deals, those kind of things.

Q So you would look at -- one of the things you would look at is relative number of customers, for example?

A Sure.

Q And if you were to do such a benchmark analysis -- well, strike that.

If you were to apply a benchmark analysis to FPL's costs and rates to determine if they were operating in an especially efficient manner would it be necessary to compare FP&L to with other electric utilities with similar economies of scale?

A I don't know that -- the answer is no. I am sure the -- that the adjustments could be made to prorate the analysis such that you end up with an apples-to-apples comparison.

Q And if you had such a benchmark analysis, do you believe it would be necessary to compare FP&L to other utilities with similar economies of scale?

A No, I -- the answer is no. And I think I answered that in the last answer to your question, in that you could -- if you could effectively prorate it to assure you have an apples-to-apples comparison, you are talking about comparing FPL, whether it has to be the same economies of scales, the comparative peer, or could it be smaller or larger.

And the answer is, to the prior question, if you could prorate and make that adjustment, then the exact comparison may not be necessary.

Q Thank you.

Can you look at page 17 of your testimony, please.

A Page 17?

Q Yes, sir. And if you could just review lines eight through 13.

A Yes. I have read it.

Q And is the point you're making here that FP&L's customers pay for any improvements that have been made and, therefore, should receive the benefit of those

improvements?

A Yes. And let me tell you why I think that's important. FPL comes to this commission and -- and asks each time it's having major investments for permission -- for example, plants usually require a CCN, and/or major construction projects. And the company puts on evidence and explains that it's going to do this investment, and this is the result. We expect to do a good job. And these are the benefits to consumers.

FPL has been successful. The results have come out the way they said. And now they want a bonus on top of it. And I -- I think that's incorrect.

Q Okay. It is true, however, as you have just discussed, that it was FP&L's management that picked the specific investments and improvements, correct?

A FPL's management picked it. And whether that was the final result or -- sometimes these cases involve some give-and-take and those -- sometimes your topic doesn't get selected by the Commission.

So I -- I haven't analyzed all those, but it's not necessarily true.

Q Well, it certainly is FP&L's management's decision as to what type of improvements they will present to the Commission for approval, correct?

A Oh, absolutely. Absolutely. And they are already getting bonuses in their financial package. I don't know why they are trying to give a bonus to the shareholders who have done nothing.

Q Out in the competitive marketplace, if a company is able to develop a specific tool or product, and is able, therefore, to earn short-term economic profits based on that product, they are rewarded; are they not?

A Sure, because they are the ones with that tool or product. And while they're the only ones that have it, they're going to reap the rewards.

Q And I could refer to that period of time, or the money that's generated during that period of time they are the only person that has it as generating a short-term economic profit, correct?

A Yes, until other competitors are able to duplicate the -- the magic of the first company.

Q Okay. Would benchmarking FP&L's operating metrics against similarly-sized electric utilities reveal whether their production processes were more efficient than that of their peers?

A It may.

Q So is it true that in a competitive marketplace, a firm that invests in its facilities to keep them as efficient as possible can earn short-term

economic profits until its competitors invest similarly to improve their production processes?

A Yes.

MS. BROWNLESS: That's all we have. Thank you.

CHAIRMAN BROWN: Thank you.

Commissioners?

Redirect?

MR. SAYLER: Thank you, Madam Chair. I am going to go in reverse order.

FURTHER EXAMINATION

BY MR. SAYLER:

Q Mr. Lawton, you were asked just -- a question a moment ago about competitive markets and earning short-term profits?

A Yes, sir.

Q Can you explain how -- the difference between a competitive versus regulated market as it relates to that concept?

A Well, we all know the competitive market in that -- that we see in the world every day. The regulated market, we have the monopoly, in this case, the utilities. And -- and they are the only provider with a specific service territory with no competitor.

So the way you rein them in. And the

Legislature -- and I was asked about the statutes earlier -- is you try to get them to duplicate the competitive market. And you reimburse their costs and provide them an opportunity to earn a reasonable return on their investments. Those are the difference.

And they can set there own price when they come in if they are not getting high enough price. They can come in and ask the Commission to raise it, like we're doing now.

Q All right. You were asked a few questions by staff about the investments that Florida Power & Light made to lower the bills. And you were also asked questions about the management. And you made a statement -- and I am trying to understand it -- that managers are getting bonuses, so why should the shareholders get a bonus? Can you -- can you explain or expound upon that?

A Sure. You have had this discussion with witnesses throughout the week. And I think Mr. Shultz was up earlier. And he discussed the financial incentive comp.

Typically, the regulators in the utility industry provide incentive comp for management and employees. And that's not unusual to promote and encourage getting the best and the brightest to run these companies, and do a good job.

Well, management of this company has been getting bonuses and financial incentives. And -- and they should. They have done a good job. But the company now is asking, well, let's get 500 million more for our shareholders. Well, what did they do?

We don't get more money for the bondholders because they loaned money. And I mean -- you know, the bond didn't -- nobody is proposing a -- a bonus for us them. And moreover, FPL doesn't provide bonuses to their providers that may provide them good trucks and good -- good cement in their -- in there daily endeavors in the construction of keeping the facilities open.

So it seems to me that we've -- we've created this -- this -- this mechanism of bonuses for shareholders who -- who have truly done nothing to -- to -- to require it. And you're giving the bonus to the right people, the management.

Q Clarification, are you saying that that mechanism has been created or is that the proposal?

A Well, it's proposed. And it has been in the past, as we discussed with -- I discussed -- excuse me, not we. I discussed with FPL's counsel earlier that I had quoted a earlier Gulf case that the Commission has authorized a bonus. And I just hate to see commissions go down that path. I don't think it's necessary.

Q All right. Mr. Lawton, you were asked a number of questions about benchmarking analyses and comparisons. But you didn't do any benchmarking in this case for the Public Counsel's office; is that correct?

A That's correct.

Q And why was that?

A Well, it's not necessary because this whole bonus concept doesn't seem to be necessary. I don't need to benchmark and then compare FPL to the other utilities. I don't care if FPL is number one, number 10 or number 520. It doesn't matter.

I -- I just think that the regulatory scheme that we have in place today where bonuses are paid to the people that do the job, that is the management of the company -- they have received bonuses. They are getting bonuses.

And we start giving bonuses to shareholders -- it makes no sense whether FPL is No. 1. I think that's great. They should reward their management.

Q And -- but when it comes to this case, you didn't provide any testimony as opposed -- about bonuses for management in your prefiled direct; is that correct? That was another witness?

A No, I mean, that's where -- other witnesses are addressing, sure. I mean, that's -- that's -- it's a tool that this commission and commissions around the country have used for years.

Q And are you aware of who pays for those management bonuses in Florida?

A Typically, they are split. I listened to a little bit of Mr. Shultz's earlier testimony. The typical -- what I see around the country is financial-related incentive comp is -- financial-related meaning it benefits the shareholders, which does have a derivative benefit to customers.

But shareholders tend to pay half or some higher percentage of financial-related, but other bonuses are related to the operation of the company; safety, no accidents, keeping you are employees safe. Reliability and efficiency is typically measured through the SAIDI and SAIFI indexes and storm hardening. A lot of commissions look at after a storm, what -- what happens, making sure those work. And those kind of operational bonuses are paid typically 100 percent by customers. And they have been doing it for years. And it's worked.

Q All right. In addition to being asked questions about benchmarking analyses, you were asked about lower nonfuel O&M and lower bills and things of

that nature. Can you explain why not only low natural gas prices contribute, but what are the other things that contribute to, I guess, the lower rates?

A Sure. Typically, FPL, like any utility, will make investments in modernization. And we heard, again, the classic example in this case is, I think it was human resources, the witness -- she was explaining how they can the labor force in half. You have to make an investment to do that. You buy more computers, some -- maybe the computer answers the phone or whatever -- whatever is happening. May be impersonal, but it's more efficient.

And -- but to make that investment, FPL has to sit back and say, if that's going to cost me a million dollars, how much is it going to save me. Hopefully more than a million because you want to show that your investment is worthwhile.

And so those are the types of investments we see. And they will lower costs, nonfuel O&M and other costs. So that's the best example.

Q All right. And FPL has provided testimony that -- excuse me. Let me rephrase that question.

And if the efficiencies that resulted from those major investments that this company has made, if those efficiencies or lower cost did not materialize, what would be the recommendation to this commission about, say, higher O&M and things of that nature?

A I didn't hear the last part of your question. What would be my recommendation with regard to what?

Q If the efficiencies from all these investments did not materialize, lower rates, things of that nature, but, in turn, caused hire rates, explain what would be the process, if any, as it relates to FPL's management.

MR. DONALDSON: I'm going to object. I think it's a little bit outside the scope of cross.

CHAIRMAN BROWN: Mr. Sayler, can you tie it back to cross?

MR. SAYLER: Certainly.

BY MR. SAYLER:

Q I believe there were some questions about -- by Florida Power & Light, that said not only was it low natural gas prices, but there were other things, the modernizations that would be benefits. And I am just trying to explore -- trying to figure out a way to phrase the question.

If those benefits did not arrive --

CHAIRMAN BROWN: Why don't you restate the question.

MR. SAYLER: Sure. Certainly.

BY MR. SAYLER:

Q If those benefits from these investments did not materialize, would -- would customers be asking this commission to provide refunds to customers or lower the ROE?

A The answer is generally no. That's not the way this regulatory system works. Absent an imprudent action, I mean, which is rare, the -- the -- if the investment didn't work out, customers bear it. And that's what happens. So -- and I think I point that out in my testimony.

And so if it doesn't work out, customers bear it. If it works out, customers get the benefit. It's symmetric in that sense.

Q All right. And I believe this is my last question. At the very beginning of your cross-examination, FIPUG had asked you some questions about the relative value of the 50-basis-point, as you testified, surplus inflater. And I believe you gave two different numbers for that dollar amount.

So what is the value of 50-basis-point added return for FPL? How much is that worth? Sorry.

A Okay. I might have gave two different numbers because it was asked in two different contexts, $120 million per year based on the first year.

Q And that's for 50 basis points?

A 50 basis points. 240 million for 100 basis points.

MR. SAYLER: Thank you. That's it for my redirect.

Thank you, Madam Chair.

CHAIRMAN BROWN: Thank you. We do have a commissioner who has a question for you.

Commissioner Edgar.

COMMISSIONER EDGAR: Thank you, Madam Chair.

Good evening.

THE WITNESS: Hi, Commissioner.

COMMISSIONER EDGAR: A couple of your responses to redirect triggered some thoughts that I would like to hear your thoughts on.

You talked about that, in your opinion, in your experience, that shareholders should not receive a bonus under the regulatory scheme.

THE WITNESS: Yes.

COMMISSIONER EDGAR: So would you consider the terms "reward" an "bonus" to be synonymous?

THE WITNESS: I didn't --

COMMISSIONER EDGAR: Reward and bonus, would you consider those two terms to be synonymous?

THE WITNESS: I guess they could be, yeah.

COMMISSIONER EDGAR: And the reason I'm asking is I think sometimes during the course of this hearing they have been used interchangeably in some prior -- prior testimony.

THE WITNESS: What might help is if you -- if you look at -- look at it this way. If you look at Mr. Dewhurst's testimony -- I think I quoted him in my testimony, and he said there's two reasons we want the 50 basis points.

The first reason is recognition of what -- the job we have done historically. That's the first one. And so that would be the reward.

And then he says the second reasons we want this is to incent us to keep doing this good job for the future. And that would be the bonus, the karat and then the reward.

So you could -- I guess, maybe even people in this hearing are looking at that testimony or considering it that way. And they are answering one way or the other. And that's -- they have become synonymous. They could be two different things; one is the reward is what we have done for the past 10 years, and then the bonus is the -- the incentive for the future.

COMMISSIONER EDGAR: And as I said with Mr.

Dewhurst in a similar discussion, it may be a distinction not worthy of a difference or it may be a difference worthy of distinction. That's one of the things I am still -- still thinking through.

When I hear the term "bonus" used regarding performance, I generally think of it as a reward for past performance, past accomplishments, meeting a goal, that type of thing. And when I think of the term "incentive," to me, that seems to imply more future rather than past.

THE WITNESS: Well, Commissioner, I tried to solve that when I wrote this testimony. I just called it the inflater.

COMMISSIONER EDGAR: I noticed that. I did notice that. But I am using the term "incentive,"

So do you things have a role in performance regulation?

THE WITNESS: Absolutely. And -- and they've worked over the years. And I was talking about, you know, management pay scales and -- and how we -- how regulatory authorities authorize and encourage that management and employees get performance bonuses. And -- and we have that.

But then you have to sit back and say, why the shareholders. What have they done?

COMMISSIONER EDGAR: So -- so you do think that incentives have a role in effective and efficient regulation within the regulatory compact.

THE WITNESS: I do, because we are -- we're duplicating the competitive market. We all say that. The competitive market has incentives. We reward those that do. And -- and -- and the regulatory authorities have, for years, parroted the competitive market, those incentives, and used them to their advantage. And it's become very efficient.

And I think FPL could be a good example. We -- they have had incentives. And we heard -- every witness in this case that I heard -- and I've got to tell you, I didn't watch at all on TV. I was busy, but -- but every witness in this case that I heard, when they talked about -- and that was that woman witness, I wish I could think of her name, she followed Barrett, the third witness, I think. And -- and she said, our team does a good job.

And there was a number of other witnesses that kept referring to their team and -- and that's great. The team did a good job; not the shareholders.

COMMISSIONER EDGAR: I think it was probably Ms. Santos that you are referring to, if I remember correctly.

THE WITNESS: It may be, and I am terrible with names.

COMMISSIONER EDGAR: That's okay.

THE WITNESS: I'm sorry.

COMMISSIONER EDGAR: That's all right. Thank you so much.

CHAIRMAN BROWN: Mr. Sayler, any redirect to Commissioner Edgar's question?

MR. SAYLER: No, ma'am.

CHAIRMAN BROWN: Okay.

Exhibits. This witness has 193 to 197.

MR. SAYLER: Public Counsel would move that as well as --

CHAIRMAN BROWN: Just one second.

MR. SAYLER: Okay. Certainly.

CHAIRMAN BROWN: Any objections to 193 through 197?

MR. DONALDSON: No objection?

CHAIRMAN BROWN: We'll move 193 to 197.

(Whereupon, Exhibit No. 193 to 197 were received into evidence.)

CHAIRMAN BROWN: Now, you have 716 as well, which is the errata.

MR. SAYLER: Yes, ma'am. That is the exhibit related to the effect of when Mr. Pous is pulled out of his schedule. That's just the effect on it. And that's why we move that one into evidence.

CHAIRMAN BROWN: Okay. So you are requesting to mover that in.

MR. SAYLER: Yes.

CHAIRMAN BROWN: Any objections?

MR. DONALDSON: And -- and no objection understanding that, like Mr. Sayler said, this deals strictly with Mr. Pous' withdrawal.

CHAIRMAN BROWN: Okay.

MR. MOYLE: We --

MR. SAYLER: Yes.

MR. MOYLE: We would -- we would object to this to the extent that it relates to Mr. Pous' withdrawal for the same reasons that we have articulated. We're just getting it. We don't really know kind of what it means. Haven't had a chance to talk to experts about it or anything.

And so on the same basis that we previously objected with respect to coming in under -- under the Mr. Pous' depreciation issue, we would object.

CHAIRMAN BROWN: Mr. -- Mr. Sayler, would you

like to address FIPUG's objection?
     MR. MOYLE: Madam -- Madam Chair, I think there is another couple of exhibits that are in this group. And I think also, the redline, too -- I think all of those may fall into the same bailiwick. So whether you want to rule on it now or do them all at the same time is obviously your prerogative.
     CHAIRMAN BROWN: I'm just talking about 716 right now. 716 only.
     MR. MOYLE: I'm sorry. I may have the wrong one --
     CHAIRMAN BROWN: You do.
     MR. MOYLE: I'm --
     CHAIRMAN BROWN: You are talking about 715.
     MR. MOYLE: I marked it 716, the errata to the direct?
     CHAIRMAN BROWN: That's the Shultz, right? That was you are original objection?
     MS. BROWNLESS: 16 is Mr. Lawton, 716.
     CHAIRMAN BROWN: Yes, I know that.
     MR. MOYLE: Right. I -- I think I marked 716 as Lawton. That's what I was trying to --
     CHAIRMAN BROWN: Yeah, Lawton is 716.
     MR. MOYLE: Okay. And in the back he has some

stuff on -- it looks like Pous' stuff at the very bottom where he has all of these changes on line numbers that are changing numbers. So I think that's the Pous stuff, if I understood representation of counsel to OPC.

CHAIRMAN BROWN: Yeah.

MR. MOYLE: We'd like to -- isn't that right?

MR. SAYLER: Yes, Madam Chair. And, Mr. Moyle, when Pous' -- when we made -- when the decision was not to go forward with Pous, that had cascading effects on all the various -- of our witnesses' testimony that relied upon Pous.

And Mr. Lawton relied upon a schedule from Mr. Smith. And when that schedule changed, it necessitated a change in his DJL-5 as it relates to the financial-integrity metrics of Florida Power & Light. So it's a fall-out.

And this is -- if -- if we had never retained Mr. Pous for this proceeding, this is what his schedule would have looked like.

CHAIRMAN BROWN: Okay.

MR. MOYLE: Right, but they -- but -- I guess -- so, the representation, Mr. Sayler, is that everything in the errata sheet relates to Mr. Pous in the depreciation issue?

MR. SAYLER: Sorry. Repeat that question?

CHAIRMAN BROWN: Everything relates to Mr. Pous and the depreciation schedule.

MR. SAYLER: Yes. And just a clarification, it's not something that was relied upon. It's just it was informed by his things. And yes, this is just related to the pull-out of Mr. Pous.

MR. MOYLE: Okay. So for the same reasons previously articulated about the depreciation, I haven't had a chance to review it. You know, one witness' change relying on another's. It's this cascading affect we haven't had a chance to understand it, review it, due process. So we would object.

CHAIRMAN BROWN: Okay. Your objection is noted.

FPL.

MS. WILLIAMS: I feel I need to comment a little bit on this.

CHAIRMAN BROWN: Please.

MR. BUTLER: I am curious whether Mr. Moyle is objecting to the withdrawal of Mr. Pous' testimony. We considered doing so. Ultimately decided that, as OPC has said that they have a right to not present a witness, that they choose to take that route.

And I will say it's been extraordinarily expensive and burdensome for FPL to have gone through this whole proceeding, four or 500 discovery requests related to Mr. Pous' testimony from OPC. We have spent like $70,000 preparing to respond to Mr. Pous. And now we aren't. But we are not objecting to having the Pous testimony withdrawn.

If you start from that premise, I am really struggling to understand what Mr. Moyle's objection could be. You know, we're trying in good faith to do a streamlined job of pulling out the stuff that had referred to Mr. Pous' testimony. We have made those materials available, certainly answered Mr. Moyle's questions.

But you know, this seems like a situation with some potential for no good deed going unpunished that, you know, we are going to end up in a situation where we are caught up in a dispute over the admissibility of our testimony when all we have done to it is just try to strip out the part that relates to the testimony of a witness that's been withdrawn.

CHAIRMAN BROWN: All right.

MR. BUTLER: Thank you.

CHAIRMAN BROWN: I am going to go to our legal adviser.

Dear Mary Anne, I missed you.

MS. HELTON: Madam Chairman, I was actually trying to get some other work done this afternoon. So I apologize for not being here for part of the -- part of the hearing. So I did not hear everything that was going on while I was upstairs working.

But I have to say -- and I think I said this earlier this afternoon -- I also am a little bit confused. I thought -- and I was, you know, going back to Friday afternoon. I perhaps was not completely here.

But I thought I heard Mr. Moyle say on Friday afternoon that he joined OPC in their motion for a directed verdict. I thought I heard Mr. Moyle say earlier this afternoon that he had filed a motion or a joinder with that motion.

So I am not sure that I understand how he can be aligned with OPC and OPC's withdrawal of Mr. Pous' testimony and then take issue with the fact that we are trying to make the record as clean as possible to withdraw any reference to Mr. Pous so that we can have a clean record going forward so that you can have an adequate record to make a decision.

CHAIRMAN BROWN: I missed you.

MR. MOYLE: Madam Chair, I may not have done a clear and good job of explaining FIPUG's position on this issue. So if I could try to restate it or make it clear --

CHAIRMAN BROWN: Okay.

MR. MOYLE: We -- we do support the OPC motion for the directed verdict. And that motion essentially was, FPL's case is over. There is this issue. They didn't put the evidence in. Oh, and by the way, we are withdrawing Mr. Pous'. Okay. Well, that's it. And the chips fall where they may and the record is whatever the record is. So we support -- we support that.

What we don't support is a waterfall affect where now, all of a sudden, all of these witnesses are saying, well, now that the testimony is withdrawn, we've got to change all our stuff. And we are getting all of this new information coming in, you know, without a chance to look at it, understand it, review it.

I mean, this stuff is all dated, like,

yesterday and so -- they say, oh, well we are just changing numbers. If you give me an opportunity to change just one number in this case, I will take it.

And obviously I could say what's the rate increase and change one number. You know, so the idea about only changing numbers -- changing numbers can have a pretty big significance in a rate case.

So, you know, what, we are objecting to really is the -- not the withdrawal of the witness. We support the motion for the directed verdict. What we are objecting to is having a whole bunch of new information put into the record kind of live as we go.

I mean, we are just seeing it. People are saying, yeah, they worked all weekend. They changed it. FPL has this big huge -- well, whatever that redline is and other stuff.

So that's the basis for our object -- objection about new evidence coming in; not in accordance with the prehearing order, you know, not in accordance with how things are done typically here.

So we are trying to -- trying to do the best we can. Sometimes at trials things happen and you've got to react and adjust. And that's what we are doing trying to do the best we can.

CHAIRMAN BROWN: Okay. Thank you for the clarification.

Ms. Helton can you please respond to some of those comments and concerns?

MS. HELTON: I guess I take a different tact than Mr. Moyle does. I do not see this as new evidence. I see this as a removal of evidence that it sounds like Mr. Moyle was rely- -- relying upon at his own risk.

OPC, I believe, based on the research that I did this weekend -- I could not find any case law to support prohibiting go OPC from being able to withdraw its witness. I believe that OPC, based on what I could find -- now, I am not saying that I was exhaustive, but based on what I could find this weekend, I could find no reason why OPC could not withdraw its witness.

CHAIRMAN BROWN: Okay.

MS. HELTON: So as I understand it, we are not inserting new evidence. We are removing evidence so that OPC can, in fact, effectuate it's -- it's determination that it would no longer bring

Mr. Pous to the stand.

CHAIRMAN BROWN: Excellent. Thank you.

And Mr. Rehwinkle wants to address the Commission.

MR. REHWINKEL: Well, Madam Chairman, I find myself in agreement with Ms. Helton and Mr. Butler.

CHAIRMAN BROWN: Is that a first?

MR. REHWINKEL: We -- again, I regret the timing of all this, but the Public Counsel made the decision. And -- and we have been involved, as I know the company has, in carrying out the results of that.

And it's my representation to this tribunal that we have extracted Mr. Pous' and, putting aside the Slattery-related objections, we have honestly and as cleanly as possible removed the impacts of Mr. Pous' testimony from the three witnesses that incorporate his testimony.

And I have to say, in -- that what I have seen from FPL is a very good-faith effort to take out the rebuttal that no longer rebuts anything since we have pulled Mr. Pous' out.

And I have seen -- in my 31 years of practicing before this agency, I have seen testimony being stricken in the hearing and any responsive testimony to it being removed kind of -- I wouldn't say on the fly, but within the course of the proceeding in the hearing.

So I don't think it's unheard of or unprecedented. And I think it's being done correctly under the circumstances that we find ourself.

CHAIRMAN BROWN: Thank you.

FEA.

UNIDENDIFIED SPEAKER: Madam, just -- I realize I am not part of the three parties that are talking at the moment, but it sounds to me very similar to what we talked about earlier with Allis.

Folks would like some time to review these decisions before it's admitted or not admitted to determine whether they actually have an objection or whether there is an objection to be made.

This is all information coming at us. And if we had a little bit of time to take in these numbers and just look at them to determine whether there is an objection to make or not might be appreciated on all of these, whether it's Allis, Mr. Lawton, or any other witness.

CHAIRMAN BROWN: Mr. Jernigan, I think you just made the best suggestion of every one. And that's what we will do. We will hold off on admitting 716 into the record.

And right now, we are going to adjourn for a recess -- pardon me -- recess for dinner until 7:45. And we will be back here at 7:45.

Witness would you like to be excused.

THE WITNESS: Oh, thank you.

CHAIRMAN BROWN: The witness will just hang out here for --

Mr. Lawton, you are excused.

THE WITNESS: Thank you.

(Witness excused.)

MR. REHWINKEL: Thank you.

CHAIRMAN BROWN: Be back here at 745.

MR. BUTLER: Madam Chair, I'm sorry. Would indulge us with some notion of how, you know -- what our plan is for the rest of the evening just so we can let our witnesses know?

CHAIRMAN BROWN: Yes. And I thought I did that earlier. Our intention is to take up Smith, and then the FEA witnesses. And then we will adjourn for the evening.

MR. BUTLER: Thank you.

CHAIRMAN BROWN: Okay.

MR. REHWINKEL: And Mr. Smith is here.

CHAIRMAN BROWN: Okay. Mr. Smith is here? Sorry. We are taking a dinner break now.

MS. CSANK: Madam Chair, Sierra Club doesn't have any questions for any of the witnesses that are left for today. May I please be excused --

CHAIRMAN BROWN: Absolutely.

MS. CSANK: I'll come back tomorrow morning.

CHAIRMAN BROWN: Okay.

MS. CSANK: Thank you.

CHAIRMAN BROWN: See you tomorrow. We will start at 9:30 tomorrow.

MS. CSANK: Okay.

CHAIRMAN BROWN: All right.

(Brief recess.)

(Transcript continues in sequence in Volume 27.)

CERTIFICATE OF REPORTER

STATE OF FLORIDA)
COUNTY OF LEON)

I, DEBRA KRICK, Court Reporter, do hereby certify that the foregoing proceeding was heard at the time and place herein stated.

IT IS FURTHER CERTIFIED that I stenographically reported the said proceedings; that the same has been transcribed under my direct supervision; and that this transcript constitutes a true transcription of my notes of said proceedings.

I FURTHER CERTIFY that I am not a relative, employee, attorney or counsel of any of the parties, nor am I a relative or employee of any of the parties' attorney or counsel connected with the action, nor am I financially interested in the action.

DATED this 30th day of August, 2016.

Debbie R Krick

DEBRA R. KRICK
NOTARY PUBLIC
COMMISSION #GG015952
EXPIRES JULY 27, 2020