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July 16, 2002

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-VIA HAND DELIVERY-

Ms. Blanca S. Bayó
Division of the Commission Clerk
and Administrative Services
Florida Public Service Commission
2540 Shumard Oak Blvd.
Tallahassee, FL 32399-0850

Re: Docket Nos. 020262-EI and 020263-EI

Dear Ms. Bayó:

On March 22, 2002, Florida Power & Light Company ("FPL") filed a Petition for Determination of Need for an Electrical Power Plant - Martin Unit 8 and a Petition for Determination of Need for an Electrical Power Plant - Manatee Unit 3. FPL's two petitions were assigned Docket Nos. 020262-EI and 020263-EI, respectively.

On April 22, 2002, FPL moved to hold both proceedings in abeyance to allow FPL to undertake a Supplemental Request for Proposals (Supplemental RFP). On April 29, 2002, FPL filed an emergency motion for waiver of Rule 25-22.080(2), F.A.C., to allow deferral of the hearing schedule if, as a result of the Supplemental RFP, Martin Unit 8 and Manatee Unit 3 were determined to be the most cost-effective alternatives to meet FPL's 2005 and 2006 need. By Order No. PSC-02-0571-PCO-EI, Commissioner Deason, acting as prehearing officer, substantially granted FPL's emergency motion to hold both proceedings in abeyance, and by Order No. PSC-02-0703-PCO-EI, the Commission granted FPL's emergency waiver of Rule 25-22.080(2).

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FPL has completed its Supplemental RFP. FPL's analysis shows that Martin Unit 8 and Manatee Unit 3 are the most cost-effective options to meet FPL's 2005 and 2006 need for capacity. Consequently, FPL is now prepared, consistent with Order Nos. PSC-02-0571-PCO-EI

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and PSC-02-0703-PCO-EI, for the Commission to proceed with its evaluation of the need for those two units in Docket Nos. 020262-EI and 020263-EI. The documents enclosed herewith, as described below, provide the information required for that evaluation.

Enclosed for filing on behalf of FPL in Docket Nos. 020262-EI and 020263-EI are the original and fifteen copies of:

- (1) FPL's Motion for Leave to Amend Petitions for Determination of Need
- (2) FPL's Amended Petition for Determination of Need for an Electrical Power Plant-Martin Unit 8
- (3) FPL's Amended Petition for Determination of Need for an Electrical Power Plant-Manatee Unit 3

Because the same analysis supported FPL's assessment of its 2005 and 2006 capacity needs and its determination that Martin Unit 8 and Manatee Unit 3 were the most cost-effective alternatives to meet the needs, FPL previously filed a motion to consolidate both dockets. Consistent with its motion to consolidate, FPL filed along with its original Need Determination petitions a single Need Study for Electrical Power Plant and a single set of Need Study Appendices, as well as a common set of testimony for both dockets. FPL continues to seek consolidation of these dockets for hearing.

In support of its amended Petitions for Determination of Need for Martin Unit 8 and Manatee Unit 3, FPL is filing the original and 15 copies of the following documents:

- (1) Need Study For Electrical Power Plant, 2005-2006
- (2) Need Study Appendices A - D
- (3) Need Study Appendices E - J
- (4) Need Study Appendices K - O
- (5) Direct Testimony of Dr. William E. Avera
- (6) Direct Testimony of C. Dennis Brandt
- (7) Direct Testimony of Moray P. Dewhurst
- (8) Direct Testimony of Leonardo E. Green
- (9) Direct Testimony of Rene Silva
- (10) Direct Testimony of Dr. Steven R. Sim

- (11) Direct Testimony of Donald R. Stillwagon
- (12) Direct Testimony of Alan S. Taylor
- (13) Direct Testimony of William L. Yeager
- (14) Direct Testimony of Gerard Yupp

These documents reflect the results of FPL's Supplemental RFP and supercede the Need Study and Appendices and its Direct Testimony filed on March 22, 2002, in support of its initial Petitions for Determination of Need. Therefore, FPL hereby withdraws the March 22 Need Study and Appendices and the March 22 Direct Testimony.

Copies of the enclosed documents, are being provided to counsel for all parties of record. Under separate cover letter, FPL is filing its confidential appendices to the Need Study and a Request for Confidential Classification for the confidential appendices.

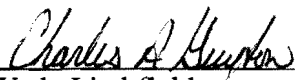
With the interruption of these proceedings for the Supplemental RFP, it is important that FPL's need determination proceedings be heard expeditiously. Prior to the Commission's granting of FPL's Emergency Motion To Hold The Proceedings In Abeyance, the parties had agreed to a schedule that would result in a hearing on October 2-4, 2002, a Commission decision on November 19, 2002, and a final order no later than December 4, 2002. FPL needs to preserve this schedule in order to meet its scheduled in-service date of June 2005 for both Martin Unit 8 and Manatee Unit 3. To facilitate this schedule, FPL has: (a) included more detailed data in the enclosed Need Study and Appendices than is required by Commission rule; (b) filed its direct testimony along with its amended petitions; (c) worked out with the intervenors free access to the primary analytical tools used in conducting the economic analysis of the Supplemental RFP; (d) agreed to a Confidentiality Agreement and process to allow intervenor access to most confidential data; and (e) agreed to expedited discovery. FPL will continue to work with the Commission and the parties to facilitate the Commission's prompt consideration of these proceedings.

Any delay in these proceedings would place at risk the in-service dates of Martin Unit 8 and Manatee Unit 3. In the event of delay, FPL would not achieve its 20 percent reserve margin criteria (or even a 15 percent reserve margin) in the summer of 2005. Without purchases of capacity to replace these facilities, an option which may not be available for the full capacity of these units, the reliability of FPL's system could be significantly adversely impacted to the detriment of FPL's customers. In the event of a delay, if FPL were to attempt to purchase capacity and energy to replace these units, FPL likely would pay higher costs than the costs it would incur if these units had met their in-service dates. Thus, delay also would adversely impact the costs paid by FPL's customers.

Because a delay would cause adverse impacts upon FPL's customers, FPL respectfully requests that these proceedings be processed according to the previously agreed schedule and that an Order on Procedure be issued. Such an order should place reasonable limits on discovery, encourage intervenors to coordinate discovery as they have previously agreed to do,

expedite discovery as previously agreed and set forth the agreed-to schedule, thereby facilitating the administration of these proceedings.

Respectfully submitted,



R. Wade Litchfield
Charles A. Guyton

Attorneys for Florida Power
& Light Company

CAG/gc
Enclosures

cc: Counsel for Parties of Record

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**BEFORE THE FLORIDA
PUBLIC SERVICE COMMISSION**

**DOCKET NOS. 020262-EI, 020263-EI
FLORIDA POWER & LIGHT COMPANY**

JULY 16, 2002

**IN RE: PETITION FOR DETERMINATION OF NEED FOR
PROPOSED ELECTRICAL POWER PLANT
IN MARTIN COUNTY
OF FLORIDA POWER & LIGHT COMPANY**

**IN RE: PETITION FOR DETERMINATION OF NEED FOR
PROPOSED ELECTRICAL POWER PLANT
IN MANATEE COUNTY
OF FLORIDA POWER & LIGHT COMPANY**

DIRECT TESTIMONY OF:

MORAY P. DEWHURST

DOCUMENT NUMBER DATE

07393 JUL 16 8

FPSC-COMMISSION CLERK

1 **BEFORE THE FLORIDA PUBLIC SERVICE COMMISSION**

2 **FLORIDA POWER & LIGHT COMPANY**

3 **DIRECT TESTIMONY OF MORAY P. DEWHURST**

4 **DOCKET NOS. 020262-EI, 020263-EI**

5 **JULY 16, 2002**

6

7 **Q. Please state your name and business address.**

8 A. Moray P. Dewhurst, 700 Universe Boulevard, Juno Beach, Florida 33408.

9

10 **Q. What is your employment capacity?**

11 A. I serve as Senior Vice President of Finance and Chief Financial Officer of
12 Florida Power & Light Company (FPL or the Company).

13

14 **Q. Please describe your educational and professional background and
15 experience.**

16 A. I have a bachelor's degree in Naval Architecture from MIT and a master's
17 degree in Management, with a concentration in finance, from MIT's Sloan
18 School of Management. I have approximately twenty years of experience
19 consulting to Fortune 500 and equivalent companies in many different
20 industries on matters of corporate and business strategy. Much of my work
21 has involved financial strategy and financial re-structuring. I was appointed to
22 my present position in July of 2001.

23

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FPSC-COMMISSION CLERK

1 **Q. What is the purpose of your testimony?**

2 A. My testimony will address two main subjects relevant to FPL's Supplemental
3 Request for Proposals (Supplemental RFP). The first subject deals with the
4 evaluation of the financial viability and business commitment of bidders
5 responding to FPL's Supplemental RFP, including the importance of ensuring
6 the supplier will have the financial strength to complete construction of the
7 proposed plant in a timely manner, as well as the strength, skills and
8 commitment to maintain and operate the facility over the term of the
9 agreement in accordance with the supplier's original promises. I will review
10 the minimum financial requirements established in the Supplemental RFP and
11 how those requirements factored into in the determination of the short list of
12 bidders.

13
14 My testimony will also support and supplement the testimony of Dr. Avera on
15 the propriety of assigning an equity penalty to the costs of non-FPL bids
16 submitted in response to FPL's Supplemental RFP when comparing those bids
17 to FPL's self-build option, the methodology employed in computing the
18 amount of debt equivalent added to the Company's balance sheet, and the
19 assumptions underlying the amounts computed.

20

21 **Q. Are you sponsoring any sections in the Need Study Document?**

22 A. Yes. I am sponsoring Appendix I, Summary of Financial and Economic
23 Assumptions, and co-sponsoring Appendix N.

1 **Financial Viability as a Non-Price Factor**

2

3 **Q. Please explain why the Company should consider as non-price factors the**
4 **financial viability of a potential supplier as well as other issues relating to**
5 **the supplier’s ability to meet its commitments.**

6 A. The Company must look both to price and non-price factors when choosing
7 the best solution to meet resource needs for providing power to customers.
8 Price, or cost, is obviously important – other things equal, the lower cost
9 alternative is preferred – and can be quantitatively evaluated. However, other
10 things may not always be equal, and an alternative that appears promising
11 solely on the basis of economic calculations may be much less so when
12 considered more broadly.

13

14 Bidders’ responses to the Supplemental RFP represent promises of future
15 commitments, which may or may not be met, depending upon the specific
16 circumstances of the particular bidder. Thus, it is necessary that FPL make
17 assessments as to the reliability of each bidder’s promises and of its likely
18 abilities to meet the commitments. Factors such as a bidder’s long-term
19 financial viability, its operating track record, its stated or implied commitment
20 to the business of operating generation projects, and its history of successfully
21 delivering against commitments in prior projects are all important when
22 making a long-term commitment to purchase power. A supplier that cannot
23 complete construction of a plant according to the schedule agreed to, either

1 because of operational failure or because of financial impairment, jeopardizes
2 FPL's ability to provide power sufficient to meet our customers' needs.

3

4 Similarly, a supplier must be able to maintain a strong financial profile over
5 the life of the project. A supplier that fails to operate and maintain a project
6 due to financial or other constraints will place FPL at risk of having to
7 purchase replacement power on short notice and at the risk of higher prices or
8 otherwise compromising system reliability. In addition, FPL may face
9 increased risk of contract disputes with a financially weakened supplier. The
10 cost of these various risks is ultimately borne in large part by our customers,
11 who will directly bear the costs of replacement power if the supplier does not
12 have the financial wherewithal to correct operational problems or to pay the
13 replacement power costs in the form of damages. Accordingly, when
14 evaluating bids, FPL must weigh a variety of non-price factors along with the
15 promised economics of each alternative.

16

17 **Q. How did FPL go about assessing financial viability?**

18 A. FPL used a number of indicators of overall current financial health as a guide
19 to assessing financial condition. Primary emphasis was placed on standard
20 indicators of creditworthiness, including coverage ratios and leverage ratios.
21 As an overall guide, credit assessments from the major credit rating agencies,
22 Standard & Poor's Corporation (S&P) and Moody's Investors Service
23 (Moody's), were used. While rating agency assessments have limitations and

1 cannot be used as an absolute or sole indicator of financial viability for all
2 purposes, I believe that for the purpose of providing a general indicator of a
3 bidder's likely ability to meet its commitments under the Supplemental RFP
4 they are a useful starting point.

5

6 **Q. How were rating agency ratings used in the evaluation process?**

7 A. Rating agency ratings were used to set a minimum threshold of credit quality.
8 Ratings are by no means perfect indicators of financial strength or viability,
9 and it would be inappropriate to draw too fine a distinction between, for
10 example a company with a BBB+ rating and one with an A- rating. However,
11 there is substantial evidence that default probabilities are correlated overall
12 with ratings and, in particular, that default probabilities increase significantly
13 as companies drop below the standard definitions of "investment grade." For
14 the purposes of the Supplemental RFP, FPL set a minimum threshold of
15 "BBB" with a "stable" outlook, and we examined the specific circumstances
16 of bidders whose ratings might be in doubt, to provide reasonable assurance
17 that the rating agencies evaluations were appropriate for the bidders' actual
18 financial circumstances.

19

20 **Q. How does FPL know that a supplier who is credit worthy today will be so
21 6 months from now, or 10 years from now?**

22 A. Financial viability and credit quality are influenced by many factors, including
23 market conditions, strategic decisions of management, and general economic

1 conditions. Thus there can be no guarantee that a company that is
2 creditworthy today necessarily will be so in the future. However, while it is
3 impossible to perfectly predict long-term viability, it is feasible to assess a
4 bidder's current financial position and likely near-term (2 to 3 year) future
5 financial position, as indicated both by publicly stated intentions and by rating
6 agency assessments, to make informed judgements as to a supplier's ability to
7 maintain a strong financial position. For FPL's purposes, the 2 to 3 year
8 assessment is very important, because it coincides with the construction
9 period for the assets that will be needed to fill the underlying capacity need.
10 Because we applied a minimum credit threshold in our evaluation, it is not
11 necessary to be absolutely precise about the relative levels of creditworthiness
12 among bidders; rather, the intent was merely to ensure that entities that do not
13 meet the minimum definition of creditworthiness were screened out. In
14 addition to a minimum credit threshold, additional forms of security
15 independent of credit ratings, such as completion and performance
16 requirements, can also be employed to protect our customers from the cost of
17 supplier non-performance.

18
19 **Q. Describe the current state of the independent power producer (IPP)**
20 **industry as it relates to capital markets.**

21 A. On average, the trend in credit quality for the IPP segment of the U.S. utility
22 industry has been negative for the past year. However, there have been
23 significant variations across companies. In general, companies that have

1 overextended and over-leveraged themselves, and/or those that have taken on
2 excessive merchant generation or trading exposure in relation to their overall
3 size, have seen their credit positions suffer most significantly. Companies that
4 have taken significant exposure in many foreign markets – in particular those
5 in Latin America – have also been negatively affected. On the other hand,
6 companies whose investment programs have been well tailored to their
7 available cash flow and balance sheet strength have been much less affected,
8 as have those that have pre-emptively supported their growth plans through
9 the issue of new equity or equity-linked securities. As a result, today there is
10 a wide range of credit and balance sheet strength in the segment: some
11 companies are eminently well positioned to meet the kinds of obligations
12 required by FPL’s Supplemental RFP, while others are not. Given this wide
13 range in financial conditions, it is especially important for FPL to carefully
14 screen bidders for financial viability.

15
16 **Q. Given the concerns you have noted above, what minimum financial**
17 **standards or requirements did FPL include in the Supplemental RFP and**
18 **the power purchase agreement?**

19 A. The Supplemental RFP and the power purchase agreement contemplate the
20 bidder maintaining a minimum credit standard and posting a completion
21 security. Additionally, the power purchase agreement requires the bidder to
22 provide performance security as described generally below. These minimum
23 standards are necessary to help ensure that the facilities which will provide

1 contracted power will be constructed, completed on schedule, and operated
2 and maintained in a manner consistent with the terms of the contract. It should
3 be noted that the completion and performance securities employed here by no
4 means entirely eliminate risk to FPL or to its customers; rather, they represent
5 an effort on the part of the Company to reduce such risk by means and within
6 limits generally consistent with current commercial practice.

7
8 **Financial security.** The power purchase agreement requires each bidder to
9 maintain, at a minimum, a BBB grade rating with a “stable” outlook or
10 provide a guarantee from another party with such credit standing. S&P’s
11 definition of an investment grade issuer is an “...obligor who has adequate
12 capacity to meet its financial commitments.” A requirement that bidders
13 maintain, at a minimum, a BBB grade rating helps ensure that the bidder will
14 be able to obtain financing for the project and that cash flows will be available
15 for ongoing maintenance of the project. As indicated earlier, default
16 probabilities escalate sharply across lower rated entities, particularly those of
17 marginal investment grade or below.

18
19 **Completion security.** To help ensure timely completion of the project, the
20 Supplemental RFP and the power purchase agreement requires that the bidder
21 provide completion security in an amount equal to no less than \$50,000 per
22 MW of committed capacity. This security provides a ready source of funds to
23 pay for replacement power if the project were to be delayed or to fail to

1 achieve its in-service date and provides an incentive to the bidder to complete
2 the project on schedule.

3
4 **Performance Security.** The purchase power agreement also requires that
5 each bidder provide performance security in an amount to be negotiated.
6 Should an event of default occur and not be cured, performance security helps
7 provide funds necessary for FPL to purchase replacement power or to operate
8 the plant.

9
10 **Q. Did these standards and requirements result in the disqualification of any**
11 **bidders from further consideration?**

12 A. Yes, the application of these standards and minimum requirements resulted in
13 FPL declaring one bidder ineligible for further evaluation beyond the initial
14 review of its proposals. As Mr. Silva describes in more detail in his
15 testimony, upon receipt of the responses to the Supplemental RFP, FPL
16 observed that some of the bidders had failed to adequately confirm their intent
17 and willingness to provide the requisite completion security consistent with
18 the terms of the Supplemental RFP. In response to a follow-up request for
19 clarification from FPL, one of these bidders again failed to confirm its intent
20 to provide the necessary completion security. That bidder was dropped from
21 further consideration. Thus, the fact that one bidder was unwilling even to
22 agree to these conditions confirms that there can be substantial differences
23 among bidders on non-price factors.

1 **Q. Were any other bidders declared ineligible for further consideration at**
2 **this stage of the evaluation based on questions regarding their financial**
3 **viability?**

4 A. As Mr. Silva indicates in his testimony, two other bidders were determined to
5 be ineligible to be included in the evaluation beyond an initial review of their
6 proposals. One of those bidders already had given FPL advance notice of its
7 inability to meet the in-service date under an existing agreement to supply
8 capacity and energy to FPL. This entity's acknowledgment of its likely
9 failure to meet an existing commitment to FPL is, I believe, due in large
10 measure to its current financially weakened state (recently downgraded to
11 "BB-" by S&P), which significantly limits its ability to finance, construct, and
12 operate the project consistent with its contractual obligations. This is
13 precisely the kind of adverse impact that FPL seeks to avoid by attempting to
14 hold bid respondents to certain minimum standards regarding financial
15 viability and security. Clearly, it would not be advantageous for FPL to
16 negotiate further with a company that has already signaled its inability to meet
17 its existing commitments, much less enter into new ones.

18
19 **Q. Where else in the evaluation process did FPL consider the financial**
20 **viability of the bidder?**

21 A. As Mr. Silva describes in his testimony, once FPL completed its economic
22 evaluations and determined which combinations of resource options were
23 among the more cost-effective portfolios, based strictly on price, the Company

1 had to assess which, if any, of the bidders should be included on a “short list”
2 of suppliers with whom FPL would enter into negotiations. The purpose of
3 the negotiations was to determine if the “short-listed” bidders in fact could
4 provide the most cost-effective alternative, as well as to assure financial
5 viability of the project. In considering candidates for the short list among the
6 more price-competitive options based on the economic analysis, FPL
7 considered the financial viability of the individual suppliers.
8

9 **Q. Did FPL eliminate any bidder from consideration for negotiations, i.e.,**
10 **not making the “short list,” based on financial viability of the bidder?**

11 A. Yes. FPL eliminated one additional entity from consideration for the short list
12 based at least in part on questions concerning that bidder’s financial viability.
13 Mr. Silva identifies this bidder as “Bidder X” in his testimony.
14

15 **Q. Please explain FPL’s reasons for electing not to include Bidder X on the**
16 **short list.**

17 A. Bidder X was eliminated from the short list because of concerns regarding its
18 financial viability. In particular, Bidder X did not maintain the requisite credit
19 rating as defined in the Supplemental RFP. Neither did it indicate that it
20 would supply a guarantee from an entity with at least a BBB rating as
21 contemplated by the Supplemental RFP. To compensate for its below
22 investment grade status, Bidder X offered an alternate security arrangement.
23 This alternate form of security provided no additional protection against the

1 risk of Bidder X not achieving its commercial service date. Moreover, the
2 purchased power agreement FPL was prepared to offer investment grade short
3 list bidders had the same security arrangement that Bidder X offered. In short,
4 Bidder X essentially offered no financial security other than that which FPL
5 would require of another investment grade bidder, yet Bidder X was below
6 investment grade.

7
8
9 FPL has good reason to be concerned about the financial viability of Bidder
10 X. Bidder X announced earlier this year that many advanced stage
11 development projects had been placed on hold pending further review. Bidder
12 X has also canceled delivery of approximately \$3 billion of turbines originally
13 slated for delivery between 2002 and 2005. Even with these actions, which
14 should serve to strengthen credit quality, Bidder X was recently downgraded
15 by both rating agencies and is currently rated "BB" by S&P and "B1" by
16 Moody's. S&P's definition of a "BB" rated issuer is one who "... faces
17 major ongoing uncertainties and exposure to adverse business, financial, or
18 economic conditions which could lead to the obligor's inadequate capacity to
19 meet its financial commitments." The rating agencies have noted concerns
20 over Bidder X's high leverage, limited financial flexibility, substantial
21 ongoing capital expenditure requirements to complete its build-out program,
22 and Bidder X's liquidity profile. At March 31, 2002, Bidder X's total debt to
23 total capitalization was 75%, or 78.5% including off-balance sheet debt. S&P

1 expressed concern “that nearly \$3.5 billion of debt matures in late 2003-early
2 2004 [which] places considerable pressure on [Bidder X’s] credit risk profile
3 given growing concerns about [Bidder X’s] access to equity and debt
4 markets.” Bidder X recently secured over \$2 billion of debt, which according
5 to S&P, will likely prevent Bidder X from obtaining unsecured debt financing
6 in the future.

7
8 Furthermore, Bidder X’s stock price has suffered immensely. The stock price
9 has fallen for five consecutive quarters, for a total loss of approximately 87%.
10 FPL does not believe it is in the best interests of its customers to accept the
11 level of financial risk associated with a company in Bidder X’s financial
12 position.

13
14 **Q. Should the Commission infer from FPL’s decision to enter into**
15 **negotiations with El Paso that the Company had no concerns with respect**
16 **to this supplier?**

17 A. No. While the credit ratings of El Paso Corporation (“El Paso”) (S&P) Issuer,
18 BBB+/ Unsecured, BBB) (Moody’s Unsecured Baa2) met the investment
19 grade criteria set forth in the Supplemental RFP, I was concerned over El
20 Paso’s ability to maintain these ratings levels throughout the construction and
21 subsequent contract period. According to S&P’s analysis of El Paso, its
22 current ratings depend on the Company executing a challenging financing
23 plan. Specifically, El Paso’s maintenance of an investment grade rating

1 depends upon successful and more or less simultaneous execution of a number
2 of initiatives, even without consideration of a possible commitment to projects
3 of the magnitude bid by El Paso in response to the supplemental RFP.
4

5 In addition to questions I had concerning El Paso's financial plan, I had
6 questions that stemmed from El Paso's announcement on May 29, 2002 of a
7 strategic repositioning plan that would downsize and restructure the merchant
8 energy segment of the business. The announcement stated further that El Paso
9 intends to concentrate future investment in its core natural gas business.
10

11 These issues would have been appropriately addressed in specific negotiations
12 with the bidder. However, as Mr. Silva describes, circumstances did not
13 warrant discussions beyond the initial meeting because the project economics
14 were not sufficient to merit selection over the two FPL self build options.
15

16 **Equity Penalty**
17

18 **Q. What is an "equity penalty" as employed by the Company in its analysis**
19 **of responses to the Supplemental RFP?**

20 **A.** An equity penalty is an adjustment made in the calculation of the total cost of
21 supply options containing purchased power obligations to reflect the fact that
22 such obligations draw upon the debt capacity of the Company and, other
23 things being equal, must be offset by increasing the ratio of equity in the

1 Company's financing mix. Mechanically, an equity penalty is the net present
2 value of the incremental cost of equity required to rebalance the Company's
3 capital structure (the incremental cost of equity is measured relative to the cost
4 of debt).

5
6 **Q. Why is it appropriate for the Company to include an equity penalty as a**
7 **cost for the non-FPL proposals in the comparison of those bids to the**
8 **FPL self-build options?**

9 A. The equity penalty is a real cost to a utility and its customers of entering into a
10 purchase power agreement. In assessing a utility's credit quality, the bond
11 rating agencies explicitly evaluate the utility's purchase power obligations.
12 Based on that examination, the rating agencies attribute to the utility's balance
13 sheet as debt-equivalent a portion of the net present value of the obligations
14 under each power purchase agreement. The effect is to increase the relative
15 share of debt and debt-like instruments in the capital structure. Accordingly,
16 the utility would need to increase equity in its capital structure to attain the
17 same level of financial security and flexibility with a purchased power
18 obligation as without. The net present value of the incremental cost of
19 increased equity to rebalance the capital structure must be added to the net
20 present value of the cost of purchased power options evaluated to determine
21 the total cost to FPL. FPL's analysis of the bids took this incremental cost of
22 capital into account. This comparison for each option enables FPL to fairly
23 evaluate competing proposals against one another and against FPL self-build

1 options. Were this not done, the economic comparison of self-build and
2 external supply options would be biased in favor of the latter, leading to
3 higher total revenue requirements to be borne by customers over the long run.
4

5 **Q. Please describe the basic methodology employed to determine the amount**
6 **of imputed debt.**

7 A. While all of the rating agencies take off-balance sheet obligations into account
8 when evaluating credit quality, S&P uses an approach that has both
9 quantitative and qualitative aspects to value the debt component of off-balance
10 sheet obligations. It involves first computing the net present value of the
11 remaining capacity payments under the contract. A qualitative analysis of
12 market, operating, and regulatory risk is then performed for each contract to
13 derive a risk factor.

14
15 Once the risk factor is determined, it is then multiplied by the net present
16 value of the remaining capacity payments to determine the amount of off-
17 balance sheet obligation to include as debt in the capital structure of the
18 company for purposes of analyzing credit quality.

19
20 **Q. Do you believe an adjustment of this type is appropriate?**

21 A. Yes. In evaluating the capital structure of any company, investors will take
22 into account major financial commitments, whether these are reflected on the
23 balance sheet or not. In general, I agree that an adjustment for off-balance

1 sheet obligations should be made in assessing the financial condition of a
2 company. While our own calculation of the appropriate amount of purchase
3 power obligation to include as a debt equivalent might be different, I believe
4 S&P's methodology produces an overall assessment that is reasonable and
5 fairly represents the general investor viewpoint.
6

7 **Q. How did the Company calculate the incremental cost of equity or “equity**
8 **penalty” for each bid in this case?**

9 A. We estimated the amount of imputed debt based on the S&P methodology
10 described above. Once the imputed debt is calculated, equity would be
11 required to rebalance the Company's capital structure (currently
12 approximately 55% equity on an adjusted basis) in order to maintain
13 comparable financial flexibility and credit quality. The equity penalty
14 represents the net present value of the incremental cost of the equity added to
15 the capital structure.
16

17 The equity penalty is then added to the net present value of the capacity
18 payments under each contract to determine the total cost of each option. Once
19 this is done, a meaningful comparison of the total cost of each option with
20 FPL's self-build option can be made. The equity penalty computations are
21 shown in Appendix N of the Need Study.
22

1 **Q. Please indicate the risk factor that the Company used in its computation**
2 **of the equity penalty attributed to each outside proposal and explain the**
3 **basis for that factor.**

4 A. FPL employed a risk factor of 40 percent. During the RFP process, FPL
5 furnished S&P with the basic terms of the power purchase agreement reflected
6 in the RFP. FPL requested that S&P provide an estimate of the risk factor it
7 would attribute to the contract in determining the amount of off-balance sheet
8 debt to add back to FPL's balance sheet for purposes of evaluating the
9 Company's credit quality. S&P indicated that it likely would assign the
10 contract a risk factor ranging from 40 to 60 percent, i.e., it would add to the
11 Company's balance sheet between 40 and 60 percent of the net present value
12 of the capacity payments as debt-equivalent. To be conservative and to avoid
13 debate over which portion of this range more fairly represents the appropriate
14 risk factor, FPL elected to use the bottom of the range, i.e., 40 percent, for
15 purposes of its analysis.

16
17 **Q. Does this 40 percent risk factor consider the impact of a potential**
18 **supplier's financial viability, as discussed earlier in your testimony?**

19 A. No. The risk factor assigned by S&P represents the rating agency's
20 assessment of the debt characteristics of a particular purchased power
21 agreement. While this entails an examination of a variety of qualitative
22 factors related to the underlying contract and the extent to which the related
23 financial risks are borne by FPL and its customers, S&P's assessment

1 implicitly presumes that the generating facility has been placed in service and
2 is operating under the terms of the purchased power agreement contemplated
3 in the Supplemental RFP. Thus, the risk factor does not directly address the
4 financial viability of individual suppliers or the impact that this has on the
5 ability of a particular bidder to meet its commitments.

6
7 **Q. Has the Commission previously endorsed the use of an equity penalty in**
8 **assessing the true costs of purchased power alternatives?**

9 A. Yes. In Order No. PSC-01-0029-FOF-EI, the Commission found Florida
10 Power Corporation's consideration of imputed debt based on a risk factor of
11 40% to be appropriate for purposes of comparing third party proposals to
12 FPC's self-build option, the Hines Unit 2. The Commission also allowed
13 consideration of imputed debt in approving FPL's Standard Offer Contract in
14 Order No. PSC-99-1713-TRF-EG.

15
16 **Q. Does this conclude your testimony?**

17 A. Yes, at this time.