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M E M O R A N D U M

NOVEMBER 3, 2003

TO: DIVISION OF THE COMMISSION CLERK AND ADMINISTRATIVE SERVICES

FROM: OFFICE OF THE GENERAL COUNSEL (KEATING) WCK

RE: DOCKET NO. 030001-EI - FUEL AND PURCHASED POWER COST RECOVERY CLAUSE WITH GENERATING PERFORMANCE INCENTIVE FACTOR.

Attached is the DIRECT TESTIMONY OF MATTHEW BRINKLEY on behalf of Commission Staff to be filed in the above-referenced docket.

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DOCKET NO. 030001-EI: [Fuel and purchased power cost recovery clause with generating performance incentive factor.]

WITNESS: **Direct Testimony Of Matthew Brinkley,**
Appearing On Behalf Of Staff

DATE FILED: November 3, 2003

DIRECT TESTIMONY OF MATTHEW BRINKLEY
DOCKET NO. 030001-EI
NOVEMBER 3, 2003

Q. Please state your name and business address.

A. My name is Matthew Brinkley. My business address is 2540 Shumard Oak Blvd., Tallahassee, Florida, 32399.

Q. By whom are you employed and in what capacity?

A. I am employed by the Florida Public Service Commission as a Regulatory Analyst IV in the Bureau of Surveillance/Finance, Division of Economic Regulation.

Q. Please provide a brief description of your educational background and your professional experience.

A. I received a Bachelor of Science degree with a major in Accounting and a minor in Finance from Florida State University in 1991. I received a Master of Business Administration from Florida State University in 1992. I received my Certified Public Accountant license in 1992 and practiced public accounting from 1992 to 1994.

Since joining the Florida Public Service Commission in 1994, I have held responsibilities relating to accounting, finance, and economic research and other accounting and ratemaking matters. Within the ratemaking

area, I prepare the rate base, net operating income, capital structure, and other related schedules for electric and gas utilities under a rate review. These schedules are the basis for deriving base rates.

Q. What is the purpose of your testimony?

A. The purpose of my testimony is to recommend to the Commission that base amounts used for calculating incremental security and hedging costs for recovery through the fuel or capacity cost recovery clauses should be adjusted for growth in kilowatt-hours sales. To not convert historic amounts to rates, i.e., adjust historic expenses for growth, results in costs being recovered implicitly in base rates and explicitly in a cost recovery clause. This a form of double recovery.

Q. **Why is such an adjustment appropriate?**

A. It is overly simplistic and wrong to say that base rates were set to recover a particular dollar amount of a given expense, so anything above that is incremental and not recovered in rates. That analysis is equivalent to saying that base rates were set to generate revenues of a given amount and anything above that was not contemplated to be generated. The conclusion reached by that logic is to refund all revenues above the revenues determined in a rate case. If the assertion that rates are not set to cover increasing expenses were true, another conclusion one could reach is that every year or two the utility would be back in for a rate increase. Clearly, rates are expected to generate more revenues which will cover increased costs as the utility grows.

Q. **How would an adjustment be made?**

A. In a rate case, expenses are used to determine total revenue requirements which are ultimately translated into rates based on billing determinants approved in the rate case. Similarly, any expense can be converted to a cents per unit based on the billing determinants in the rate case. Since the utility collects that cents per unit on every unit sold, as the utility sells more energy, it recovers proportionally more for the expense (or less if the company sells less energy.) To determine if base rates recover a cost in a later year, the cost in the later year would be divided by the billing determinants for the later year and if the recovery rate exceeds the cost rate, it would be concluded that no additional cost recovery is necessary. To the extent that the cost rate exceeds the recovery rate, that incremental rate could be applied to the later year billing determinants to calculate the amount for consideration for separate recovery.

Q. **Can you provide an example?**

A. Yes. If $100,000 was allowed for an expense item in the last rate case and rates were set based on 25,000,000 KWH sales, the expense represents a recovery rate of $0.0004/KWH. If the KWH's sold today were 50,000,000 KWH, then the utility would implicitly recover $200,000 by the rate. To compare an actual expense today of $300,000 to the original $100,000 used to set rates instead of $200,000 ignores the impact of growth in revenues.

Q. **Do historic and current expenses have to be converted to cents per KWH to determine what is incremental to base rates?**

A. No. A shortcut method is to multiply the base year expense by the percentage change in energy sold from the base year to the current year. If energy sales increased 100%, the base year expense of $100,000 would be grossed-up to $200,000 which is then the basis of determining what is incremental.

Q. **Is this methodology appropriate when the base year used is a year subsequent to a projected test year in a rate case?**

A. Yes. Regardless of the year chosen as a base year, the base year expense should be adjusted for sales growth from the time of the base year to the year in question. Adjusting for growth is just a short-cut for looking at a base cost as a per unit rate and can be thought of as a fallout.

Q. **Has this methodology ever been proposed before the Commission?**

A. Yes. On page 7 of Korel M. Dubin's testimony in Docket No. 001148-EI, Ms. Dubin proposed "in order to ensure that there is no double recovery, FPL's proposed methodology calls for the GridFlorida costs to be adjusted for Transmission Costs in Base Rates. Each year the amount of transmission costs currently in base rates is to be adjusted for sales as described below. This amount would then be subtracted from the

GridFlorida costs before inclusion in the Capacity Cost Recovery Factor calculation." After walking through an example, she goes on to say, "This results in the transmission cost in base rates escalated to 2003 to reflect the increase in sales in 2003." Further on page 11 of her testimony, she says "FPL believes it is appropriate for the Commission to expressly approve the methodology to recover the GridFlorida transmission costs, to the extent they exceed the amount reflected in base rates, through the Capacity Cost Recovery Clause. Such approval would: 1) avoid double recovery, 2) avoid under/over recovery of costs, 3) would be administratively efficient and would greatly facilitate review of the level and basis for transmission costs in the future, and 4) appear to be the type of costs the Commission acknowledged would be appropriate in establishing the Capacity Cost Recovery Clause." (See Exhibit MGB-1.)

Q. **Does the existence of a rate case settlement have implications with grossing-up?**

A. Yes and no. Adjusting an expense for growth in order to calculate what should be recovered through a cost recovery clause is not a change in base rates and is apart from the stipulations approved in Docket Nos. 001148-EI and 000824-EI. It only a short-cut method of converting historical and current year expenses to *rates* to see if an actual expense rate exceeds the base rate the company charges. The goal is to prevent double recovery which occurs where normal growth in base rate expenses is allowed separate recovery through a clause. In fact, the existence of rate case settlements makes it even more important to do this.

Q. **Why is it more important to gross-up under rate case settlements?**

A. With normal rate of return regulation, if expenses rise faster or slower than revenues, the company's ROE will rise or fall in part, accordingly. If ROE's rise or fall too far, base rates can be reset according to the new levels. If a company were to double recover in a large enough fashion, the ROE would be higher than it would otherwise, and it would at least afford the *possibility* of a change in base rates. Under the settlements approved for FPL and PEFI, the ROE is no longer the basis for determining if a refund or change in rates is required. Under settlements that limit the use of ROE's to trigger rate reviews, it is even more important to prevent double recovery of expenses by adjusting base year expenses for growth in KWH sales.

Q. **What is the impact of revenue caps in rate case settlements as far as grossing up base year expenses?**

A. The existence of a revenue cap with escalation clauses does not necessarily result in a refund. The revenue caps in place for FPL and PEFI are set high enough to account for normal growth. If a cap does result in a refund, it could be argued that it would be necessary to reduce the gross-up amount proportionally across all expenses so a refund wouldn't be made once through base rates and again in a cost recovery clause. The argument for that approach is that since the "allowed" growth of the company's revenues were capped, any base amounts should be adjusted only for the allowed growth, not the pre-refund revenue growth. The problem with that approach is that it takes what would be a straightforward calculation of a growth adjusted expense and backs out the refund which raises cost recovery through a clause by an equivalent amount. In essence, it would force ratepayers to give back their base rate refund through a cost recovery clause. The calculation of what is allowable through a cost recovery clause should be made in isolation of any base rate refunds to prevent clauses from being used to undermine base rate refunds ordered by stipulation.

Exhibit MGB-2 shows a sample calculation of how to determine gross-up amounts in the absence of rate-case stipulations. Adjusting for growth keeps neutral the utility's rate of return. That is, the projected NOI equals the required NOI. Exhibit MGB-3 shows a sample calculation of

allocating a revenue refund to reduce the expense growth adjustments. If done, the utility's NOI is what is was before the revenue refund; i.e., the utility gets back its refund in the cost recovery clause. Although only considering one line item expense out of all expenses would not completely undermine the ordered refund if it is a small enough percentage, in principal the refund ordered by the settlement agreement should not reduced at all.

Q. Briefly, could you summarize your testimony?

A. Yes. If the Commission decides to allow recovery of incremental costs where the incremental cost is based on an historic year, the Commission should gross up (or down) the historic (base) year for the growth (or decline) in energy sales in kilowatt-hours from the base year to the current year. Grossing up a base year amount is merely a mathematical short-cut to converting historic and current year expenses into *rates* and examining what is incremental on that basis.

Q. Does this conclude your testimony?

A. Yes, it does.

FLORIDA POWER & LIGHT COMPANY

TESTIMONY OF KOREL M. DUBIN

DOCKET NO. 001148-EI

AUGUST 15, 2001

Adjustment for Transmission Costs in Base Rates

In order to ensure that there is no double recovery, FPL's proposed methodology calls for the GridFlorida costs to be adjusted for Transmission Costs in Base Rates. Each year the amount of transmission costs currently in base rates is to be adjusted for sales as described below. This amount would then be subtracted from the GridFlorida costs before inclusion in the Capacity Cost Recovery Factor calculation. For illustrative purposes, we have used the preliminary 2000 Cost of Service. (See KMD-1, Page 5 of 6). This shows that the imbedded cost of retail transmission service in 2000 is $265 million. However, this amount will be updated to reflect the results of the 2002 cost of service. This $265 million would be divided by actual 2000 MWh sales of 87,959,341 which results in 0.3013 cents per kWh. This 0.3013 cents per kWh multiplied by the projected 2003 MWh sales of 98,415,270 results in $296.5 million transmission costs included in base rates adjusted for sales. This results in the transmission cost in base rates escalated to 2003 to reflect the increase in sales in 2003. (See KMD-1, Page 2 of 6, Note 1). This $296.5 million (KMD-1, Page 2 of 6, Line 6) is then subtracted from the total payment to GridFlorida of $366 million (KMD-1, Page 2 of 6, Line 5) resulting in a difference of $69.5 million (KMD-1, Page 2 of 6, Line 7).

Adjustment for Oil Backout

One other adjustment FPL proposes is to reflect an Oil Back-out flow back to

A. FPL believes it is appropriate for the Commission to expressly approve the methodology to recover the GridFlorida transmission costs, to the extent they exceed the amount reflected in base rates, through the Capacity Cost Recovery Clause. Such approval would; 1) avoid double recovery, 2) avoid under/over recovery of costs, 3) would be administratively efficient and would greatly facilitate review of the level and basis for transmission costs in the future, and 4) appear to be the type of costs the Commission acknowledged would be appropriate in establishing the Capacity Cost Recovery Clause.

First, FPL's proposed methodology, whereby the GridFlorida transmission costs recovered through the Capacity Cost Recovery Clause are adjusted for the amount included in base rates, avoids double recovery of these costs.

Second, these incremental transmission costs are volatile and as such are more appropriately reflected in a clause to avoid over/under recovery of costs. As described in the Joint Panel Testimony regarding the GridFlorida proposal, the Joint Applicants currently have pending requests for interconnection of 53 plants representing 26,468 MW of non-utility owned generation to come on line between 2001 and 2005. The speed with which future interconnections are made is uncertain and will result in unpredictable fluctuations in GridFlorida's System Charge. There is also fluctuation in costs due to the various transition proposals of the pricing plan. As described in GridFlorida Witness William Ashburn's prepared Direct Testimony, the cost shifting

Example Gross-up Calculation

MGB-2

	Base Year 1984		Current Yr 2001	Actual 2001	Gross-up Without	Gross-up With
RATE BASE (AVERAGE)	$1,000		$1,653			
RATE OF RETURN	X 7.00%	X	7.00%			
REQUIRED NOI	$70		$116			
Operating Revenues	$300		$496			
Adj. for Excess Revenues						
Operating Expenses:						
Operation & Maintenance	$127		$210			
Sample Expense	23		38	34	$34	$34
(On cents per KWH basis:	0.767		0.767	0.686)	($23)	($38)
					$11	($4)
Depreciation	60		99			
Taxes	20		33			
Total Operating Expenses	$230		$380			
PROJECTED NOI	$70		$116			
KWH experienced	3000		4,959			
Base Rate	$0.10		$0.10			

Growth in energy sold 3% per year

Conclusion: Without grossing up, although base recovery of .767 cents/KWH is more than sufficient to recover the sample expense, $11 (or .081 cents/KWH) too much is recovered through a clause. This extra amount is double recovered.

With grossing up in this example, it is recognized that base rates are sufficient to recover growth-related increases in the sample expense.

Example Gross-up Calculation with Refund

MGB-3

		MFR 1984		Proj. Before Cap 2001	Adjustments		Proj. After Cap 2001	Actual 2001
RATE BASE (AVERAGE)		$1,000		$1,653			$1,653	
RATE OF RETURN	X	7.00%	X	7.00%		X	7.00%	
REQUIRED NOI		$70		$116			$116	
Operating Revenues		$300		$496	(1% refund) ($5)		$491	
Adj. for Excess Revenues								
Operating Expenses:								
Operation & Maintenance		$127		$210	($2.74)		$207	
Sample Expense		23		38	(0.50)		37.52	34
On cents per KWH t		0.767		0.767			0.764	
Depreciation		60		99	(1.29)		97.88	
Taxes		20		33	(0.43)		32.63	
Total Operating Expenses		$230		$380	($5)		$375	
PROJECTED NOI		$70		$116	$0		$116	
KWH		3000		4,959	Less: 1%		4,909	
Base Rate		$0.10		$0.10			$0.10	

Growth in energy sold 3% per year

Conclusion: A refund of revenues if allocated across expenses pro rata to adjust the gross-up results in a higher increment (lower base) keeping NOI constant. This shows that reducing the gross-up gives back the refund to the utility which wasn't the intent of the rate case settlements.