ORIGINAL

RECEIVED-FPSC
02 MAR -4 PM 3:04
COMMISSION CLERK

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Review of the Retail Rates of Florida Power & Light Company	)))	DOCKET NO. 001148-EI Filed: March 4, 2002

NOTICE OF FILING
DIRECT TESTIMONY OF H.G. WELLS

Lee County, Florida, by and through its undersigned counsel, hereby gives notice that on this 4th day of March, 2002, it filed Direct Testimony of H.G. Wells in the above-styled docket.

Respectfully submitted this 4th day of March 2002.

Robert Scheffel Wright

Robert Scheffel Wright
Florida Bar No. 966721
Diane K. Kiesling
Florida Bar No. 233285
John T. LaVia, III
Florida Bar No. 853666
LANDERS & PARSONS, P.A.
310 West College Avenue (ZIP 32301)
Post Office Box 271
Tallahassee, Florida 32302
Telephone (850) 681-0311
Telecopier (850) 224-5595

Attorneys for Lee County, Florida

AUS
CAF
CMP
COM 5 + rg
CTR
ECR
GCL 1
OPC
MMS
SEC 1
OTH

RECEIVED & FILED
FPSC-BUREAU OF RECORDS

11474

DOCUMENT NUMBER-DATE
02484 MAR-4 02
FPSC-COMMISSION CLERK

CERTIFICATE OF SERVICE
DOCKETS 001148

I HERBY CERTIFY that a true and correct copy of the foregoing has been furnished by Hand-delivery(*), and U.S. Mail to the following parties on this 4th day of March, 2002.

Robert V. Elias, Esquire* Division of Legal Services FPSC 2540 Shumard Oak Boulevard Tallahassee, Florida 32399-0850	David L. Cruthirds, Esquire Attorney for Dynegy, Inc. 1000 Louisana Street, Suite 5800 Houston, TX 77002-5050
John T. Butler, P.A. Steel Hector & Davis, LLP 200 South Biscayne Boulevard Suite 4000 Miami, Florida 33131-2398	Bill Walker* Florida Power & Light Company 215 South Monroe Street, Suite 810 Tallahassee, FL 32301-1859
Thomas A. Cloud W. Christopher Browder Gray, Harris & Robinson, P.A. Post Office Box 3068 Orlando, Florida 32802-3068	Joseph A. McGlothlin, Esq.* Vicki Gordon Kaufman, Esq. McWhirter Reeves 117 S. Gadsden Street Tallahassee, Florida 32301
John W. McWhirter, Jr., Esq. Attorney for FIPUG McWhirter Reeves 400 North Tampa Street, Suite 2450 Tampa, Florida 33601-3350	Jack Shreve * John Roger Howe Office of Public Counsel c/o The Florida Legislature 111 West Madison Street, Room 812 Tallahassee, FL 32399-1400
Ms. Angela Llewellyn Tampa Electric Company Post Office Box 111 Tampa, Florida 33601	Lee L. Willis* James D. Beasley Ausley & McMullen Law Firm 227 South Calhoun Street Tallahassee, Florida 32301

Harry W. Long, Jr. Tampa Electric Company Post Office Box 111 Tampa, Florida 33601	James A. McGee Post Office Box 14042 St. Petersburg, FL 33733-4042
Paul Lewis, Jr.* Florida Power Corporation 106 East College Avenue, Suite 800 Tallahassee, FL 32301-7740	Dawson Glover, III Town of Sewall's Point One South Sewall's Point Road Sewall's Point, FL 34996
Linda Quick South Florida Hospital and Healthcare 6363 Taft Street Hollywood, FL 33024	Michael B. Twomey, Esquire Post Office Box 5256 Tallahassee, FL 32314-5256
Mark Sundback, Esquire Kenneth Wiseman, Esquire Andrews & Kurth Law Firm 1701 Pennsylvania Ave., N.W. Suite 300 Washington, DC 20006	Jon C. Moyle, Esquire* Cathy M. Sellers, Esquire 118 North Gadsden Street Tallahassee, FL 32301
Michael Briggs Reliant Energy Power Generation, Inc. 801 Pennsylvania Ave. Suite 620 Washington, DC20004	Frederick M. Bryant* FMPA 2061-2 Delta Way Tallahassee, FL 32303
Leslie J. Paugh, Esq.* Landers & Parsons 310 West College Avenue Tallahassee, Florida 32301	Marchris Robinson Manager, State Government Affairs Enron Corporation 1400 Smith Street Houston, Texas 77002-7361

Melissa Lavinson PG&E National Energy Group Company 7500 Old Georgetown Road Bethesda, MD 20814	Seminole Electric Cooperative, Inc. Timothy Woodbury 16313 North Dale Mabry Highway Tampa, FL 33688-2000
Kenneth Hoffman Rutledge Law Firm Post Office Box 551 Tallahassee, Florida 32302-0551	CPV Atlantic, Ltd 145 NW Central Park Plaza, Suite 101 Port Saint Lucie, FL 34986
Myron Rollins Black & Veatch Post Office Box 8405 Kansas City, MO 64114	Jennifer May-Brust, Esq. Colonial Pipeline Company 945 East Paces Ferry Road Atlanta, GA 30326
G. Garfield R. Knickerbocker/S. Myers Day, Berry Law Firm CityPlace 1 Hartford, CT 06103-3499	Michelle Hershel* Florida Electric Cooperatives Association, Inc. 2916 Apalachee Parkway Tallahassee, FL 32301
Richard Zambo, Esq. Florida Industrial Cogeneration Assoc. 598 SW Hidden River Ave. Palm City, FL 34990	Sofia Solernou 401 South MacArthur Avenue Panama City, FL 32401
Thomas J. Maida* N. Wes Strickland Foley & Lardner Law Firm 106 E. College Avenue, Suite 900 Tallahassee, FL 32301	Bruce May, Esquire* Holland Law Firm Bank of America 315 South Calhoun Street Tallahassee, FL 32302-0810
Homer O. Bryant 3740 Ocean Beach Boulevard Unit 704 Cocoa Beach, FL 32931	Robert C. Williams, P.E. FMPA 8553 Commodity Circle Orlando, FL 32819-9002
Publix Super Markets, Inc. 936 George Jenkins Blvd. Lakeland, FL 33815	Steven H. McElhaney 2448 Tommy's Turn Oviedo, FL 32766

Duke Energy North America Lee E. Barrett 5400 Westheimer Court Houston, TX 77056-5310	Calpine Eastern Thomas W. Kaslow The Pilot House, 2nd Floor Boston, MA 02110
Mr. Paul J. Chymiy NUI Energy, Inc. 550 Route 202-206 Bedminister, NJ 07921-0760	Mirant Americas Development, Inc. Beth Bradley 1155 Perimeter Center West Atlanta, GA 30338-5416
FP&L R. Wade Litchfield 700 Universe Boulevard Juno Beach, FL 33408-0420	Mr. David Owen Assistant County Attorney Lee County, Florida Post Office Box 398 Ft. Myers, FL 33902

Robert Scheffel Wright

ATTORNEY

BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION

In Re: Review of the Retail Rates of Florida Power & Light Company,
PSC Docket No. 001148-EI

DIRECT TESTIMONY OF H.G. WELLS

ON BEHALF OF

LEE COUNTY, FLORIDA

March 4, 2002

DIRECT TESTIMONY OF H.G. WELLS

PSC Docket No. 001148-EI, Florida Power & Light Company Rate Case

Introduction

Q. Please state your name, address and occupation.

A. My name is H. G. (Pat) Wells. My address is 38 Beech Street, Homosassa, Florida 34446-4332. I am an independent energy consultant.

Q. On whose behalf are you testifying?

A. I am testifying on behalf of Lee County, Florida, a retail customer of Florida Power & Light Company (FPL), a substantial user of electric energy, who is vitally interested in the outcome of this proceeding. Just as FPL is required to provide service to its retail customers, Lee County is required to provide service to the people of Lee County. While the County is aggressive in innovative energy conservation and modern facility designs which reduce electric energy usage and demand, the County continues to pursue every possibility for improvements in the efficiency and cost-effectiveness of its purchases and services.

Q. Please tell the Public Service Commission about your background and experience.

A. I graduated from Louisiana Tech with a B. S. in Electrical Engineering in 1950 and continued graduate studies at the University of Texas until joining the Navy during the Korean conflict. I served four years at the naval shipyard in San Francisco during this time. For the next eight years I obtained diverse engineering and management experience in manufacturing and design. In 1963, I was employed by Florida Power Corporation ("FPC") and served in a variety of engineering and planning positions until 1975, when I became Assistant Vice President for Corporate Planning. In this position I was responsible for Electric Rates & Research, System Planning, Corporate Modeling, Computer Services, and Scheduling & Coordination. In 1976, FPC formed a subsidiary company, Electric Fuels Corporation ("Electric Fuels"), of which I was elected President. In 1982, Florida Progress Corporation was formed, and both FPC and Electric Fuels became subsidiaries of the new company. I continued as President and CEO of Electric Fuels until my retirement in 1986. Throughout my service at both Florida Power and Electric Fuels I testified on many occasions before the Florida Public Service Commission (the "PSC" or the "Commission") on a wide range of subjects, including construction budgets, planning, rates, fuels, and transportation. In the mid 1970's I served as chairman of the Florida Operating Committee, the predecessor of the Florida Electric Coordinating Group.

Since my retirement, I have been involved as an independent energy consultant and expert witness on electric rate matters for governmental units and firms in the energy, coal, and transportation fields. From this experience I have become familiar with a broad range of subjects in utility operations, planning, finance, engineering and, management. Almost all of my experience has been responsible, practical and, hands-on. For instance, I was responsible for corporate planning during FPC's budget crisis during the oil embargo in 1973, when several hundred million dollars in construction had to be curtailed or stopped. Later, I was at the center of the decision to convert to coal at FPC's Crystal River facility, and to construct two additional coal units there. These decisions are still assisting FPC to maintain low cost in relation to the other major Florida utilities. During these many years I served on a number of industry committees and frequently appeared before security analysts and other financial groups and conferences. I have testified before this Commission and other utility regulatory commissions on a variety of electric utility issues. I have continued to assist clients in the energy field on a variety of subjects. My total experience in the energy field is now almost forty years.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to address certain specific issues in this case. My testimony is not intended to be comprehensive but rather to focus on particular areas within the subjects I will address. The specific issues which I address include: (1) the allocation of cost responsibility among rate classes, including appropriate principles or "transition rules" to be followed in implementing any rate changes ordered by the Commission in this case; (2) the appropriate return on equity for FPL; (3) some comments on the impact of FPL

Group on FPL; and (4) recommendations concerning FPL's request for a 30 basis point reward for good management performance.

Q. Please summarize your testimony.

A. In this case, the Commission should continue to follow the transition rules that it has historically followed with respect to allocating any revenue increase or decrease among FPL's rate classes. The Commission should authorize FPL to set its rates based on an authorized rate of return on equity between 10.00 and 10.25 percent, with a common equity ratio of no more than 60 percent imputed for ratemaking purposes. The Commission should pay careful attention to FPL's parent, FPL Group, and to FPL's affiliates in evaluating FPL's risk and management performance. The Commission should deny FPL's proposal for a 30 basis point reward for management performance.

<u>Cost Allocation and Transition Rules for Implementing Rate Changes</u>

Q. What practices, policies, or "transition rules" has the PSC followed in allocating rate changes among the various classes of retail customers?

A. Historically, while recognizing the desirability of moving the cost responsibility of a utility's various rate classes toward "parity," i.e., an equalized rate of return for all classes, the PSC has applied and followed three key principles or "transition rules" in implementing rate changes:

1. If there is a system rate increase, no class gets a decrease;

2. If there is a system rate decrease, no class gets a rate increase; and

3. No class gets an increase or decrease greater than 1.5 times the system average increase or decrease.

For example, in FPL's 1981 and 1983 rate cases, the Commission recognized the desirability of moving toward parity but limited the revenue responsibility increases to any class to 1.5 times the system average increase. In FPL's 1984 rate case, the Commission applied the same constraint and allocated the classes farthest from parity the maximum allowed increase of 1.5 times the system average increase. In the 1984 rate case for Florida Power Corporation, the Commission allocated a system rate increase so as to move FPC's rate classes toward parity, with no class receiving an increase of more than 1.5 times the system average increase, and with no class receiving a decrease in its allocated share of cost responsibility. The Commission applied similar principles in Gulf Power Company's 1990 rate case. In FPC's 1991-92 rate case and Tampa Electric Company's ("TECO") 1992-93 rate case, the Commission adopted comprehensive stipulations of the parties on the cost of service issues.

Q. What, if any, justification has the Commission provided for following these policies?

A. In its order in TECO's 1992-93 rate case, the Commission recognized the following as the appropriate criteria to allocate revenue responsibility among rate classes: (1) cost to serve; (2) rate history; (3) public acceptance of the rate structure; (4) customer understanding and ease of application; (5) consumption and load characteristics of the rate classes; and (6) revenue stability and continuity. In FPL's 1981 case, the Commission recognized the general desirability of moving classes toward parity but simultaneously recognized that "the impact on customers' bills must be considered in allocating revenues." Accordingly, the Commission determined to allocate the rate increase so as to move FPL's rate classes "within plus or minus 20% of the system rate of return" and "also set the following constraint: No customer class shall receive a revenue increase greater than 1.5 times the system average increase as a result of this proceeding."

Q **In your opinion, are these policies or "transition rules" appropriate?**

A. Yes. The transition rules promote rate stability and continuity, promote revenue stability and continuity, allow for gradual changes over time, and avoid abrupt changes which could be brought on by either new policies of the Commission or unusual economic situations. These principles are consistent with the goal of "public acceptance" of rates and rate structure. They prevent any class from benefitting from the unfair treatment of another class. Significantly, these principles result in generally fair and equitable treatment of the various rate classes -- they ensure that any changes are made in the right direction, but at the same time they ensure that different classes do not have their rates adjusted in opposite directions, which many would regard as unfair and which would certainly challenge the public acceptability of the utility's rates.

Q. Do you have any examples of what you mean by new policies of the Commission?

A. Yes. For instance, among other things, the Commission could change its position on the appropriate cost of service methodology, which could result in significant or even dramatic shifts in revenue responsibility between and among classes.

Q. Are there other factors which could cause instability?

A. Yes. Changes in such factors as load characteristics (peak demands, energy usage, load factor, etc.) between rate classes over time could give rise to "jumping around" from rate class to class. An anomalous test year might result in changes in cost allocation factors or inter-class relationship and give a similar result. Unusual or sudden changes in fuel price is another. The experience of the oil embargo of the 70's and sudden price jumps which resulted may be less likely today, but are still possible. The recent crisis arising from the terrorist acts of last year are a reminder that neither our political nor our economic security is ever certain.

Q. Even though FPL has had no rate structure adjustment in approximately 17 years, is it still appropriate to follow these transition rules?

A. Yes. These are sound, fair, equitable, and reasonable ratemaking principles, and the Commission should follow them in this case.

Rate of Return on Equity

Q. Do you have any comments on FPL's requested rate of return on equity?

A. Yes, I do. As a practical business person, I will leave the academic approach to the cost of capital issue to others. My experience in finance is more hands on and depends to some extent on the old saying "follow the cash." I do not criticize the academic approach, but trust that other viewpoints will be helpful to this Commission in determining the most appropriate rate of return on equity for FPL. I have examined numerous reports of FPL and its affiliates, particularly those filed with the Securities and Exchange Commission (SEC) which appeared pertinent to the financial condition of FPL and its parent company. The approach to this subject has considerable complexity introduced by the particular business combinations comprising FPL's parent company, FPL Group, and the various other subsidiaries of FPL Group. These include FPL Capital and FPL Energy. The latter two companies do not file extensive reports to the SEC, so some of their results must be derived from the information as filed by FPL and FPL Group.

Q. Do you have general comments rising from your review?

A. Yes. The financial reports of FPL and its affiliates, including FPL Group, show a very large company with very substantial assets. The assets of FPL have been considerably depreciated due to the assets' average age. The company produces a strong steady cash flow sufficient to fully fund its operations and ongoing debt service and partially fund its construction obligations. Through the third quarter of 2001, FPL generated $1,742 million in cash. <u>During the same period</u>, FPL issued no new long-term debt, paid off $560 million in commercial paper, used $850 million for new capital assets and paid $478 million in dividends to FPL Group. There was an offset of $400 million back from FPL Group as a capital contribution. FPL's rate of net cash generated per unit of sales is considerably higher than other Florida electric public utilities. FPL has a very conservative balance sheet for a utility, with a substantially higher ratio of common stock equity than most utilities.

Q. What effect has this performance had on FPL's financial results?

A. FPL's recent rates of return on equity have been above the allowed 11% midpoint level and above the upper limit of the range (plus or minus 1.0 percent, or 100 basis points) authorized by the PSC. Actual returns for 2000, 1999, and 1998 were 12.2%, 12.1% and 12.6% respectively. A refund arrangement was agreed upon by FPL and the Public Counsel, and approved by the PSC, to refund a portion of these earnings above the allowed rate. This agreement allows for a 66 2/3% refund up to a certain threshold and 100% above the threshold. The earnings effect of the annual revenue reduction was offset by lower special depreciation up to $100 million, at FPL's discretion, in each year of the three year agreement period. In the year 2000, approximately $23 million was refunded. This does not appear to have materially impacted the financial performance of FPL.

Q. What other factors should be considered in setting the range for FPL's authorized rate of return on equity?

A. Another factor that the Commission should consider is FPL's capital structure. Of the major Florida electric utilities, FPL has the highest ratio of common equity to total capital. This relatively high common equity ratio tends to increase the safety of FPL's common stock from an investor's viewpoint. The ratio for the three largest electric utilities in Florida are FPL– 64%, Florida Power Corporation– 52%, and Tampa Electric Company– 58%. FPL's ratio has been increasing over the last several years. Last year, FPL issued no new debt while retiring old debt. While this reduces the financial risk of the company, it can also increase the cost to FPL's customers since the cost of equity capital is significantly greater than the cost of debt -- thus, the higher the equity ratio, the higher the overall cost of capital.

Q. Do you have any recommendations regarding these ratios?

A. Yes. First, I do not believe the PSC should take any action to restrict FPL's ability to change the relationships, e.g., FPL's common equity ratio, inherent in its capital structure, or to mandate any particular capital structure for FPL to achieve in "the real world." On the other hand, however, since the impact on FPL's customers arising from the higher equity ratio would be significant, it is my opinion and recommendation that the PSC should either (a) adjust the allowed rate of return on equity to compensate for common equity ratios above approximately 60% or (b) further adjust the rate of return on equity if the PSC were to allow FPL to continue to have a 64% common equity ratio for ratemaking purposes.

Q. Do you have a recommendation for FPL's rate of return on equity?

A. Yes. Based on the existing equity ratio of FPL, I believe that the midpoint of FPL's authorized rate of return on equity should be set between 10.00% and 10.25%, assuming that the Commission adjusts or imputes a common equity ratio of 60% to FPL for ratemaking purposes in this case. If the Commission does not adjust the common equity ratio for ratemaking purposes, then I believe that the Commission should set FPL's authorized rate of return midpoint at approximately 9.75%. In my opinion, either arrangement will still allow FPL to achieve adequate financial results to continue to attract the necessary capital to finance future construction and operations required to meet its customers' needs.

Parent and Affiliate Relationships

Q. Are their other factors which the PSC should consider in this case?

A. Yes. The financial reports of FPL Group show a different picture from that of FPL. Other FPL Group affiliates and subsidiaries include FPL Capital and FPL Energy. These units are engaged in an ambitious construction program at a number of sites around the U. S. which anticipates a doubling of FPL Energy's generating capacity, which already amounts to some 4,400 MW. By 2003, they anticipate reaching the 10,000 MW level. While these subsidiaries have made substantial commitments with regard to this program, much more financing will be required.

Q. Will this program impact FPL's customers?

A. I can only answer that it may. While it appears that much of the dividends up-streamed from FPL to FPL Group has supported these operations, after payment of FPL Group's stock dividend, the demands of the construction program of FPL Group's other units must be supported more and more internally to FPL Group. These operations are currently producing profits and a positive cash flow. However, their financial strength does not compare to that of the regulated utility, FPL.

Q. Do any of the FPL Group operations give rise to concerns regarding potential impacts on FPL, its cost of capital, and its retail customers?

A. Examining the FPL Group operations is not as straightforward as is the case for FPL, since the public filings are much more restricted. However, some information is available through FPL Group filings with the SEC and other public information. The principal other activity of FPL Group involves FPL Capital and FPL Energy. These units' principal business is the development, construction and operation of electric generating facilities throughout the U.S. FPL Energy operates about 4,400 megawatts of generation in a non-regulated environment. Current plans call for expansion to about 10,000 megawatts. This is an ambitious program with considerably more risk than that of FPL. For instance, some of FPL Energy's contracts were with California utilities which have not paid for all of the power supplied by FPL Energy. In fact, one of those utilities has been operating under the protection of the bankruptcy statutes. While FPL Energy is vigorously pursuing resolution of these problems, the outcome cannot be assured. Public filings of FPL Group indicate profitability above that of FPL alone, but returns during this period of expansion fall far short of those of FPL.

Q. What, if any, implications do these concerns have for the Commission's decisions in this case?

A. As the owner of FPL, FPL Group is actually a part of FPL management. To the extent management is an issue in this case, these concerns should be considered by the PSC.

Q. Are there other considerations which may impact FPL?

A. The potential exists for many more problems beyond the ones I just mentioned. Investors do not like uncertainty. The financial health of FPL Group and FPL are tightly linked. In order to build another 5,000 MW or so of capacity, FPL Group, FPL Capital, and FPL Energy will be going to investors to raise that capital, through both equity and debt. The steady flow of cash from FPL to FPL Group will be required to support this activity. Last year's failed merger of FPL Group and Entergy Corporation is well known to investors. In 2000, this failure resulted in a $67 million charge to FPL Group of which $62 million landed in FPL 's lap. This is a good example of activity at the FPL Group level impacting FPL. While FPL customers may not directly pay for the $62 million through rates (I trust the Commission will see to that), it is not an example of superior, or even good, managerial performance for which the utility should be awarded 30 basis points. And, it is an example of how FPL Group's activities can unfavorably affect FPL.

Q. Do you see other concerns?

A. Yes. I have also identified several "real life" concerns. First, two of FPL Energy's customers are California utility companies which were caught in that state's rate "freeze". When fuel prices rose substantially (as they had everywhere in the early 1970's) these utilities fell into a sudden loss situation, with the cost of generating and delivering energy higher than the rates charged. They were unable to pay the energy bill to FPL Energy. While FPL Energy is vigorously pursuing this, the outcome is uncertain. One of these California utilities is operating under the Chapter 11 Bankruptcy Statute. The bottom line is, FPL Group's operation are less secure than those of FPL. While the likelihood of a problem at a sister company spilling over to FPL may be low, I believe it is a possibility. And as owner of FPL, FPL Group is part of FPL's management, and FPL Group's actions should be considered when appropriate.

Proposed Reward for Management Performance

Q. Do you have any recommendations with regard to FPL's proposal that its authorized rate of return on equity be increased as a "reward" for its management performance?

A. Yes. FPL has asked the Commission to approve a 30 basis point reward for performance in this case. While my concerns about FPL Group's activities may or may not apply directly to the management of FPL, the public utility company, it is clear that the two (FPL Group and FPL) are tightly linked. I do not see anything in the management of either FPL or FPL Group that would justify such a "freebie" to the companies' management or their shareholders. Additionally, approval of this 30 point reward will almost certainly result in the increased return flowing immediately to the higher risk projects I have discussed, and I do not believe that this is consistent with the best interests of FPL's retail customers in Florida.

Q. Do you have any recommendations about the reward?

Yes. The Commission should deny FPL's request for the reward.

Q. Does this conclude your direct testimony?

A. Yes, it does.